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BUSINESS ENVIRONMENT

Text and Cases

Francis Cherunilam

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TEXT AND CASES

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PREFACE TO THE TWENTY-FIFTH EDITION

It is with great joy and gratitude that I present the 25th edition of the pioneering comprehensive Indian book on *Business Environment*. It was indeed adventurous to attempt such a work at a fairly young age, more than three decades ago, when there was no model book to help conceptualise the scope and structure, no internet to source information, word processing by computer was strange, printing technology was crude, courier service was absent and had to encounter a host of other handicaps of those days. The experience, however, was exciting and the response of the academic community has been overwhelming. That this work filled an important academic void is indicated by the fact that it was after its publication that universities and institutes started including *Business Environment* as a subject in the curricula of Management and Commerce courses. This book is an expanded version of my first book *Business and Government* which was very well received by the academia. After the advent of the book *Business Environment*, many universities and institutes replaced the course *Business and Government* with *Business Environment*.

Over the last three decades, the book was thoroughly modified and revised a number of times, zeroing in the changes in the business environment and needs of the academic community. Almost every year, there was either a new edition or reprint.

I recall here that the confidence bestowed on me and the constant encouragement by late Sri D.P. Pandey, the founder of Himalaya Publishing House Pvt. Ltd., were greatly instrumental in bringing me up as an author. I would like to place on record my indebtedness to the entire *Himalaya* family, particularly to Mr. Anuj Pandey and Mr. Niraj Pandey, for the enduring encouragement.

I am very grateful to the academic community for the great encouragement. And no words to thank the Almighty for the profuse blessings!

Cochin, **DR. FRANCIS CHERUNILAM**

21st June 2016.

PREFACE TO FIRST EDITION

The modern business is placed in a very complex and intricate environment. The constraints and opportunities provided by the nature of the economy and the economic system, political and legal framework, social system, geographical and ecological conditions, demographic factors, etc. have profound impact on the business. The type of product to be manufactured and marketed, the marketing strategies to be employed, the way the business should be organised, the technology to be adopted etc. are all influenced by the environmental factors. For formulating appropriate business strategies, one should, therefore, have proper understanding of the business environment.

This book is a humble attempt to sketch the various important aspects of the business-environment interface. A major part of the work is devoted to deal with the socio-economic and political and legal environment of the business in India.

I am very grateful to Prof. N. Somasekhara, Chairman, Department of Industrial Management, Indian Institute of Science, Bangalore, who was kind enough to write a Foreword to this book. I should also like to record my gratitude to all those who helped me, in one way or other, in my endeavour. I must particularly thank Mr. D.P. Pandey and the Himalaya Publishing House Pvt. Ltd. for their constant encouragement.

It may be pointed out here that as the business environment changes quite frequently, any work on this subject can be hardly up-to-date. In fact, when this book was in press, some modifications in Government policy have taken place. Some of these policy modifications are stated in the *Postscript* given at the end of the book.

Constructive criticisms and suggestions will be most welcome.

FRANCIS CHERUNILAM

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Part 1

AN OVERVIEW OF BUSINESS ENVIRONMENT

Business decisions in general and strategies in particular are moulded by the business environment – those external factors like the economic, political/ regulatory, social/demographic, technological and natural factors which make up the opportunities for and threats to business and internal factors like the resources, capabilities and goodwill of the organisation, internal power relationships etc. which decide the strengths and weaknesses of the firm. A thorough understanding of the business environment, therefore, is a prerequisite for making any strategic decision. Indeed, formulation of strategy is some times defined as establishing a proper firm-environment fit.

This *Part* starts with a general introduction to the broad nature of business environment, and environmental analysis and forecasting. It also presents a broad picture of the Economic Environment, Political and Government Environment, Natural and Technological Environment, and Demographic Environment.

Chapter 1

A GLIMPSE OF BUSINESS ENVIRONMENT

Structure

Meaning of Business Environment

Types of Environment

Competitive Structure of Industries

Environmental Analysis and Strategic Management

Summary

References

Annexure 1.1: Transformation of Indian Two-wheeler Market

No business enterprise functions in a vacuum. Business is an integral part of the ecology and social system and, therefore, its decisions and performance are influenced by a host of diverse factors. Important decisions related to business such as what business to do, which should be the customer segments to target at and what strategies be adopted, where to do the business, when to do the business, how to do the business, whether to continue a business, whether to expand a business and if yes where and how to expand it, and so on are influenced by a number of factors which constitute what is generally referred to as the business environment.

Business Environment refers to all those internal and external factors which impact the functioning/performance of a firm and/or its decision-making, particularly strategies. Although the scope of the term business environment includes, in a broad sense, both internal and external factors impacting the business (i.e., internal and external environments) in its common usage it often refers to the external factors.

MEANING OF BUSINESS ENVIRONMENT

Business Environment consists of all those factors that have a bearing on the business, such as the strengths, weaknesses, internal power relationships and orientations of the organisation; government policies and regulations; nature of the economy and economic conditions; socio-cultural factors; demographic trends; natural factors; and, global trends and cross-border developments. *Transformation of the Indian Two-wheeler Market* given at the end of the chapter illustrates the impact of business environment on the business.

BUSINESS ECOLOGY

The business ecology indeed is very similar to the human ecology (or any ecology for that matter). Just as the survival and success of any individual depend on his innate capability – such as the physiological and psychological factors — to cope up with the environment and the extent to which the environment is conducive to the development of the individual, the survival and success of a business firm depend on its innate strength — resources at its command, including physical resources, financial resources, human resources, the inter-linkages and synergy, skill and organisation — and its adaptability to the environment and the extent to which the environment is favourable to the development of the organisation. The survival and success of a firm, thus, depend on two sets of factors, *viz.,* the internal factors (the internal environment) and external factors (the external environment).

The external environment has, broadly, two components, *viz.*, business opportunities and threats to business. Similarly, the organisational environment has two components: strengths and weaknesses of the organisation. Thus, strategy formulation is properly pitting the organisational factors (the internal environment) against the opportunities and threats in the external environment. In other words, business decisions are conditioned by two broad sets of factors, *viz.,* the internal environment and the external environment.

BUSINESS-ENVIRONMENT INTERRELATIONSHIP

Any meaningful organisation has certain mission, objective(s) and goal(s) and a strategy to achieve them. Business environment has a bearing on the shaping of all these integral and interrelated elements. It is, therefore, only very appropriate that formulation of strategy is sometimes defined as establishing a proper *firm-environment fit*. Indeed, the mission/objectives/goals themselves should be based on an assessment of the external environment and the organisational factors (*i.e.,* the internal environment). A SWOT analysis (analysis of the strengths and weaknesses of the organisation and opportunities and threats in the environment), therefore, is one of the first steps in the strategic management process. Business dynamics, to a large extent, is a dependent factor — it depends on, *inter alia,* the environmental dynamics. Hence, the importance of environmental analysis.

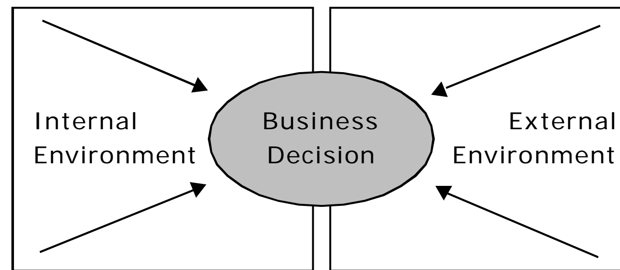

Fig. 1.1 : ***Factors Influencing Business Decision***

TYPES OF ENVIRONMENT

On the basis of the extent of intimacy with the firm, the environmental factors may be classified into different types or levels. As indicated above, there are, broadly, two types of environment, the internal environment, *i.e.,* factors internal to the firm and external environment, *i.e.,* factors external to the firm which have relevance to it.

The internal factors are generally regarded as *controllable factors* because the company has control over these factors; it can alter or modify such factors as its personnel, physical facilities, organisation and functional means, such as marketing mix, to suit the environment.

The external factors, on the other hand, are, by and large, beyond the control of a company. The external or environmental factors such as the economic factors, socio-cultural factors, government and legal factors, demographic factors, geo-physical factors etc., are, therefore, generally regarded as uncontrollable factors.

It may, however, be noted that a firm may not sometimes have complete control over all the internal factors. Also, it is sometimes possible to change certain external factors.

Some of the external factors have a direct and intimate impact on the firm (like the suppliers and distributors of the firm). These factors are classified as micro environment, also known as task environment and operating environment. There are other external factors which affect an industry very generally (such as industrial policy, demographic factors etc.). They constitute what is called macro environment, general environment or remote environment.

Although business environment consists of both the internal and external environments, many people often confine the term to the external environment of business. In this book too, in the subsequent chapters, the term refers mostly to external environment of business.

Business environment may be considered at three levels:
- Internal environment
- Micro environment/task environment/operating environment
- Macro environment/general environment/remote environment

INTERNAL ENVIRONMENT

The important internal factors which have a bearing on the strategy and other decisions are outlined below.

Value System

The value system of the founders and those at the helm of affairs has important bearing on the choice of business, the mission and objectives of the organisation, business policies and practices. It is a widely acknowledged fact that the extent to which the value system is shared by all in the organisation is an important factor contributing to success.

The value system of the organisation influences its portfolio strategy, HRM, marketing strategy and CSR.

The value system of JRD Tata and the acceptance of it by others whose matter were responsible for the voluntary incorporation in the Articles of Association of TISCO, its social and moral responsibilities to consumers, employees, shareholders, society and the people.

After the EID Parry Group was taken over by the Murugappa Group, one of the most profitable businesses (liquor) of the ailing Parry Group was sold off as the liquor business did not fit into the value system of the Murugappa Group.

The value system and ethical standards are also among the factors evaluated by many companies in the selection of suppliers, distributors, collaborators etc.

BOX 1.1 : VALUES, GOVERNANCE AND EXCELLENCE

Infosys Technologies Limited is a publicly held company based in India that provides information technology consulting and software services to Fortune 1000 companies and employs more than 3,000 people worldwide. Infosys has based its growth on several key principles of corporate governance: best practices, financial markets, and human capital. Its core value: To achieve our objectives in an environment of fairness, honesty, transparency, and courtesy towards our customers, employees, vendors, and society at large.

All Infosys activities are continually benchmarked with global best practices. The Firm`s quality control and project management have helped it achieve total quality management accreditation. Feedback from process audits enable the reengineering of internal processes when required. International accounting practices are also followed. Infosys publishes all financial reports according to both US and Indian Generally Accepted Accounting Practices. Best practices at Infosys are captured through a knowledge management systems that makes experience gained from various client assignments freely available in an intranet repository.

The first Indian-registered direct listing on a US market, Infosys began trading on Nasdaq in March 1999. Infosys viewed the listing as a way to achieve a more liquid currency (through stock options) for attracting the best employees and future acquisitions. It anticipates that its presence on Nasdaq will give potential customers greater comfort and confidence in the company.

Infosys views its employees as its key resource. With "wealth creation for employees" as one of its stated objectives, Infosys provides innovative compensation and benefit packages. Infosys pioneered the concept of the employee stock ownership plan in India. Infosys also offers such benefits as training, asset acquisition, loans, housing, and personal assistance services. This combination of stock options and benefits allows Infosys to attract top talent to contribute to its growth.

Infosys won the first National Corporate Governance Award (1999), instituted by the Ministry of Finance and sponsored by the UTI.

***Source:** Financial Times, reproduced in M.R. Iskander and N. Chamlou, Corporate Governance: A Framework for Implementation.*

Vision, Mission and Objectives

Vision, mission and objectives set the scope, direction, philosophy and pace of development.

The business domain of the company, priorities, direction of development, business philosophy, business policy etc., are guided by the vision, mission and objectives of the company. Ranbaxy's thrust into the foreign markets and development were driven by its mission "to become a research-based international pharmaceutical company". Arvind Mills' mission – "To achieve global dominance in select businesses built around our core competencies through continuous product and technical innovation, customer orientation and focus on cost effectiveness", – has driven its future development strategy including the portfolio strategy, and indicated the thrusts required in the functional areas to help achieve the mission.

Management Structure and Nature

The organisational structure, the composition of the Board of Directors, extent of professionalisation of management etc., are important factors influencing business decisions.

Some management structures and styles delay decision-making while some others facilitate quick decision-making.

The Board of Directors being the highest decision-making body which sets the direction for the development of the organisation and which oversees the performance of the organisation, the quality of the Board is a very critical factor for the development and performance of company. The private sector in India presents extreme cases in this respect. At one end, there are companies with highly qualified and responsible Board and at the other end there are companies which do not possess these qualities.

The shareholding pattern could have important managerial implications. There are very large companies where majority of the share is held by the promoters (like Wipro) and there are large firms where the promoters' position is very vulnerable (like the Tata Group of Companies).

Financial institutions had large shareholding in many Indian companies. The stand of nominees of financial institutions could be very decisive in several critical instances.

Internal Power Relationship

Factors like the amount of support the top management enjoys from different levels of employees, shareholders and Board of Directors have important influence on the decisions and their implementation.

The relationship between the members of Board of Directors and between the chief executive and the Board are also a critical factors.

Internal factors determine the potential of a company to meet the environmental challenges.

Human Resources

The characteristics of the human resources like skill, quality, morale, commitment, attitude etc., could contribute to the strength and weakness of an organisation. Some organisations find it difficult to carry out restructuring or modernisation because of resistance by employees whereas they are smoothly done in some others.

The involvement, initiative etc., of people at different levels may vary from organisation to organisation. The organisational culture and overall environment have bearing on them. John Towers, M.D., Rover Group, observes that a Japanese company of 30,000 employees is 30,000 process improvers. In a Western company, it is 2,000 process improvers and 28,000 workers.[1] And in an Indian company?

Company Image and Brand Equity

The image of the company matters while raising finance, forming joint ventures or other alliances, soliciting marketing intermediaries, entering purchase or sale contracts, launching new products etc. Brand equity is also relevant in several of these cases.

Miscellaneous Factors

There are a number of other internal factors which contribute to the business success/failures or influence the decision-making. They include the following.

1. *Physical Assets and Facilities* like the production capacity, technology and efficiency of the productive apparatus, distribution logistics etc., are among the factors which influence the competitiveness of a firm. *For example*, as quality is very important in the pharmaceutical industry, particularly for a global player, in the case of Core Healthcare not only there is no compromise on quality but also the company made the quality norms stricter than international or other relevant standards and the quality mantra has been well imbibed throughout the organisation.

Both tangible and intangible assets and the structure and nature of management shape the organisational strength.

2. *R&D and Technological Capabilities,* among other things, determine a company's ability to innovate and compete.
3. *Marketing Resources* like the organisation for marketing, quality of the marketing men, brand equity and distribution network have direct bearing on marketing efficiency. They are important also for brand extension, new product introduction etc.
4. *Financial Factors* like financial policies, financial position and capital structure are also important internal environment affecting business performances, strategies and decisions.

EXTERNAL ENVIRONMENT

As stated earlier, the external business environment consists of a micro environment and a macro environment.

Micro Environment

The micro environment is also known as the Task Environment and Operating Environment because the micro environmental forces have a direct bearing on the operations of the firm.

"The micro environment consists of the actors in the company's immediate environment that affect the performance of the company. These include the suppliers, marketing intermediaries, competitors, customers and the publics."[2] The macro environment consists larger societal forces that affect all the actors in the company's micro environment — namely, the demographic, economic, natural, technical, political and cultural forces."[3]

It is quite obvious that the micro environmental factors are more intimately linked with the company than the macro factors. The micro forces need not necessarily affect all the firms in a particular industry in the same way. Some of the micro factors may be particular to a firm. *For example,* a firm which depends on a supplier may have a supplier environment which is entirely different from that of a firm whose supply source is different. When competing firms in an industry have the same micro elements, the relative success of the firms depends, *inter alia,* on their relative effectiveness in dealing with these elements.

Suppliers

An important force in the micro environment of a company is the suppliers, *i.e.,* those who supply the inputs like raw materials and components to the company. The importance of reliable source/sources of supply to the smooth functioning of the business is obvious. Uncertainty regarding the supply or other supply constraints often compel companies to maintain high inventories causing cost increases. It had been pointed out that factories in India maintained indigenous stocks of 3-4 months and imported stocks of 9 months as against an average of a few hours to two weeks in Japan.[4] The liberalisation, however, has caused a significant change in the situation.

Supply chain management is critical to the efficiency of a firm.

Because of the sensitivity of the supply, many companies give high importance to Vendor development. Vertical integration, where feasible, helps solve the supply problem. *For example,* Nirma has always been a believer of the logic that captive production plants for raw materials is the best way to production costs in check and it has gone for a mammoth backward integration. In many cases, however, outsourcing is more beneficial.

It is very risky to depend on a single supplier because a strike, lock out or any other production problem with that supplier may seriously affect the company. Similarly, a change in the attitude or behaviour of the supplier may also affect the company. Hence, multiple sources of supply often help reduce such risks.

The supply management assumes more importance in a scarcity environment. "Company purchasing agents are learning how to "wine and dine" suppliers to obtain favourable treatment during periods of shortages. In other words, the purchasing department might have to "market" itself to suppliers."[5]

Recognising the critical importance of the supply factor, companies all around the world are increasingly resorting to *partnering/relationship marketing*. (For details, see the author's *Business Marketing* (Himalaya Publishing House). Partnering is becoming more and more international and this provides a challenging opportunity for Indian suppliers to become international players.

Customers

As it is often exhorted, the major task of a business is to create and sustain customers. A business exists only because of its customers. Monitoring the customer sensitivity is, therefore, a prerequisite for the business success.

A company may have different categories of consumers like individuals, households, industries and other commercial establishments, and government and other institutions. *For example,* the customers of a tyre company may include individual automobile owners, automobile manufacturers, public sector transport undertakings and other transport operators.

In choosing the customer segments, a company should consider such factors as the relative profitability, dependability, stability of demand, growth prospects and the extent of competition.

Depending on a single customer is often too risky because it may place the company in a poor bargaining position, apart from the risks of losing business consequent to the winding up of business by the customer or due to the customers switching over to the competitors of the company.

With the growing globalisation, the customer environment is increasingly becoming global. Not only that the markets of other countries are becoming more open, the Indian market is becoming more exposed to the global competition and the Indian customer is becoming more "global" in his shopping.

Competitors

A firm's competitors include not only the other firms which market the same or similar products but also all those who compete for the discretionary income of the consumers. *For example,* the competition for a company's televisions may come not only from other T.V. manufacturers but also from two-wheelers, refrigerators, cooking ranges, stereo sets and so on and from firms offering savings and investment schemes like banks, Unit Trust of India, companies accepting public deposits or issuing shares or debentures etc. This competition among these products may be described as *desire competition* as the primary task here is to influence the basic desire of the consumer. Such desire competition is generally very high in countries characterised by limited disposable incomes and many unsatisfied desires (and, of course, with many alternatives for spending/investing the disposable income).

Competition has different levels and dimensions.

If the consumer decides to spend his discretionary income on recreation (or recreation-cum-education), he will still be confronted with a number of alternatives to choose from like T.V., stereo, two-in-one, three-in-one etc. The competition among such alternatives which satisfy a particular category of desire is called *generic competition*.

If the consumer decides to go in for a T.V., the next question is which form of the T.V. — black and white or colour with remote control or without it etc. In other words, there is a *product form competition*. Finally, the consumer encounters the *brand competition, i.e.,* the competition between the different brands of the same product form.

An implication of these different demands is that a marketer should strive to create primary and selective demand for his products.

The liberalisation has dramatically transformed the competitive environment in India.

Consequent to the liberalisation, the competitive environment in India has been undergoing a sea change. Many companies restructured their business portfolio and strategies. In many industries where a seller's market existed a buyer's market has emerged.

The competitive environment is detailed in the section *Competitive Structure of Industries* later in this chapter.

Marketing Intermediaries

The immediate environment of a company may consist of a number of marketing intermediaries which are "firms that aid the company in promoting, selling and distributing its goods to final buyers".[6]

The marketing intermediaries include middlemen such as agents and merchants who "help the company find customers or close sales with them",[7] physical distribution firms which "assist the company in stocking and moving goods from their origin to their destination"[8] such as warehouses and transportation firms; marketing service agencies which "assist the company in targeting and promoting its products to the right markets"[9] such as advertising agencies, marketing research firms, media firms and consulting firms; and financial intermediaries which finance marketing activities and insure business risks.

Different marketing intermediaries can be very helpful in formulating and operationalising the marketing strategy.

Marketing intermediaries are vital links between the company and the final consumers. A dislocation or disturbance of the link, or a wrong choice of the link, may cost the company very heavily. Retail chemists and druggists in India once decided to boycott the products of a leading company on some issue such as poor retail margin. This move for collective boycott was, however, objected to by the MRTP Commission; but for this the company would, perhaps, have been in trouble. Hindustan Lever too faced major challenge when it faced a collective boycott in Kerala on the issue of trade margin.

Financiers

Another important micro environmental factor is the financiers of the company. Besides the financing capabilities, their policies and strategies, attitudes (including attitude towards risk), ability to provide non-financial assistance etc. are very important.

Publics

A company may encounter certain publics in its environment. "A public is any group that has an actual or potential interest in or impact on an organisation's ability to achieve its interests."[10] Media publics, citizens action publics and local publics are some examples.

Some companies are seriously affected by such publics. *For example,* one of the leading companies in India was frequently under attack by the media public, particularly by a leading daily which was allegedly bent on bringing down the share prices of the company by tarnishing its image. Such exposures or campaigns by the media might even influence the government decisions affecting the company. Many companies are also affected by local publics. Environmental pollution is an issue often taken up by a number of local publics. Actions by local publics on this issue have caused some companies to suspend operations and/or take pollution abatement measures. Non-government organisations (NGOs), particularly in developed countries, have been mounting up protests against child labour, sweat labour, cruelty against animals, environmental problems, deindustrialisation resulting from imports and so on. Exports of developing countries, particularly, are affected by such developments.

Growth of consumer publics (like NGOs) is an important development affecting business.

It is wrong to think that all publics are threats to business. Some of the actions of the publics may cause problems for companies. However, some publics are an opportunity for the business. Some businessmen, *for example,* regard consumerism as an opportunity for the business. The media public may be used to disseminate useful information. Similarly, fruitful cooperation between a company and the local publics may be established for the mutual benefit of the company and the local community.

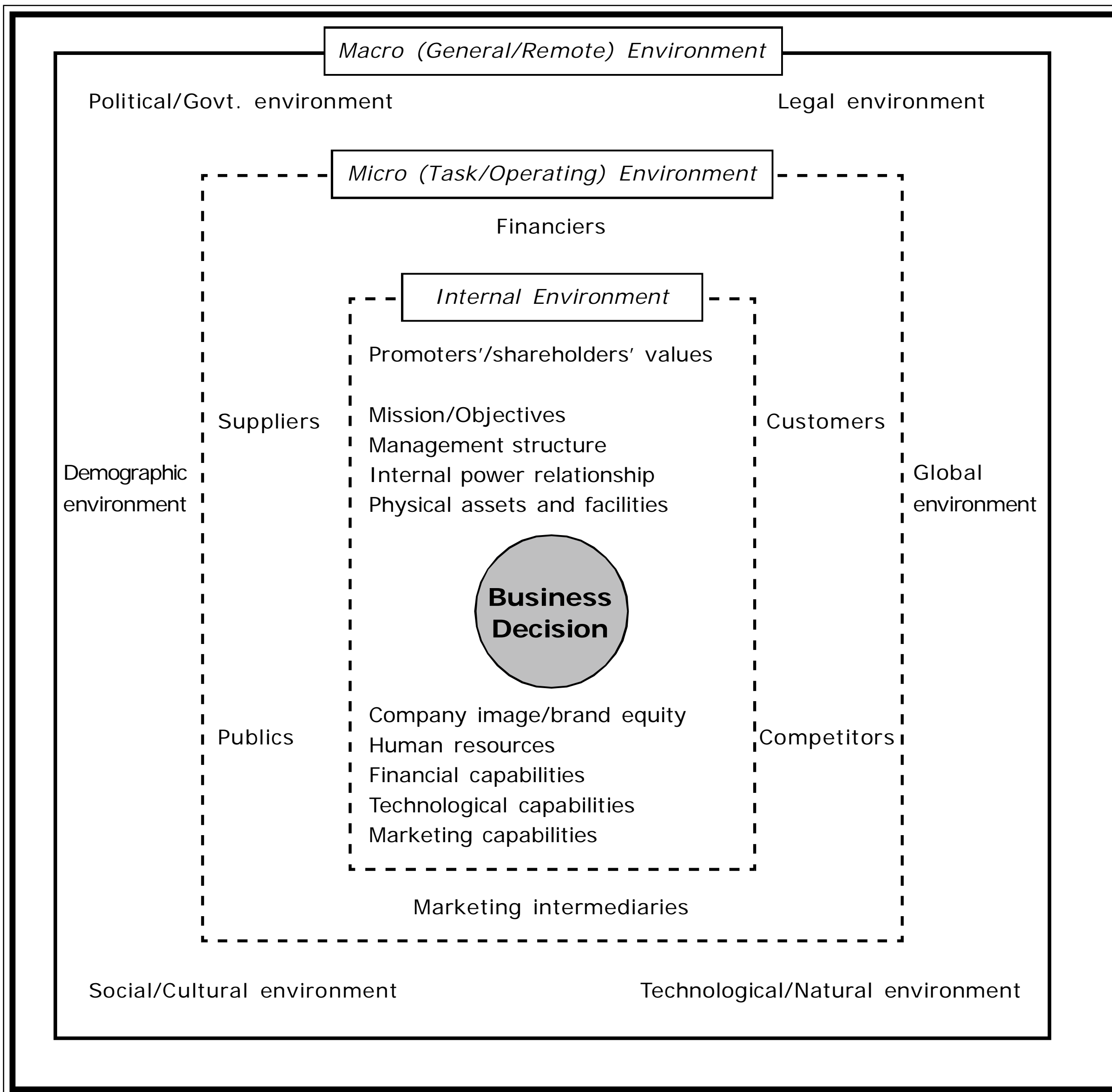

Fig. 1.2 : ***Business Environment***

MACRO ENVIRONMENT

A company and the forces in its micro environment operate in a larger macro environment of forces that shape opportunities and pose threats to the company.

Macro Environment, also known as General Environment and Remote Environment, refers to factors which affect business in general.

The macro forces are, generally, more uncontrollable than the micro forces. When the macro environment is uncontrollable, the success of a company depends on its adaptability to the environment. *For example,* if the cost of the imported components increases substantially because of the depreciation of the domestic currency, a solution may be their domestic manufacture.

Important macro environment factors include economic environment, political and regulatory environment, social/cultural environment, demographic environment, technological environment, natural environment, and global environment. Several of these are dealt with in some detail in subsequent chapters.

Even domestic business is affected by certain global factors.

Global Environment

The global environment refers to those global factors which are relevant to business, such as the WTO principles and agreements; other international conventions/treaties/agreements/ declarations/protocols etc.; economic and business conditions/sentiments in other countries etc. Similarly, there are certain developments, like a hike in the crude oil price, which have global impact.

BOX 1.2 : THE 21st CENTURY INTERNATIONAL SYSTEM

The international system of the twenty-first century will be marked by a seeming contradiction: on the one hand, fragmentation; on the other, growing globalisation. On the level of the relations among states, the new order will be more like the European state system of the eighteenth and nineteenth centuries than the rigid patterns of the Cold War. It will contain at least six major powers – the United States, Europe, China, Japan, Russia, and probably India – as well as a multiplicity of medium-sized and smaller countries. At the same time, international relations have become truly global for the first time. Communications are instantaneous; the world economy operates on all continents simultaneously. A whole set of issues has surfaced that can only be dealt with on a worldwide basis, such as nuclear proliferation, the environment, the population explosion, and economic interdependence.

Source: *Henry Kissinger, Diplomacy (Touchstone, New York, 1994).*

The WTO principles and regulations have far-reaching implications for Indian business. Acceptance of product patents, *for example,* seriously impacts the Indian pharmaceutical industry. The import and investment liberalisations mandated by WTO have substantially changed the competitive environment in India.

Economic conditions in other countries may affect the business. *For example,* if the economic conditions in a company's export markets are very good, export prospects are generally very good and *vice versa*. Recession in other countries can increase the import threats, including dumping.

International political factors can also affect business, like war or political tensions or uncertainties, strained political relations between the nation and other countries (which sometimes even culminates in sanctions).

Developments in information and communication technologies facilitate fast cross-border spread of cultures, significantly influencing attitudes, aspirations, tastes, preferences and even customs, traditions and values. This has significant implications for business.

BOX 1.3 : THE CONTAGION AMERICAN FLUE

Globalisation and the increasing global business interdependence make the fortunes of companies, some times even of national economies, dependent on the economic conditions in other countries. For example, the slow down in the US economy during 2000-2001 has sent its shock waves to India too. The IT sector in the US was very badly hit by the economic slow down as it forced US firms to sharply reduce their IT spends and defer projects that were not critical. The IT companies seriously affected by the recession resorted to massive lay offs (during February-March, 2001, Cisco laid off 8000, Lucent 10,000 and Intel 5000 people). Besides, massive numbers have been benched – people currently without work in the company (but not retrenched) waiting for projects. In March 2001, it was reported that about one lakh Indian tech professionals were on the bench in the US. The revenue warnings by the tech firms sent their stock prices deep down. As the US IT firms were major clients of Indian IT majors, companies like Infosys, Wipro, HCL and many others were hit hard. The American tech flue thus affected the business of the Indian firms, their share prices, the nation`s export earnings and the lucrative employment market. In early 2001, Infosys bench was reported to have swelled to 2500 from the normal levels

of 700-8000. A number of companies laid off people. According to a Business Today *(April 6, 2001) feature, "one out of every five engineers in the country's finest IT companies could soon have nothing to do; salaries which grew by between 20 and 30 per cent last year will grow by just 0-5 per cent this year; entry level intake will decline by 20 per cent (that will mean nearly 2500 less job across India's top five software companies); and earnings could dip by between 2 and 13 per cent."[11] The setback, however, had its share of opportunities too. This provided a right time to acquire companies in the US. In March 2001, the scrips of US based software companies were trading 0.2 to 0.3 times their revenues which made them very attractive for acquisition. The economic down-turn time provides a particular edge to low cost firms. It was expected to bring more offshore work to India Table 1.1, adapted from* Businessworld *March 26, 2001, lists the possible effects of the American flue on two Indian IT firms and their planned responses.*

In fact, the very news of the US recession made its impact on the major markets across the globe. According to a news report entitled "US recession fears haunt Europe, Asia" in The Economic Times, *4 January, 2000, "concern about a rapidly slowing US economy resounded through global markets, sending shares and the dollar lower and bonds higher in European trading. Technology shares were particularly hard hit, with the Stoxx European tech sector index down 7 per cent, on 3rd January, matching an overnight tumble in the Nasdaq Composite and taking it to levels last seen in December 1999.*

Several key Asian stock markets posted sharp losses on 3rd January, with high-tech shares leading the way down following the US Nasdaq's seven per cent dive. Hong Kong and Singapore stock markets led the falls with drops of more than two per cent, while Australian shares lost their New Year zeal and ended the day down as well.

The Hang Seng Index ended the morning session down 2.1 per cent as shares of companies whose revenues are reliant on sales to the US fell sharply. Singapore shares succumbed to a broad based sell-off. The Straits Times Index slumped 2.5 per cent by midday, its lowest in two-and-a-half months. Taiwan's key TAIBX also reflected Wall Street's woes. It ended 0.8 per cent down."

TABLE 1.1 : THE EFFECT AND RESPONSE

Infosys		**Wipro**	
The Pressures	*The Counters*	*The Pressures*	*The Counters*
• Higher costs due to addition of 3400 people in the past year • Revenues from the US account for 65-70 per cent of its turn over • Large US clients have announced cutbacks on jobs • Does a large number of low value maintenance projects	• Offset this by raising revenue productivity by 6-8% this year • Increase presence in other markets like Europe and Japan • Get senior management to be more involved with sales • Beef up sales teams abroad and make them more aggressive	• 30 per cent revenue from telecom and Net-working may be hit • Further squeeze on operational margins • Pressure on costs due to addition of over 4000 workers • Some large US clients are cutting down jobs and projects	• Improve productivity, slash expenses in non-core areas • Just in time recruitment to manage manpower inventory • Increase focus on alternative markets like Europe and Japan • Cut down training time while maintaining quality

COMPETITIVE STRUCTURE OF INDUSTRIES

The competitive structure of industries is a very important business environment. Identification of forces affecting the competitive dynamics of an industry will be very useful in formulating strategies.

According to Michael Porter's well-known model of structural analysis of industries, the state of competition in an industry depends on five basic competitive forces, *viz.*,

1. Rivalry among existing firms
2. Threat of new entrants

Besides competition from existing firms in the industry, a firm may face competition from substitutes and new entrants including forward integration by suppliers and backward integration by buyers as also their bargaining power.

3. Threat of substitutes
4. Bargaining power of suppliers
5. Bargaining power of buyers.

Fig. 1.3 depicts the five forces competitive structure of industry. The diagram is a slightly modified presentation of the one provided by Porter. The arrows in the diverse directions indicate opposing forces. *For example,* just as the buyers and suppliers may have bargaining power over the firm, the firm may also have some bargaining power over the buyers and suppliers.

Threat of Entry

A growing industry often faces threat of new entrants that can alter the competitive environment. There may, however, be a number of barriers to entry. Potential competition tends to be high if the industry is profitable or critical, entry barriers are low and expected retaliation from the existing firms is not serious.

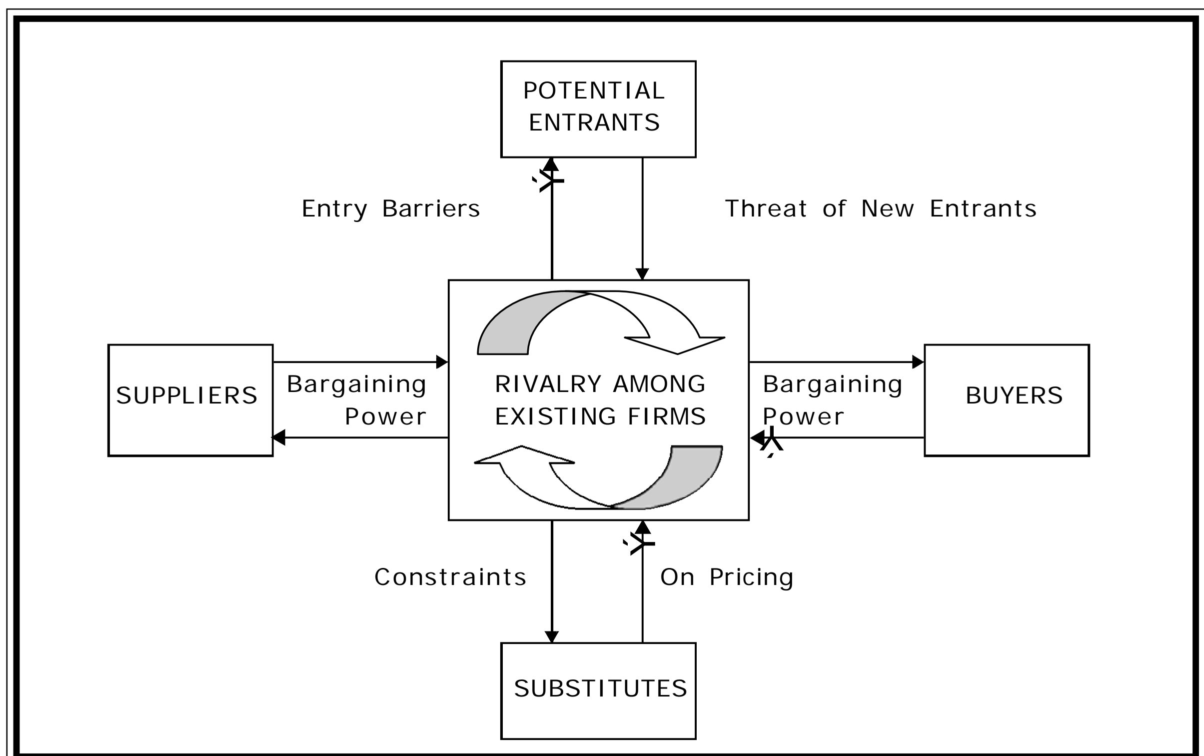

Fig. 1.3 : Forces Driving Industry Competition

The following are some of the important common entry barriers:

Government policies, strategies of existing players and industry characteristics like technological factors and capital investment size can create entry barriers.

1. ***Government Policy:*** In many cases, government policy and regulation are important entry barriers. *For example,* prior to the economic liberalisation in India, government-dictated entry barriers were rampant, like reservation of industries/products for public sector and small-scale sector, industrial licensing, regulations under MRTP Act, import restrictions, restrictions on foreign capital and technology etc.
2. ***Economies of Scale:*** Economies of scale can deter entry in two ways: it keeps out small players and discourages even potentially large players because of the risk of large stakes.
3. ***Cost Disadvantages Independent of Scale:*** Entry barrier may also arise from the cost advantages, besides that of economies of scale, enjoyed by the established firms which cannot be replicated by new firms, such as proprietary product technology, learning or

experience curve, favourable access to raw materials, favourable location, government subsidies etc.

4. ***Product Differentiation:*** Product differentiation characterised by brand image, customer loyalty, product attributes etc. may form an entry barrier forcing new entrants to spend heavily to overcome this barrier.
5. ***Monopoly Elements:*** Proprietary product/technology, monopolisation/effective control over raw material supplies, distribution channels etc. are entry barriers which are insurmountable or difficult to overcome.
6. ***Capital Requirements:*** High capital-intensive nature of the industry is an entry barrier to small firms. Further, the risk of huge investment could be a discouraging factor even for other firms.

Rivalry among Existing Competitors

Rivalry among existing competitors is often the most conspicuous of the competitions. Firms in an industry are "mutually dependent" – competitive moves of a firm usually affect others and may be retaliated. Common competitive actions include price changes, promotional measures, customer service, warranties, product improvements, new product introductions, channel promotion etc.

There are a number of factors, which influence the intensity of rivalry. These include**:**

1. ***Number of Firms and their Relative Market Share, Strengths etc.:*** Rivalry is likely to be affected by the number firms, their relative market shares, competitive strengths, etc.
2. ***State of Growth of Industry:*** In stagnant, declining and, to some extent, slow growth industries, a firm is able to increase its sales only by increasing its market share, *i.e.,* at the expense of others.
3. ***Fixed or Storage Costs:*** When the fixed or storage costs are very high, firms are provoked to take measures to increase sales for improving capacity utilisation or reducing storage costs.
4. ***Indivisibility of Capacity Augmentation:*** Where there are economies of scale, capacity increases would be in large blocks necessitating, in many cases, efforts to increase sales to achieve capacity utilisation norms.
5. ***Product Standardisation and Switching Costs:*** When the product of different firms are standardised, price, distribution, after-sales service, credit etc. become important strategic variables of competition. Absence of switching costs makes firms more vulnerable.
6. ***Strategic Stake:*** Rivalry in an industry becomes more volatile if a number of firms have high stakes in achieving success there. *For example,* a firm which regards a particular industry as its core business will give great importance to success in that industry.
7. ***Exit Barrier:*** High exist barriers (*for example,* compensation for labour, emotional attachment to the industry etc.) tend to keep firms competing in an industry even though the industry is not very attractive.
8. ***Diverse Competitors:*** Rivalry becomes more complex and unpredictable when competitors are very diverse in their strategies, origins, personalities, relationships to their parents etc.
9. ***Switching Costs:*** In some cases, a barrier to entry is created by switching costs (*i.e.,* one-time costs facing the buyer of switching from one supplier's product to another's) such as cost of retraining the employees, cost of new ancillary equipment etc.

Competition among existing players is influenced by technological factors, cost structure, characteristics of firms, exit barriers and anticipations.

10. ***Expected Retaliation:*** The potential entrants' expectations about the reactions of the existing competitors may also sometimes deter entry.

Threat of Substitutes

An important force of competition is the power of substitutes. "Substitutes limit the potential returns in an industry by placing a ceiling on the price firms in the industry can profitability charge. The more attractive the price performance alternative offered by substitutes, the firmer the lid on industry profits."[13]

Firms in many industries face competition from those marketing close or distant substitutes. Porter points out that substitute products that deserve the most attention are those that are: (1) subject to trends improving their price-performance trade-off with the industry's product, or (2) produced by industries earning high profits.[14]

Bargaining Power of Buyers

For several industries, buyers are potential competitors – they may integrate backward. Besides, they have different degrees of bargaining power. "Buyers compete with the industry by forcing down prices, bargaining for higher quality or more services, and playing competitors against each other – all at the expense of industry profitability".[15]

Important determinants of the buyer power, explained by Porter, are the following:

The bargaining power and potential for backward integration of buyers may affect a firm.

1. The volume of purchase relative to the total sale of the seller.
2. The importance of the product to the buyer in terms of the total cost.
3. The extent of standardisation or differentiation of the product.
4. Switching costs.
5. Profitability of the buyer (low profitability tends to pressure costs down).
6. Potential for backward integration by buyer.
7. Importance of the industry's product with respect to the quality of the buyer's product or services.
8. Extent of buyers' information.

Bargaining Power of Suppliers

The important determinants of supplier power are the following:

A firm may be challenged by the bargaining power and the potential for forward integration of suppliers.

1. Extent of concentration and domination in the supplier industry.
2. Importance of the product to the buyer.
3. Importance of the buyer to the supplier.
4. Extent of substitutability of the product.
5. Switching costs.
6. Extent of differentiation or standardisation of the product.
7. Potential for forward integration by suppliers.

Porter's analysis, thus, shows that competition in an industry goes well beyond the established players. "Knowledge of these underlying sources of competitive pressure highlights the critical

strengths and weaknesses of the company, animates its positioning in its industry, clarifies the areas where strategic changes may yield the greatest payoff, and highlights the areas where industry trends promise to hold the greatest significance as either opportunities or threats. Understanding these sources will also prove to be useful in considering areas for diversification, though the primary focus here is on strategy in individual industries. Structural analysis is the fundamental underpinning for formulating competitive strategy."[16]

STRATEGIC GROUPS

The strategic group may be considered as the micro competitive environment for a firm.

The analysis of an industry within the framework of the five forces model will give a general picture of the competitive forces. Useful as this analysis is, it is not sufficient enough for formulating competitive strategies. More in-depth knowledge of the competitive situation is needed because the competitive environment and competitive strategies of different firms within an industry may not be the same. The size, resources and strengths of the firms etc. may differ between firms. Again, firms differ with respect to portfolio strategy, product mix in each business, market segments targeted, marketing mix strategy, backward or forward integration, extent of outsourcing, intra-corporate linkages, parent-subsidiary relationships etc. The strategic dimensions for a particular firm usually form an internally consistent set. An industry normally has firms with a number of different, though internally consistent, combinations of dimensions. Analysis of the strategic dimensions of the homogeneous sets of firms in a heterogeneous industry is an important step in structural analysis of industry. In other words, it is necessary to identify the various strategic groups within an industry. According to Porter, "a strategic group is the group of firms in an industry following the same or similar strategy along the strategic dimensions".[17] Normally, a small number of strategic groups capture the essential strategic differences among firms in the industry although one may even think of the extreme cases of an industry having only one strategic group (*i.e.,* all the firms are similar *vis-à-vis* the strategic dimensions) on the one end and each firm in an industry amounting to a strategic group on the other end. *For example,* in advanced countries like USA, there are two significant strategic groups in the pharmaceutical industry, namely, the proprietary group (*i.e.,* firms that concentrate on patented drugs and who expend enormous resources on R&D), and the generic group (*i.e.,* firms depending on off-patent drugs). In India, in many industries there are, at a very broad level, firms in the organised sector and firms in the unorganised sector. Competitive strategies of the unorganised sector firms are often different from those in the organised sector (it is possible that there are more than one strategic group in each of these sectors). Organised sector firms are normally national or at least regional players whereas the unorganised sector firms, by and large, are local or at best regional player. The direct and major competitors and market/target customers of these groups would be different and, therefore, the marketing strategies would be different. In the furniture industry, *for example,* Godrej and Allwyn are national players and their important customers are corporates and other quality-conscious customers – organisations and individuals – who are not very price-sensitive. The numerous firms in the unorganised sector in this industry are largely local players and they cater mostly to price-sensitive customers. In the hotel and restaurant industry, the competitors of a five star hotel is mostly other five star hotels and they have many common strategic dimensions. The five star hotels, therefore, form one strategic group. Similarly, three star hotels constitute another strategic group.

There may be barriers to shifting strategic position from one strategic group to another. Such barriers are referred to as mobility barrier. *For example,* an assembler of personal computers may encounter several barriers to shift to the position of a fully integrated computer manufacturer, such as barriers of technology, capital investment, human resources and organisation, brand image and market standing of established firms etc. Similarly, there are several barriers to entering the proprietary group by generic drug firms, such as capital investment, research facilities, human resources, high risks of investment on R&D etc. In contrast, it is easier for a proprietary drug firm to enter the generic group.

Implications of Strategic Groups

The concept of strategic groups has implications for industry analysis and identification of opportunities and threats. A company's immediate competitors are firms within the same strategic group.

Second, the nature and intensity of competition and business prospects vary from strategic group to strategic group. The choice of strategic group is, therefore, very important.

Third, high mobility barriers normally help insulate the group from new entrants and facilitate high profitability. "The firms in strategic groups with high mobility barriers will have greater profit potential than those in groups with lower mobility barriers. These barriers also provide a rationale for why firms continue to compete with different strategies despite the fact that all strategies are not quickly successful".[18]

Inter-firm rivalry is the strongest in the strategic group.

Fourth, "just like entry barriers, mobility barriers can change; and as they do (such as if the manufacturing process becomes more capital-intensive), firms often abandon some strategic groups and jump into new ones, changing the pattern of strategic group. Mobility barriers can also be influenced by firm's choices of strategy. A company in an undifferentiated product industry, *for example,* can attempt to create a new strategic group (with higher mobility barriers) by investing heavily in advertising to develop brand identification...Or it can try to introduce a new manufacturing process with greater economies of scale".[19]

Fifth, the competitive standing of the different strategic groups would be different with respect to each of the five competitive forces. *For example,* the threat of new entrants is less in respect of the proprietary group compared to the generic drug group. The bargaining power of the buyers is also weak for patented drugs because of no or limited alternative. Such is the case with competition from substitutes. Players in the strategic group of fully integrated firms may not be subject to as much supplier power as other firms because of their lesser dependence on the outside suppliers. (It is, of course, true that in a number of cases outsourcing firms have advantages over integrated ones.)

Limitations of Porterian Models

The five forces and strategic group models provide very useful frameworks for analysing the nature of competition in an industry. These models, however, suffer from some important shortcomings mentioned below.

In many industries, competition is a process driven by innovation and industry structures are very significantly changed by innovation. In a later work, Porter has recognised the role of innovation in revolutionising industry structure. Innovations, according to him, can unfreeze and reshape industry structure. He holds that after a period of turbulence triggered by innovation, the structure of an industry once more settles down to a stable pattern. Once the industry stabilises in its new configuration, the five forces and strategic group concepts can once more be applied. This view of the evolution of industry structure is often referred to as punctuated equilibrium. The punctuated equilibrium view holds that long periods of equilibrium, when industry's structure is stable, are punctuated by periods of rapid changes when industry structure is revolutionised by innovation. Thus, there is an unfreezing and refreezing process.

COMPETITOR ANALYSIS

Competitor analysis is necessary for formulating right strategies and determining the right positioning for the firm in the industry.

Competitor analysis encompases goals, strategies, capabilities and perceptions.

Competitor analysis seeks to find answers to certain basic questions such as:

1. Who are the competitors of the firm?
2. What are the current strategies of the competitors?
3. What are their future goals and likely strategies?
4. What drives the competitor?
5. Where is the competitor vulnerable?
6. How are the competitors likely to respond to the strategies of others?

Porter has suggested a framework for competitor analysis, consisting of four diagnostic components, *viz.,* future *goals*, *current strategy*, *assumptions* and *capabilities*.

As Porter observes, "its goals, assumptions, and current strategy will influence the *likelihood, timing, nature*, and *intensity* of competitor's reactions. Its strengths and weaknesses will determine its ability to initiate or react to strategic moves and to deal with environmental or industry events that occur".[20]

Competitor Response Profile

An analysis of these components will help to formulate what Porter calls competitor's response profile, *i.e.,* answers to critical questions such as: What moves or developments will provoke the competitor and how is the competitor likely to respond or retaliate?

The competitor response profile seeks to predict the competitor's offensive moves and defensive capabilities.

Future Goals

Analysis of future goals would be helpful to identify the attitude and behaviour of the competitor and likely strategies. As Porter observes, "a knowledge of goals will allow predictions about whether or not each competitor is satisfied with its present position and financial results and, thereby, how likely that competitor is to change strategy and the vigour with which it will react to outside events.... or to moves by other firms?"[21]

Knowledge of competitor's goals may help to predict its reactions to strategic changes.

Goals of both the business unit and corporate parent need to be examined.

In 1996, the CEO of ICI had revealed that it wanted to increase the contribution of its Asian operations from 15 per cent to 25 per cent of the total and earmarked 800 million pounds for investment in Asia, including 200 million for India. It was believed that a part of it would go for acquisitions. Similarly, the CEO of Hindustan Lever (now HUL) revealed the intention to raise the company's contribution to the Unilever's global turnover from about 5 per cent to 10 per cent within a decade. Falling in line with the parent's portfolio strategy, HLL identified the processed food business as a major thrust area. It was, thus, clear that the HLL would go for massive capacity expansion, including M&A.

Assumptions

It is critical to understand:

1. The competitor's assumptions about itself.
2. The competitor's assumptions about the industry and the other companies in it.

A firm may perceive itself as a socially-conscious organisation, the industry leader, quality-conscious firm, highly ethical etc. Such assumptions will, obviously, guide the way the firm behaves, including reactions to competitors' moves.

A firm's strategies are shaped by its assumptions and capabilities.

A firm would also have assumptions about the industry and competitors, like the industry prospects; competitors' goals, capabilities and weaknesses; competitors' possible behaviours and reactions etc.

The strategies and moves of a firm will be influenced by the above two assumptions.

The assumptions may or may not be correct.

Current Strategy

Identification of the current strategies of the competitors is a very important component of competitor analysis. "A competitor's strategy is most usefully thought of as its key operating policies in each functional area of the business and how it seeks to interrelate the functions."[22]

Capabilities

The ability of a firm to accomplish its goals and to respond to competitor's moves depends on its strengths and weaknesses. Analysis of the strengths and weaknesses of the competitors is, therefore, very important.

VALUE CHAIN

Porter points out that a firm's value chain is an important determinant of competitive advantage.

Value is the amount buyers are willing to pay for what a firm provides them. The total revenue reflects the value. Creating value for buyers that exceeds the cost of doing so is the goal of any generic strategy.

The value chain displays total value and consists of value activities and margin. Value activities are the physically and technologically distinct activities a firm performs.

There are, broadly, two types of value activities, namely, primary activities and support activities.

Primary activities include: *(i)* inbound logistics (activities associated with receiving, storing and disseminating inputs to products); *(ii)* operations (processing activities); *(iii)* marketing and sales; and *(iv)* services.

Support activities include: *(i)* procurement (purchasing of inputs); *(ii)* technology development; *(iii)* human resource management and *(iv)* firm infrastructure (includes general management, planning, finance, accounting, legal and government affairs and quality management).

The efficiency with which value creating activities are carried out is an important determinant of competitive advantage.

Each of these activities may be subdivided into several activities. *For example,* marketing and sales include activities such as advertising, sales promotion, sales force management, marketing research etc.

A firm gains competitive advantage by performing these strategically important activities more cheaply or better than its rivals. A firm should strive to understand not only its own value chain activities but also of the competitors', distributors' and suppliers'. This has important implications for the business marketers.

BENEFITS OF STRUCTURAL ANALYSIS

The purpose of the structural analysis is to diagnose the competitive forces and to identify the strengths and weaknesses of the firm *vis-à-vis* the industry, to help formulate an effective competitive strategy that "takes offensive or defensive action in order to create a *defendable* position against the five competitive forces".[23]

Structural analysis would enable a firm to answer such questions as:

1. How vulnerable is the firm against potential entrants? In other words, are there or how insurmountable are the entry barriers? Or, what measures can it take to ward off new entrants?
2. How serious is the threat of substitutes? What strategies should the firm employee against them?
3. What is the nature of supplier power? How to combat it?
4. How powerful are the buyers? How to deal with their bargaining power?
5. What are the strengths and weaknesses and strategies of the established competitors and how to cope with them?

ENVIRONMENTAL ANALYSIS AND STRATEGIC MANAGEMENT

An analysis of SWOT (*i.e.,* strengths and weaknesses of the company and the opportunities and threats in the environment) plays a very important role in the strategic management or business policy. A look at the strategic management process would make the importance of the external-internal factors nexus more clear.

Glueck defines strategy as a "unified, comprehensive and integrated plan relating the strategic advantages of the firm to the challenges of the environment. It is designed to ensure that the basic objectives of the enterprise are achieved."[24] Strategic management is defined as "that set of decisions and actions which leads to the development of an effective strategy or strategies to help achieve corporate objectives."[25]

Establishing the right firm-environment fit is the essence of strategy formulations.

Chandler describes strategic management as "the determination of the basic long-term goals and objectives of an enterprise and the adoption of courses of action and allocation of resources necessary to carry out these goals".[26] According to Paine and Naumes, "Strategic management involves the decision-making and the activities in an organisation which: (1) have wider ramifications, (2) have a long time perspective, and (3) use critical resources towards perceived opportunities or threats in a changing environment".[27]

Strategic management or business policy is, thus, the means to achieve the organisational purpose. Strategic management process involves determining the mission and objectives, analysis of the environmental opportunities and threats and evaluating the strengths and weaknesses of the firm to tap the opportunities or to combat the threats, formulating strategies to achieve the objectives on the basis of the SWOT analysis, choosing the most appropriate strategy, implementation of the strategy and reformulation of the objectives or strategy, if needed.

The strategic management process is schematically presented in Fig. 1.4. A very brief account of the steps in the strategic management process is given below. A detailed discussion of strategic management is, obviously, beyond the scope of this book; what is given below is only a sketch.

As the objective of this chapter is to the highlight the importance of the environmental analysis to managerial decision-making, more space is devoted to the description of this step than the other steps.

Formulation of Mission and Objectives

Mission and objectives define the philosophy, scope and tasks of an organisation.

Determining the mission and objectives of the company is the first step in the strategic management process. A strategy is, in fact, a means to achieve the ends or objectives. It should, however, be noted that objectives should not be static, they should be dynamic. That is changes in the environment and/or changes in the organisational strengths and weaknesses may call for modifications to the objectives. A company should, therefore, appraise how well its objectives tap the firm's opportunities and resources. Dynamic companies conduct audit of their objectives and reformulate or reorient the objectives, if desirable, to ensure that the company's objectives are the most appropriate, given the environment and the company's resources. It is such appraisal and the resultant reorientation of the business which have enabled many companies to achieve remarkable successes.

To formulate clear objectives, it is essential to get definite answers to certain questions, *viz.*, "What business the company is in?", "What should the company's business be?", "What will the company's business be?" As Gluek aptly remarks, "objectives help define the organisation in its environment."[28] Environmental analysis will help find answer to the question "What should the company's business be?" If 'what should be the business' is different from 'what is the business', there is certainly a need for redefining the business, matching the company resources to the environment. The question 'what will the company's business be?' exposes another dimension of business objectives, namely, the long-term perspective. As Drucker succinctly puts it, 'what will the business' is related to 'what changes in the environment are already discernible that are likely to have high impact on the characteristics, mission, and purpose of our business?' and 'how do we now build these anticipations into our theory of business, into its objectives, strategies and work assignments?'"[29]

SWOT Analysis

Identification of the threats and opportunities in the environment and the strengths and weaknesses of the firm is the cornerstone of business policy formulation; it is these factors which determine the course/courses of action to ensure the survival and/or growth of the firm.

The environment might present many opportunities, but a company might not have the strengths to exploit all the opportunities. Similarly, sometimes a firm will not have the strength to meet the environmental threats. If a company, thus, finds that it will not have the competence to survive in a particular line of business, it will be prudent to give it up and concentrate on such business/businesses for which the firm is most competent. The economic liberalisation ushered in India in 1991 drastically changed the business environment. Many companies have exited several of their businesses and have been concentrating on their core businesses. *For example,* the Ceat exited four non-tyre businesses (glass fibre, electronics, photocopiers and nylon code)

BOX 1.4 : WHERE RAYMOND WANTS TO BE?

Raymond has been a well known fabric brand in India. The Raymond Ltd. over time had made significant investments in process-oriented businesses such as cement, steel and polyester fibre, besides textiles.

Gautam Hari Singhania, 36, who took over from Vijaypat Singhania as chairman and managing director in 1998, sought to put Raymond on a strong footing, restructuring its business portfolio based on a SWOT analysis. So, in early 1999, says Singhania, "We started looking at our business portfolio, and decided where we wanted to be as compared to where we are today. We decided there were three areas that the company did not want to be in, in our long-term strategy. One was filament yarn, the second was cement, and the third, steel." These businesses were either not giving adequate returns or were making losses. The company also did not have the expertise to run these units. Raymond, therefore, pulled out of these businesses and decided to focus on the core business of dressing (textiles and readymade apparel).

The divestment of these three businesses brought in about ₹ 1,100 crore. Out of this, ₹ 291 crore was used to repay outstanding debt and this helped to substantially reduce the interest burden. The company also spent around ₹ 158 crores for buying back shares through the open market route and this increased the Singhanias' share in the Raymond from 27 to 31 per cent. The company has been left with a large amount for investment – for developing the existing core business or entering new businesses (including acquisition).

In Singhania's vision, Raymond must turn itself into a lean and efficient company, before striking out to conquer new territory overseas. While Raymond claims to be among the top three fabric brands in the world in integrated worsted (wool-blended) fabrics, it certainly isn't a household name anywhere except South Asia. "The endeavour is to make it a truly global brand," says the chairman.

Courtesy: *Roshun Povaiah, "Everybody Loves Raymond", A&M, 31 March, 2001.*

and decided to concentrate on its core business – tyre. Funds obtained by the divestment have been used, in many cases, to consolidate or further develop the businesses they have decided to focus on.

Indeed, *strategic management* has come to assume great importance as a result of the liberalisation. The liberalisation, by substantially expanding the scope of private enterprise and removing the entry and growth restrictions, has given a substantial leeway to private enterprise to decide the portfolio strategy. A number of companies have changed their business portfolios (*i.e.*, the businesses they are in). Many have entered new businesses (Reliance, *for example*) and exited some of their businesses, while many have done both (like the Tata Group and RPG Group). A number of companies have been growing organically as well as by acquisitions (*e.g.*, Gujarat Ambuja).

Changes in the business environment across the world may change the industrial scenario of nations. Wells, *for example,* has pointed out in his well-known *International Product Life Cycle* model[30] that certain products which were exported in the early stages of the product life cycle by high income countries like the USA were later imported by them. Other countries which acquired the technology would be able to produce them cheaper because of low labour cost or would sometimes improve the technology. Thus, although the US had a very dominant position in electronic products and had been exporting them in the beginning, later countries like Japan started exporting them to the US and replacing the US in other markets too. An analysis of products traded by countries like Japan, Korea, Taiwan etc. would show the changes in the comparative advantages.

Strategy is shaped by mission/ objectives and SWOT.

The environmental opportunities and threats should be evaluated in the light of the strengths and weaknesses of the internal factors comprising finance, technology and skill, production facilities, personnel and marketing capabilities. The capability of a company to exploit the environmental opportunities or to meet the challenges depends on the strength of these factors. Procter and Gamble (P&G), Unilever's arch rival globally, had a tough time in India because

Hindustan Lever sitting entrenched with its long standing familiarity of the Indian market and marketing prowess was a formidable force in India.

Japanese companies saw an opportunity in the US market segments for compact fuel-efficient cars, small screen T.V.s, low horsepower tractors etc., which were rather neglected by the American firms. As the Japanese firms were marketing these products in the home market, they were, unlike the American counterparts, comfortable with these products. The conjecture of the market opportunity and the strategic strength enabled the Japanese companies to penetrate the American market. After having consolidated their position in these segments, they have moved up to other segments with the strength of the reputation they established.

The general success of the Japanese in the world market is attributed to the right choice of the products and markets, based on a proper understanding of the environment and the internal strengths. Kotler and Fahey point out that "the Japanese government and companies work hard to identify attractive global markets. They favour industries that require high skills, high labour intensity and only small quantities of natural resources: candidates include consumer electronics, cameras, watches, motorcycles and pharmaceuticals. They prefer product markets that are in a state of technological evolution. They like product markets where consumers around the world would be willing to buy the same product designs. They look for industries where the market leaders are complacent or underfinanced."[31]

Strategic Alternatives and Choice of Strategy

After the identification of the environmental opportunities and threats and the organisational strengths and weaknesses (and the reformulation of the mission and objectives, if needed), the next tasks in the strategic management process are the consideration of strategic alternatives and the choice of the most appropriate strategy/strategies.

A company may be confronted with several alternatives such as:

- Should the company continue in the same business or get out of it?
- If it should continue in the same business, should it grow by expanding the existing units, establishing new units or by acquiring other units in the industry?
- If it should diversify, should it diversify into related areas or unrelated areas?
- Should it grow by vertical integration?

A company which plans to market its products in foreign markets may have the following alternatives:

For choosing the appropriate strategy, alternative strategies shall be properly evaluated vis-à-vis their suitability, feasibility and acceptability.

- Manufacture the product completely in the home country and export it to the foreign market.
- Establish manufacturing facility in free areas such as export processing zones and make exports from there.
- Establish manufacturing facility in the foreign country and undertake the complete manufacturing of the product there.
- Manufacture the components at home and assemble the product in the foreign market.
- Contract some foreign firm for manufacturing the product and do only the marketing of it.
- Enter into licensing/franchising agreement with a firm in the foreign market.
- Establish a joint venture abroad for manufacturing and marketing the product.

The choice of the strategy should invariably be based on the evaluation of the various alternatives.

Implementation

A good strategy is not a sufficient condition for success; its effective implementation is equally important. Many good strategies fail to achieve the results because of poor implementation. It is necessary to formulate a detailed plan to achieve the objectives by means of the chosen strategy. The term implementation is used in a broad sense so that it encompasses also the formulation of the plan to implement the strategy.

In a multi-unit business, formulation of different levels of strategies is an essential and important aspect of implementation. There are three levels of strategies applicable to such a business.

Corporate Level Strategy: This is the master strategy to achieve the overall corporate objectives. The other levels of strategies are designed to implement the corporate strategy and they are, therefore, formulated with reference to the corporate strategy.

SBU Level Strategy: It is the strategy to achieve the specific objectives of the strategic business unit (SBU) so as to help achieve the overall corporate objectives. A SBU is "an operating division of a firm which serves a distinct product/market segment or a well-defined set of customers or a geographic area. The SBU is given the authority to make its own strategic decisions within corporate guidelines as long as it meets corporate objectives."[32] The SBU is also known as 'operating division'.

Functional Level Strategy: The ultimate success of the SBU level strategy will depend, among other things, on the effectiveness with which it is translated to management functions like marketing, finance, production, R&D etc. *For example,* if some of the SBU level objectives are to be achieved by introducing a new product, the R&D, production, finance and marketing departments will have to be geared up to this task. In a single unit business, there are, obviously only two levels of strategies, namely, the corporate level and the functional level.

A strategy may fail because of inherent weakness of the strategy, environmental changes or implementation failure.

The task of implementation involves mobilisation and deployment of resources, including personnel needed for implementation, organising and assigning tasks to the various elements of the organisation. For effective implementation of the strategy, it is essential to formulate an implementation strategy.

Motivation and high morale of people from top to bottom of the organisation are essential for successful implementation of the strategy, besides their potential capability.

Evaluation

"Evaluation of strategy is that phase of the strategic management process in which the top managers determine whether their strategic choice as implemented is meeting the objectives of enterprise."[33]

Failure to achieve the results may arise from any one or more of the following:

1. Improper implementation of the strategy.
2. Environmental changes which were not anticipated while formulating the strategy.
3. Inappropriate strategy.

Improper implementation of the strategy may be due to: *(a)* inappropriateness of the implementation strategy; *(b)* inefficiency and/or lack of commitment of the personnel in charge of implementation; *(c)* wrong assignment of the tasks; or *(d)* inadequacy of resources.

Environmental changes such as increase in competition, changes in consumer preferences or attitudes, technological changes which could not be anticipated while formulating the strategy etc. may come in the way of achieving the results.

Sometimes, environmental changes will make the achievement of the objectives easier. Such favourable changes in the environment which help achieve the objectives easily may sometimes even conceal the drawbacks of the strategy or its implementation.

The chances of environmental changes affecting the effectiveness or achievements of the strategy indicate the need for constant monitoring of the environment and modification or reformulation of the strategy, as and when necessary.

An inappropriate strategy may be the result of a wrong diagnosis (of the environmental threats and opportunities or the internal strengths and weaknesses) or of a wrong strategic choice resulting from the faulty evaluation of the alternatives.

In Fig. 1.4, the loop connecting the evaluation to the beginning phase of the strategic management process indicates that strategic management is a continuous process, the evaluation providing the feedback for modifications.

Conclusion

The key to business success is the most effective utilisation of the company's resources (resources here mean not only the existing resources but also the additional resources it can mobilise and augment for any specific task). This involves the evaluation of the company's strengths and weaknesses in the light of the environmental threats and opportunities and taking appropriate measures to harness the opportunities or to combat the threats and formulation of strategies accordingly. Companies which fail to do so are often doomed to failure.

Constant monitoring of the environment and timely and appropriate steps to tap the opportunities and to meet the challenges are essential for success. Environmental analysis will indicate the potential and prospective businesses.

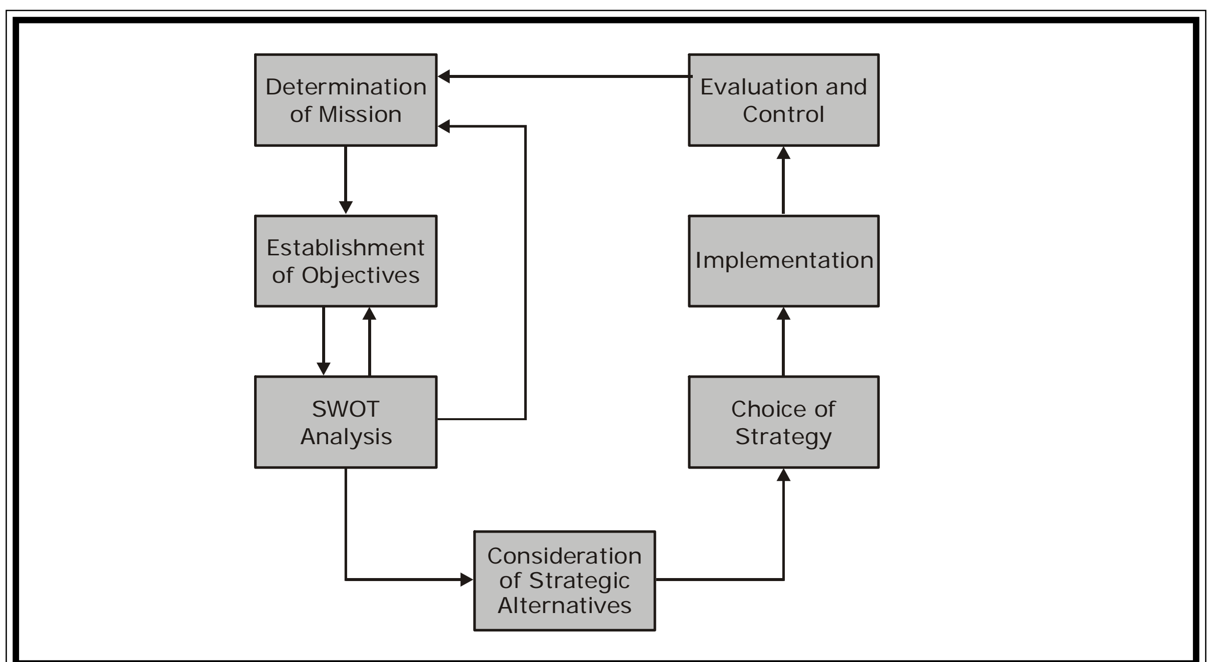

Fig. 1.4 : Strategic Management Process

SUMMARY

Business Environment consists of all those factors that have a bearing on the business.

The survival and success of a business firm depend on its innate strength — resources at its command — and its adaptability to the environment and the extent to which the environment is favourable to the development of the firm. The survival and success of a firm, thus, depend on two sets of factors, *viz.,* the internal factors – the internal environment – and external factors – the external environment. However, the term business environment often refers to the external factors.

The external environment has, broadly, two components, *viz.*, business opportunities and threats to business. Similarly, the organisational environment has two components: strengths and weaknesses of the organisation.

As the company, generally, has control over the internal factors, they are generally regarded as *controllable factors* because it can alter or modify such factors as its personnel, physical facilities, organisation and functional means, such as marketing mix, to suit the environment.

The external factors, on the other hand, are, by and large, beyond the control of a company. The external or environmental factors such as the economic factors, socio-cultural factors, government and legal factors, demographic factors, geo-physical factors etc., are, therefore, generally regarded as uncontrollable factors.

Those external factors which have a direct and intimate impact on the firm (like the suppliers and distributors of the firm) are classified as micro environment, also known as task environment and operating environment. There are other external factors which affect an industry very generally (such as industrial policy, demographic factors etc.). They constitute what is called macro environment, general environment or remote environment.

Figure 1.5 gives a bird's eye view of the important components of the different levels of business environment.

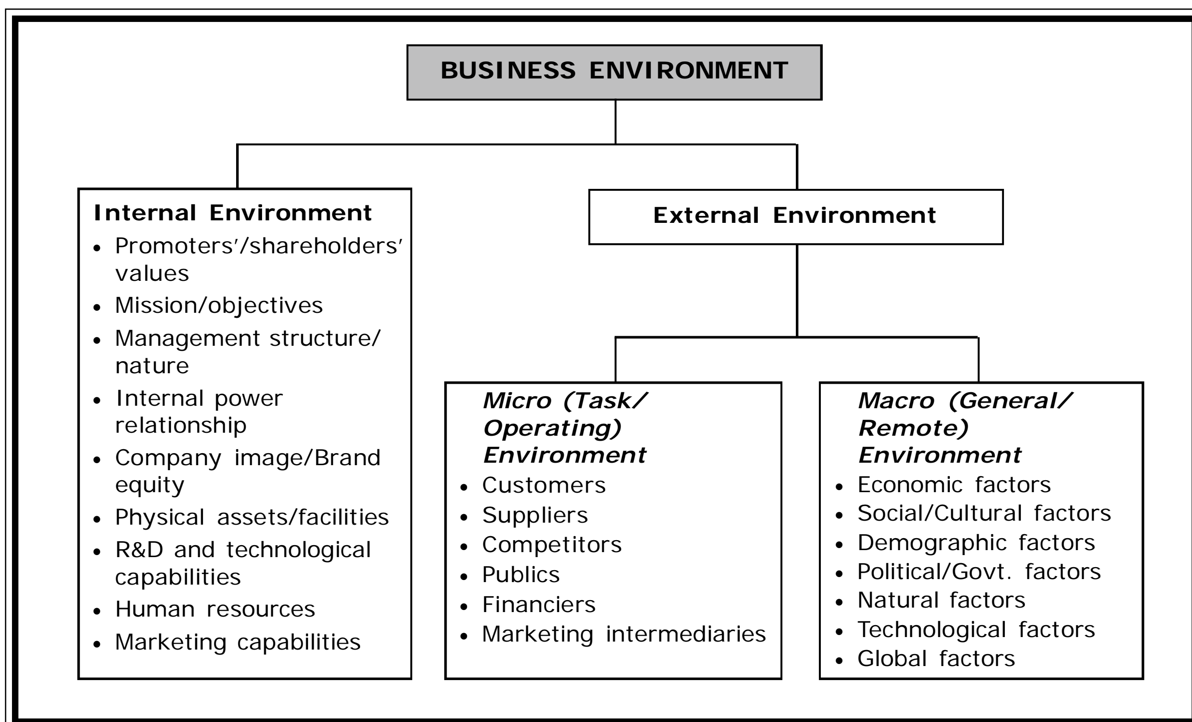

Fig. 1.5 : Components of Business Environment

Strategy is sometimes referred to as a proper firm-environment fit. An analysis of the strengths and weaknesses of the organisation and opportunities and threats in the environment (SWOT analysis) is, in fact, one of the first steps in the strategic management process. Business dynamics, to a large extent, is a dependent factor — it depends on, *inter alia,* the environmental dynamics. Environmental analysis, therefore, is fundamental to management.

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ANNEXURE 1.1

Transformation of Indian Two-wheeler Market

The transformation of the Indian two-wheeler market since the mid-1980s may be taken as a case to illustrate the impact of changes in the business environment on business.

Prior to the initiation of the liberalisation of the Government policy towards this sector in the 1980s, the two-wheeler market in India was a seller's market characterised by long waiting periods for popular brands. The *Chetak* brand of scooter introduced in 1972 by Bajaj Auto Ltd., the flagship company of the Bajaj group founded in 1926, ruled the Indian two-wheeler market as the unchallenged leader for about one-and-a-half decades. The demand for *Chetak* in the highly protected Indian market, which also had a few other firms producing scooters/motorcycles, was so high that the waiting period for getting delivery of it after looking averaged about 10 years.

The main components of policy liberalisation in respect of two-wheelers, initially, were broad banding and permission for foreign collaboration. Broad banding meant defining the product in broad generic terms (two-wheeler) in the industrial license instead of very narrowly as earlier (scooter of 150 cc, motor cycle of 250 cc etc.). When the product was defined in narrow terms, it was necessary to obtain specific license to manufacture every product item and broad banding meant that with the license for two-wheeler the licensee could manufacture any type of two-wheeler. The result of broad banding was freedom for the manufacturers to decide the product mix as per the market demands and their strategy, increase in competition and better choice for consumers. The seller's market attracted new players. Lohia Machines which entered the scene with technical collaboration with Piaggio of Italy garnered good advance booking for its scooters even before it commenced production because of the high pent up demand for scooters in India. The amount of money which Lohia Machines moped up by advance booking before it had put up the production facilities for its yet-to-be introduced scooter was said to be more than the capital investment requirement for plant and machinery. Since 1986, it introduced different models of scooter (*LML Vespa* brands).

It is, however, the advent of the new generation fuel-efficient motorcycles with Japanese collaborations that posed real challenge to Bajaj. The new competition started with the launch of the 100 cc *TVS-Suzuki* in 1984. Since 1996, TVS-Suzuki introduced several technologically well-improved motorcycle models. A much greater challenge to Bajaj came from *Hero Honda* which entered the market in 1985 with the highly fuel-efficient CD100 with its blockbuster ad punchline "fill it, shut it, forget it." It soon penetrated the market well and the Indian two-wheeler landscape was for a spectacular change in favour of the new generation products, with the excitement of the youth increasing with the competitive introduction of newer and newer models by different players.

The shift in the demand pattern for two-wheelers was caused by socio-economic and demographic changes that the nation was undergoing. The new generation motorcycles excited the youth market, the size of which was growing fast. The growing disposable income fostered the demand growth. The increase in the number of women employees and the attitudinal change (as in the case of ladies' riding two-wheelers) and the advent of two-wheelers like *Kinetic Honda* and sub 100 cc scooterette, like TVS's *Scooty,* which could be started by turning the key as against kick-starting the old generation two-wheelers attracted women employees and girl students to these products. Kinetic, with several foreign collaborations, introduced a slew of models targeting, particularly, the female segment. Factors like convenience of carrying gas cylinder also made *Kinetic Honda* an attractive two-wheeler and it came to be regarded as a product that fit well the ladies and gents.

The delicensing and further liberalisation of foreign investment policy (allowing even 100 percent foreign equity) added further momentum to the transformation of the two-wheeler market. Honda now has a wholly owned subsidiary in India to manufacture and market two-wheelers. TVS and Suzuki amicably parted ways long back. After severing the technical ties with Suzuki, TVS's performance has only improved, thanks to the emphasis on process improvement and R&D and astute marketing strategies, with added thrust on globalisation.

The technological improvements which made the products user-friendly and improved the operational efficiency helped to increase the demand for two-wheelers. The inadequacies and the poor state of the public transport system have also been contributing to the increase in demand for the two-wheelers. The introduction of technologically improved and better designed newer and newer models, a corollary of the heightened competition, has kept the demand growing. When the growth trend in the cities and large towns began to become discouraging, semi-urban and rural areas began to gain important place in the marketing strategy of companies.

The easy availability of finance and fall in the interest rates also significantly contributed to the demand boom in the two-wheeler market. The increase in disposable income, easy and cheap credit and changing consumer attitude also encouraged the migration of two-wheeler owners to cars, in many cases first to a second hand car and later to new/higher segment cars.

The sweeping changes in the competitive environment triggered by changes in the government policy and fostered by socio-economic and demographic transformation have brought about a profound structural change in the Indian two-wheeler industry. The market for the traditional type of scooters (like the Bajaj's old models) shrunk substantially and they have been phased out. Some popular two-wheeler firms like Jawa Motor Cycle (which manufactured the popular motorcycle brands *Yezdi*, *Road King* and the export brand *Oil King*) and popular models like *Bajaj Chetak* and *Rajdoot* disappeared from the scene.

Hero Honda not only unseated Bajaj Auto from No. 1 position in the Indian market but also has been world's No. 1 since 2001. Its *Splendor* emerged as the largest selling motorcycle during three years since 2000.

Bajaj Auto, however, is now doing well in the domestic market, although the legendary scooter *Chetak* is no more on the scene, and is increasing its global presence, because of attaining global competitiveness by a series of measures which substantially improved innovativeness and efficiency to compete assiduously to entice consumers with better fuel efficiency, technological features, styling, after-sales service and financing arrangements. Serious attempts are on to expand the overseas markets.

How has Bajaj faced this challenge of technological sophistication and customer delight-oriented transformation of the Indian two-wheeler market?

Bajaj sought to counter the new competition from other scooters by emphasising the low maintenance cost and fuel efficiency of Bajaj scooters. But it became very obvious that the real threat was from the motorcycles. In a bid to check the erosion of the scooter's share of the two-wheeler market, Bajaj unleashed a new promotion, positioning scooter as a family vehicle with ads showing a whole family happily on a scooter. Further, the well-known *Hamara Bajaj* campaign bliz sought to bank on the *swadeshi* sentiment so as to make the Bajaj scooter appealing to the consumers. However, the decline of the traditional scooter segment was sure to be steep. In 1986, Bajaj introduced a 100 cc bike in collaboration with Kawasaki of Japan strategising that "if the motorcycle is eating into the market of scooter, let our own bike take a share of it."

The critical elements of Bajaj Auto's growth are indicated below.

- Internationally competitive R&D capabilities
- Proven technological know-how
- Cost and quality balance
- Unique designs
- Products in sync with market needs
- Warranty and trained service support
- Distribution network covers 50 countries
- Dominant presence in several countries
- All products customised as per market needs

The message of the above factors is that those domestic firms which can measure up to global standards can survive well in the domestic market and also expand its business to foreign markets while those firms which fail to attain global competitiveness will become insignificant or vanish.

The transformation of the two-wheeler industry has been caused by changes in the:

- Political/government/regulatory environment
- Technological environment
- Competitive environment
- Economic environment (including financial sector environment)
- Socio-cultural and demographic environment

Political/government/regulatory environment can seriously impact the business. The industrial policy changes (broad banding and later delicensing and policy changes in respect of foreign technology and capital). Liberalisation of policy in respect of foreign technology/capital enabled Indian firms to launch new business/products. This increased competition benefited consumers.

As 100 per cent FDI was not allowed initially, foreign firms had to enter the Indian market via joint ventures; later when 100 per cent FDI became possible foreign firms could establish wholly owned subsidiaries. This has tended to encourage foreign firms to reconsider their collaborations with Indian firms and go it alone. This has changed the competitive dimensions of the two-wheeler industry. It also made Indian firms to give added thrust to R&D. Further, it also indicates that changes in Government policy can also influence the market entry strategy of foreign firms (for example, joint venture versus wholly owned subsidiary).

The new generation two-wheelers and the rising disposable income and socio-demographic changes significantly increased the demand for two-wheelers.

Changes in the Government policy increased competition, to the benefit of the consumers and the two-wheeler industry itself. Changes in the financial sector environment – competition between banks and other financiers, ease of obtaining finance and relatively low interest rates helped boost the demand for two-wheelers and cars.

Changes in the consumer attitude, economic position and financial sector environment cause consumer migration from one product category to another serving the same basic need

(here transportation) but according more convenience/utility and social status. Socio-economic and demographic changes often cause changes in demand pattern or bring in new patterns of demand (for example, demand for products like Kinetic Honda and Scooterette). Such changes open new opportunities that could be seized by companies. Such changes can also cause threat to existing products/firms calling for changes in their product/over all business strategies.

Bajaj which was highly dominant in the scooter market exited this segment and is concentrating on motor cycles. Honda is taking advantage of the expanding scooter market with new generation scooters.

Indian two-wheeler firms like Bajaj, Hero and TVS have given a lot of thrust to R&D and they have been putting up a good fight to the foreign firms. They have also been expanding their foreign business.

Firms which fail to respond to the changing business environment by improving operational efficiency, modifying product mix, becoming innovative and, in general, very competitive would vanish.

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Chapter 2

NATURE, SCOPE AND OBJECTIVES OF BUSINESS

Structure

Business System/Process

Classification of Business

Classification of Industries

Characteristics of Business

Goals of Business

Summary

References

The term business is used in different senses, varying from the scope of the main economic activity of an individual/firm, type of economic activity to the whole gamut of industrial and commercial activities associated with them.

According to the *Chambers Dictionary,* the word business means employment, trade, profession or occupation; a task or errand incumbent or undertaken; commercial activity; a commercial or industrial concern, etc. Thus, the term "business" is used in different senses. In a functional sense, it is used to refer to the functions or activities of an organisation or individual. Sometimes, it is used to the enterprise or unit running the business. The term is also used in a very broad sense to embrace the whole business system, comprising the whole gamut of industry and commerce.

The term business encompasses all those economic activities related to production and exchange of goods or services for money or an economic return.

BUSINESS SYSTEM/PROCESS

The actual exchange of goods or services for money (*i.e.,* sale) is only one of the last activities in the business stream. There are many activities directed at the production of the goods/ services and the marketing which goes much beyond the selling.

There are many prerequisites for production. Factors of production have to be obtained and efficient production facilities set up. Arrangements have to be made for the timely availability of raw materials and all other required inputs. A variety of activities are involved in the marketing of the output. A business unit may undertake all or some or one of these activities. Figure 2.1 gives a summary view of the spectrum of the business process.

Taking a total view of the macro business system, business starts with the entrepreneurial activity of organising the factors of production like land, labour, capital, technology etc. Note that procurement of each of these may involve several business activities.

The next stage is production, *i.e.*, bringing out the product to be marketed, using the factors of production.

The next stage, *i.e.*, marketing, may involve numerous activities associated with distribution and after-sales service.

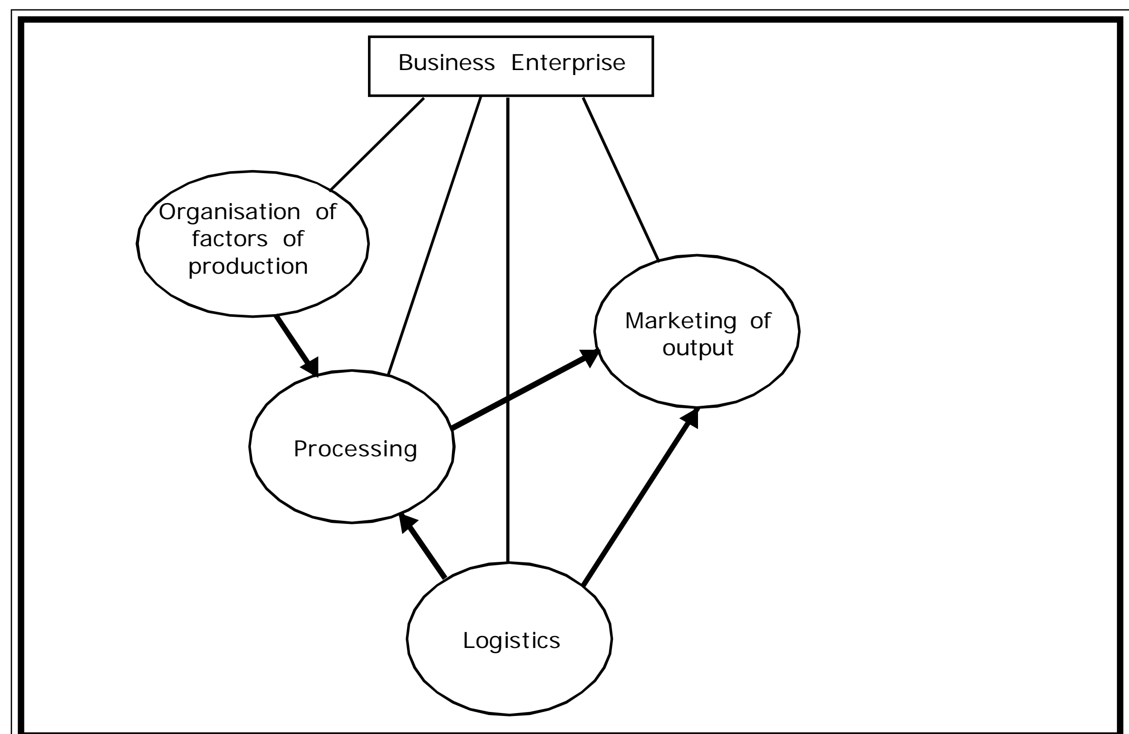

Fig. 2.1 : ***Business System***

The model represented here is an aggregation of macro business system which may encompass numerous business activities of varying nature and dimensions. Each of some of these activities may constitute a business. For example, the marketing stage may involve different businesses like sole distribution, wholesaling, retailing, transportation, warehousing, financing etc.

Figure 2.2 and description of it, under the section *Characteristics of Business*, provides further elaboration.

BUSINESS SECTORS

The business sector consists of two main sub-sectors, *viz.*, industrial sector and the tertiary (services) sector. The industrial sector consists, mostly, of the manufacturing activities. Activities like generation of electricity and construction are also included under the industry.

The services sector includes trade and commerce, insurance, banking, professions, transport, repairs and maintenance and a host of other activities. It has been the fastest growing sector in most of the economies. Development of industrial and agricultural sectors requires a variety of services. Major part (nearly two-thirds of the total in the) of the income and employment in most of the economies is generated by the services sector. The contribution of this sector to the GDP is more than 60 per cent in the developed economies and nearly 50 per cent in the developing economies.

A host of services are involved in the organisation of factors of production, procurement of inputs and marketing of the output. Innumerable number of business enterprises and individuals are involved in the provision of different services.

In short, the scope of business is very wide indeed and it encompasses a gamut of economic activities of different nature — organisation of production through distribution and sale of the product to after-sales service.

CLASSIFICATION OF BUSINESS

The following classification[1] of business enterprises elucidates the broad scope of business.

1. Business which Produce Goods

Broadly, there are two categories of goods. They are:

(i) Commodities

(ii) Products

Commodities are the goods produced by the *primary* sectors, *i.e.*, agriculture and mining.

Products are goods produced by the *secondary* (*i.e.*, manufacturing) sector. In other words, they represent manufactured or processed goods, unlike commodities which have not undergone any processing or manufacturing. Wheat, for example, is a commodity whereas wheat flour is a processed product. Similarly, tomato is a commodity whereas tomato sauce is a processed product.

Important types of enterprises which come under business which produce goods are:

(a) Farms, dairies and other agricultural producers.

(b) Mines, fisheries, lumbering enterprises and others which extract natural resources.

(c) Manufacturing enterprises.

1. Those producing machinery, materials or supplies for other business enterprises.
2. Those producing goods for consumption.

2. Businesses which Produce Service

An economy has three major sectors of economy, namely, the primary sector, secondary sector and the tertiary sector. Reference to the primary and secondary sectors have been made in the preceding section.

The *tertiary* sector is the sector which provides services. As an economy develops, the share of the services sector in the total employment and income increases. The advanced economies, like the United States of America, Canada, West European countries and Japan are mostly service economies in the sense that the major share of the total employment and national income are generated by the services sector. The services sector accounts for about two-thirds of the gross domestic product (GDP) of several advanced countries and over 50 per cent of the developing countries. The share of services in the GDP of India increased from 39 per cent in 1980 to 56 per cent in 2005. These figures clearly indicate that the services sector is the fastest growing of the three sectors and that the dynamic services sector holds out enormous business opportunities.

In most of the economies, the major part of the income and employment is generated by the service sector.

The services sector includes not only the business which produce services but all the following types of businesses listed here (that is serial number 2 to 5).

Businesses which produce services include:

(a) Transportation enterprises
(b) Telephone and telegraph companies
(c) Producers of electric light and power
(d) Hotels, restaurants and other producers of services of food and shelter
(e) Enterprises furnishing household services like laundries
(f) Enterprises providing entertainment like theatres
(g) Enterprises providing IT services

3. Businesses which Distribute Goods

Businesses which distribute goods also come under services.

Distribution, which is one of the very important functions of marketing, encompasses all those activities associated with moving the product from the producer to the consumer.

Businesses which distribute goods include:

(a) Wholesale merchants of various types
(b) Retail merchants of various types
(c) Importers and exporters

4. Businesses which Facilitate Distribution of Goods

There are different types of firms which aid or facilitate the distribution of goods, *viz*.,

(a) Warehouses and other storage businesses.
(b) Auction houses, exchanges and other enterprises which afford places of trade.
(c) Transportation firms.

(*d*) Advertising firms

(*e*) Financing firms.

5. Businesses which Deal in Finance and Financial Services

Modern Business firms depend to a large extent on funds raised from external sources. There is indeed a variety of businesses which facilitate this. Many of these firms now offer a variety of financial services. It is in fact one of the important prospective areas of business.

They include:

(*a*) Commercial banks, cooperative banks and indigenous banks

(*b*) Development banks

(*c*) Merchant banks other financial services firms

(*d*) Insurance companies and investment firms

(*e*) Stock exchanges

Production, Trade and Ancillary Services

Another way of looking at the total business system at the macro level is to consider it as consisting of the two major functions of production and trade and a number of ancillary services which facilitate production and trade. This is depicted in Fig. 2.1.

Commerce bridges the place gap and the time gap between the producer and the consumer.

We have seen that the scope of business is so wide that it encompasses all those activities facilitating production and marketing of goods and services. We have also seen in the preceding sections the important categories of activities which come under business.

One traditional classification of business is into industry and commerce.

Industry is concerned with the production of goods and services whereas commerce involves all those activities encompassing the trade in goods and services.

CLASSIFICATION OF INDUSTRIES

Industry consists of all those firms which produce goods and services. In other words, industry is that part of the business which creates *form utility* (*i.e.*, by converting the material from one form to another; for example by converting the raw material into finished product).

The term industry eludes a satisfactory definition. An industry may be defined as a group of firms competing against one another. Thus, the tyre industry, for example, is made up of all the tyre manufacturing firms, like MRF, Dunlop, Ceat, J.K., Apollo, Vikrant, etc. Similarly, firms like Hindustan Unilever, Godrej, Wipro, Nirma and so on constitute the soap industry. In a monopoly, there is, however, only one firm. Further, there may not be any competition between different firms in a nationalised industry. It should also be noted that many firms manufacture and market products belonging to different industries. For example, the product lines of Hindustan Lever include soaps and detergents, talcum powder, toothpaste, agro-chemicals, edible oils, cattle feed etc.

Industries may be classified on the bases of use of the output, ownership category, size etc.

CLASSIFICATION BASED ON THE NATURE OF ACTIVITY

One of the important types of classification of industries is the basis or the nature of the activity, as given below.

1. *Extractive Industries:* These are industries which extract goods from the natural sources and these include farming, lumbering, fishing, mining and oil extraction. Their outputs are mostly 'commodities.'

2. *Genetic Industries:* These are industries related to genetics or breeding. Examples include breeding animals, birds and plants. Biotechnology (BT) has emerged as a very dynamic segment of this industry.

3. *Manufacturing Industries:* Manufacturing industries process raw materials into intermediates or finished products. The manufacturing industries may be broadly classified into basic industries (*e.g.,* iron and steel); capital goods industries (*e.g.,* machines); intermediate goods industries (*e.g.,* tyres and tubes) and consumer goods industries (*e.g.,* refrigerator, soap).

4. *Construction Industries:* It is a booming industry in developing countries like India and involves construction of roads, railways, bridges, harbours, dams, canals, buildings etc.

5. *Service Industries:* As mentioned earlier, the services sector is the most dynamic sector of the economy in many countries. The service industries include a host of services like banking; insurance; transportation; services of professionals like doctors, lawyers, consultants etc.; services of advertising and market research firms; financial services and so on.

6. *IT Industries:* One IT industry is a sunrise industry. Several segments of it fall within the service sector. It is a major industry facilitating and driving the growth of a number of other industries.

CLASSIFICATION BASED ON COMPETITIVE STRUCTURE

With respect to the competitive structure, there are the following forms of industries.

1. *Monopoly:* Monopoly is a market situation characterised by a single-firm industry. There is, thus, no competition. The Indian Railways is example of monopoly. As there is only one firm in a monopoly industry, the consumers are likely to be exploited because of the absence of competition. It is, therefore, necessary to have effective government control of private monopolies. The Monopolies and Restrictive Trade Practices (MRTP) Act was the major law to control monopoly power in India. The MRTP Act was replaced by the Competition Act.

Liberalisation and globalisation have been changing the competitive structure of industries.

In some sectors, economies of scale may justify monopoly because fragmentation would result in high cost. There had been a tendency to establish public sector monopoly in such areas. The trend, however, has been changing.

If there is only one buyer of a product, that situation is described *as Monopsony* (Monopoly refers to single seller). If the situation is one of the single seller and single buyer, that is known as *bilateral monopoly*.

2. *Duopoly:* Duopoly is an industry or competitive situation characterised by only two firms (*i.e.,* sellers). The caprolactum industry in India was characterised by duopoly situation.

3. *Oligopoly:* If an industry consists of only a few firms (producers/sellers), it is known as oligopoly. If the major chunk of the market, say 80 or 85 per cent, is accounted for by a few firms and even if there are a number of firms for the remaining share, it may be regarded as a case of oligopoly.

Two forms of oligopoly can be distinguished — perfect oligopoly where the product is homogeneous and imperfect oligopoly when some degree of differentiation exists between the products of different firms.

Several high-tech industries are oligopolistic in nature. In India, industries such as automobile and computer hardware had been under oligopoly. The liberalisation, however, has been bringing out a change.

The global liberalisation and the resultant mergers and acquisitions (M&As) are leading to the emergence of an oligopolistic condition in several industries.

It has been observed that although a number of firms exist in some industries during certain periods, in due course the number of firms shrink either because firms which become sick or weak are closed down or because some firms are taken over by others.

Collusive pricing (all the firms jointly deciding the pricing strategy) or price leadership (*i.e.*, the leading firm initiating price changes and others following it) are common under oligopoly.

Restrictive *cartel* practices such as output restrictions, market sharing and collusive pricing are some of the evils of oligopoly. As cartels for such restrictive practices are illegal, firms may form cartels secretly or informally.

4. *Monopolistic Competition:* Monopolistic competition or industry is characterised by the existence of a large number of firms selling products which are close, but not perfect, substitutes. Product differentiation is an essential feature of monopolistic competition. The more differentiated is the product of a firm from those of others, the greater may be its competitive advantage and freedom in pricing. Firms in the oligopolistic competition also often incur selling costs for bringing about product differentiation through promotional strategies and to market the product.

The textile industry is an example of monopolistic competition. Although some industries like sugar may be regarded as monopolistic on the basis of the number of firms, there is hardly any product differentiation. Similarly, although on the basis of the number of brands available, the toilet soap industry may appear to be monopolistic, while considering the number of firms it tends more towards oligopoly because the major chunk of the market is controlled by a small number of firms like Hindustan Lever, Godrej, Wipro, Colgate-Palmolive, P&G, Nirma etc.

The main advantage of monopolistic competition is that consumers have good choice and get the benefits of competition (like attention to quality, after-sales service, cost etc.). It is, however, argued that monopolistic competition means a lot of waste of resources from the society's point of view. Product differentiation in several cases is superfluous and selling costs are a social cost.

5. *Perfect Competition:* Perfect competition is a situation characterised by a large number of firms selling homogeneous products and each firm accounting for a very insignificant share of the market so that no single firm has any control over the market.

The requirements for or features of perfect competition are: *(i)* large number of firms; *(ii)* homogeneous products; *(iii)* free entry and exit (*i.e.*, there should not be any artificial restrictions on the entry of new firms and for the exist of existing firms); *(iv)* perfect knowledge on the part of the buyers and sellers about the conditions in the market; *(v)* complete mobility of factors of production between industries; and *(vi)* no transport costs (transport costs cause price distortions).

When the first three conditions mentioned above are satisfied, it is a case of *Pure Competition.*

Under perfect competition, a firm earns only *normal profits* which is defined as those profits which are just sufficient to induce the firm to stay in the industry, if there are supernormal profits, this will attract new firms and drive down the profits. If a firm is not able to earn normal profits, it would leave the industry.

Although perfect competition is generally regarded as an ideal situation (because firms earn only normal profits and there is no exploitation of consumers), it rarely exists as it is very difficult

for all the conditions of perfect competition to be satisfied. Although several standardised products are turned out by large number of firms (examples: nuts and bolts, screws, nails etc.), some of the requirements of perfect competition like perfect knowledge of market conditions on the part of the buyers and sellers may be non-existent.

The major disadvantage of perfect competition is absence of variety and this limits consumer choice.

SIZE-BASED CLASSIFICATION

On the basis of the size of the capital investment, industries may be classified into tiny, small, medium and large-scale industries.

USE-BASED CLASSIFICATION

On the basis of the nature of the output and its use, industries are classified into basic industries, capital goods industries, intermediate goods industries and consumer goods industries.

Use-based classification is often used to evaluate the performance trends and the structural transformation of the industrial sector.

Basic Industries: Basic industries are those industries which provide essential inputs for the development of other industries and the economy. In other words, these are industries which provide bases for development of other industries. For example, the iron and steel industry forms a basis for the development of the engineering industry. Fertiliser is regarded as a basic input for the agriculture. Coal, oil and electricity are also regarded as basic industries because growth of modern industry depends on the supply of these vital inputs.

Capital Goods Industries: Capital goods industries are those industries which produce machinery, equipment or tools. A capital good is one which is instrumental in producing other goods or services. The capital goods do not directly serve any consumption requirement. They are used to produce consumer goods (and other goods) and services. The capital goods industries are capital intensive in nature, *i.e.*, they require heavy capital investment.

Intermediate Goods: Intermediate goods are goods which have already undergone manufacturing process but which form inputs for other industries as material for further processing, part or component.

Consumer Goods Industries: Consumer goods industries are those industries the output of which serve the final consumption requirements. The consumer goods may be broadly classified into *Consumer Durables* and *Consumer Non-durables*. Consumer non-durables are those goods which are used up at once or within a relatively short period, like foodstuffs, cigarette, soap, electric bulb, etc. Consumer durables, on the other hand, serve the consumers over a relatively long period, like car, bicycle, electric fan, television, refrigerator, etc. A distinguishing characteristic of the consumer durables is that their life or service may be extended by repairs.

The following list shows important industries that come under the different categories.

I. Basic Industries

- Mining and quarrying
- Fertilisers
- Heavy inorganic chemicals
- Cement
- Iron and steel basic industries
- Non-ferrous basic metals
- Electricity

II. Capital Goods Industries

- Hand tools and small tools
- Specialised equipment
- Machine tools
- Agricultural machinery (tractors)
- Heavy electrical equipment
- Electric cables and wires
- Railroad equipment
- Heavy vehicles

III. Intermediate Goods Industries

- Cotton spinning
- Jute textiles
- Tyres and tubes
- Synthetic resins and plastics
- Man-made fibres
- Dye-stuffs
- Products of petroleum and coal (petroleum refinery products)
- Bolts, nuts, nails, screws, springs, chains, etc.
- Manufacture of metal
- Dry cells

IV. Consumer Goods Industries

A. Consumer Durable Goods

- Electric fans
- Telecommunication equipment
- Motorcycles and bicycles

B. Consumer Non-durable Goods

- Food manufacturing
- Tobacco manufactures
- Cotton weaving
- Paper and paper product
- Rubber footwear
- Drugs and pharmaceuticals
- Soaps and glycerine
- Electric lamps

Input-based Classification

On the basis of the nature or source of the major input, industries may be classified into agro-based, forest-based, marine-based, metal-based, chemical-based, etc.

An agro-industry is one which uses agricultural product as the major input, like the sugar, jute textile and cotton textile industries.

Similarly, forest-based industries are those which use forest products as their major inputs, like the plywood industry, paper industry, etc.

Industries which depend mostly on marine products like fish are generally regarded as marine-based industries.

Metal-based industries, as the name indicates, are those industries which are based on metals, like the engineering industries.

Industries like fertilisers, pesticides, paints and varnishes, dyestuffs, drugs and medicines, aromatics, etc. are regarded as chemical-based industries as chemicals are their major or basic inputs.

Proprietary-based Classification

On the basis of the nature of ownership, industrial undertakings are grouped under public, private, joint and cooperative sectors.

In India, public sector played a dominant role in the strategic, basic and heavy industries. The private sector dominates many consumer goods industries and plays an important role in a number of other industries. The cooperative sector plays a very important role in industries like sugar, cotton textiles and fertilisers. The joint sector where both the government/public sector and private sector jointly own the enterprise also exist in some areas.

CHARACTERISTICS OF BUSINESS

Business characteristics are multidimensional.

Business, defined as any activity carried out with the intention of making financial benefit, has the following characteristics.

Exchange of Goods or Services for Income: Business invariably involves the exchange of goods or services for income, mostly by money payments. The buyers must get or at least expect to get some satisfaction to make them buy the goods or services. Hence, it would be more appropriate to say that business involves exchange of goods or services for consumer satisfaction and income.

Recurring Activities: The activities of a business enterprise are normally recurring in nature and it operates more or less continuously. This does not, however, mean that a firm engaged in a business of seasonal nature should necessarily be having business even during the off-season or that there should not be any lock-outs or lay-offs.

Profit Motive: Profit motive is another general characteristic of business enterprises. This naturally influences the choice of products, market segments, technology, plant size, pricing strategy etc. Although some public sector firms do not aim to make profits, many public sector firms aim at generating profits.

Risks: Business involves several risks. Indeed, one of the economic theories of profit regards profit as a *reward for risk bearing*. Common risks in business pertain to changes in technology, consumer tastes and preferences, supply conditions, competitive situation, demand conditions etc.

DYNAMICS OF MODERN BUSINESS

Several characteristics of modern business are embedded in the emerging trends and other dynamics of the business environment. The important ones include the following.

Strategic Orientation: Strategic management may be defined as establishing a proper firm-environment fit. A firm may have certain strengths and weaknesses and the business environment presents opportunities and threats. The industry characteristics, including competitive situation, market characteristics, technological factors often change. Based on the assessment of internal and external factors, a dynamic firm will define the scope of its business with future perspective and competitive intent.

Global Orientation: The liberalisation and the resultant global competitive dimensions have made global orientation inevitable for survival. Globalisation makes the business environment increasingly global even for domestic firms. As Peter Drucker cautions in his *Management Challenges for the 21st Century*, "all institutions have to make *global competitiveness* a strategic goal. No institution, whether a business, a university or a hospital, can hope to survive, let alone to succeed, unless it measures up to the standards set by the leaders in its field, any place in the world." The major competition which many Indian firms encounter in the home market now, for instance, is from foreign firms – they now face a substantially growing competition from goods produced in India by MNCs and imports. For example, although its market is confined almost entirely to India, the competition which *Nirma* encounters is indeed global. Its major competitors include MNCs like Unilever, P&G, Colgate-Palmolive, Henkal etc. Besides, there is also competition from imported products. Thus, many firms in their own home market face the technological, financial, organisational, marketing and other managerial prowess of the multinationals. Global orientation, therefore, is essential. Global orientation does not necessarily mean that a firm should be marketing its product globally. It essentially means taking advantage of the global opportunities (including technological developments, global sourcing opportunities etc.) and/or gearing up to global standards making itself capable of facing global competition.

Strategic and global orientations, moulded by professionalism, are the major drivers of modern business.

International firms are increasing their global reach and business and more and more of them are becoming global. According to the *World Investment Report* 1995, there were more than 40,000 MNCs in the world with more than 2.5 lakh foreign affiliates; according to the *World Investment Report 2009,* the number of MNCs increased to about 82,000 with about 8 lakh foreign affiliates.

Professionalisation: The growth of management education and training has contributed to the growing professionalisation which, in turn, has contributed to the growing social orientations of business.

Professionalisation imparts a certain social responsibility and dignity to management. According to Lewis Allen, "a professional manager is one who specialises in the work of planning, organising, leading and controlling the efforts of others and does so through a systematic use of classified knowledge, a common vocabulary and principles, and who subscribes to the standards of practice and code of ethics established by a recognised body."[2]

In this connection, Peter Drucker observes: "Management is independent of ownership, rank, or power. It is objective function and ought to be grounded in the responsibility for performance. Professional management is a function, a discipline, a task to be done; and managers are the professionals who practice of this discipline, carry out the functions, and discharge these tasks, it is no longer relevant whether the manager is also an owner; if he is it is incidental to his main function, which is to be a manager."[3]

A professional has enormous responsibilities. He shall not use his knowledge, skill and authority unscrupulously. He shall not knowingly do harm to his customers. He is socially bound by the ethics of his profession.

In India, several family-controlled companies have also very appreciably professionalised the management.

Strategic Operations Management In an intensely competitive market, only those firms who win the race in satisfying the consumers *vis-à-vis* product features and performance, price, delivery, services etc. can survive. It is, therefore, necessary to take a holistic view of the business system that encompasses the key determinants of the success of a firm. Figure 2.2 presents a schematic outline of the production and logistical factors making up the business system.

The business system, thus, involves the integration and management of diverse activities. On the one extreme, a firm may undertake all of these different activities, carrying on the whole production process and doing all the other operations encompassing the business system. On the other extreme, a firm can outsource most of these. Many firms now concentrate on its core competence/business and outsource the rest.

Each of the major phases of the operations shown in Figure 2.2 involve different operations and operations management encompasses all of them.

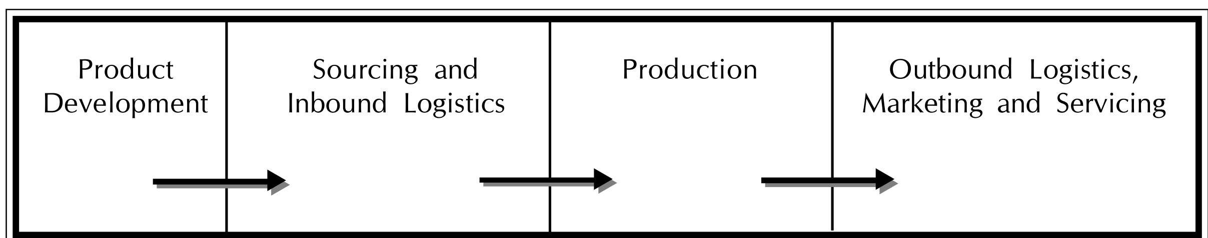

Fig. 2.2 : ***Business Process***

Operations management is becoming more and more internationally ubiquitous and conspicuous. Even a firm which markets the products only with in the domestic market may be conducting its business operations internationally like sourcing the inputs or finished products internationally or manufacturing the product abroad. A dynamic company will take advantage of the favourable conditions that exist anywhere in the world.

Operations management involves a number of strategic decisions such as make or buy?; if buy, from where to buy?, to go for partnering or not?; in which country and place to locate the manufacturing or other facilities; logistical factors and so on.

Operations management, in fact, is, to a very large extent, supply chain management. The scope of the supply chain includes procurement, production and distribution operations and it extends across organisational boundaries.

The ultimate objective of supply chain management is to "deliver products to market with variety, responsiveness, timeliness and efficiency. Corporate strategy must include organising, coordinating and executing the process of product flow as a competitive necessity and as a source of potential competitive advantage. The strategic requirements of international business determine the extent, characteristics and strategic direction of the supply chain."[4]

Managing the supply chain is also managing the value chain. As Michael Porter points out, a firm's value chain is an important determinant of competitive advantage.[5] Value is the amount buyers are willing to pay for what a firm provides them. The total revenue reflects the value. Creating value for buyers that exceeds the cost of doing so is the goal of any generic strategy. Operational efficiency is an important determinant of cost.

The value chain displays total value and consists of value activities and margin. Value activities are the physically and technologically distinct activities a firm performs.

There are, broadly, two types of value activities, namely, *primary activities* and *support activities*.

Primary activities are hard-core business functions and include: *(i)* inbound logistics (activities associated with receiving, storing and disseminating inputs to products); *(ii)* operations (processing activities); *(iii)* marketing and sales; and *(iv)* services.

Support activities are basic requirements and facilitating functions and include: *(i)* procurement (purchasing of inputs), *(ii)* technology development, *(iii)* human resource management and *(iv)* firm infrastructure (includes general management, planning, finance, accounting, legal and government affairs and quality management).

Each of the these activities may be subdivided into several activities. For example, marketing and sales include activities such as advertising, sales promotion, sales force management, marketing research etc.

A firm gains competitive advantage by performing these strategically important activities more cheaply or better than its rivals. As Porter counsels, a firm should strive to understand not only its own value chain activities but also of the competitors', distributors' and suppliers'.

Technological convergences and overlaps are critical features of emerging businesses.

Technology Overlaps and Integrated Systems There is an increasing overlapping and integration of technologies in a growing number of products/industries. For example, a modern motor car is characterised by integration of mechanical, electrical and electronic technologies. The digital technology is finding fast expanding applications in very diverse fields. As Hamel and Prahalad point out in their best seller, *Competing for the Future*, "many of the most exciting new opportunities require the integration of complex systems rather than innovation around a stand-alone product. Not only does no single business unit have all the necessary capabilities, neither does a single company or country. Few companies can create the future single-handedly; most need a helping hand. Motorola, IBM, and Apple banded together to create a new semiconductor-based computer architecture. Hoping to take advantage of the potential convergence between the videogame industry and the telecommunications industry, AT&T has formed partnerships with, or taken small equity stakes in, a number of computer game makers. Even Boeing has often found it necessary to reach out to foreign partners for the development of its next-generation aircraft."[6]

Restructuring The environmental changes make firms to restructure their business portfolio, product mix, markets, finance and organisation. Restructuring may be confined to any one of them or may pervade some or all. Companies exiting some businesses or entering new ones or doing both are common. Organisational and financial restructuring have also been common.

Focus and Diversification For some time now, there has been a universal trend towards focus one or very few businesses instead of a highly diversified portfolio of business. Many diversified companies have *unbundled* the portfolios.

Al Ries in his recent book *Focus: The Future of Your Company Depends on It* provides numerous examples of corporate disasters resulting from unfocusing encouraged by the ambition to grow fast and certain perceptions regarding business stability and optimisation of resource use, for several decades companies expanded into many diverse businesses. Ries observes that a successful company usually starts out highly focused on an individual product, service, or market. Over time, the company becomes unfocused. It offers too many products and services for too many markets at too many different price levels. It loses its sense of direction. It doesn't know where it's going or why. Its mission statement loses its meaning.[7]

Corporate portfolio restructuring are characterised by focus and diversification, either single directionally or simultaneously.

Many companies entered diverse areas by establishing greenfield enterprises and acquisitions. The objectives and expectations, however, took a rude beating; the effects on bottom-lines and shareholder values were disastrous or distressing. A number of companies sold more of their acquisitions and businesses than they choose to hold. A study of acquisitions/divestitures since around mid-l980s to mid-l990s by Ries shows the existence of a six-year itch, *i.e.*, most of the acquisitions were divested after a period of around six years.

Ries cautions that focus is not for ever. Sooner or later even the most powerful focus becomes obsolete. That is when a company must refocus itself. On the other hand, focus is not a fashion that ought to be changed a very few years. The time frame is like decades rather than years. Then too, it depends on the industry. Rapidly changing high technology industries will wear out a focus much faster than low technology industries will.[8]

Many companies have also been diversifying their business portfolio, taking advantage of the emerging opportunities like those resulting from the liberalisation. Another dimension of diversification is related to focus – expanding the product mix to cater to the diverse requirements or tastes of the market/customer group the company is focusing on.

Coexistence of Different Sectors Most industries are characterised by different sectors like tiny, small, medium and large scale units. It is common to speak of the organised and unorganised (mostly small-scale) sectors. They are also called formal and informal sectors. The competitive strategies of these sectors may differ. In many industries, the unorganised sector poses severe threat to the organised sector due to factors such as low price. For example, one major challenge the organised sector P.C. firms face is the low price of the personal computer marketed by local assemblers. Factors such as tax concessions, low labour and overhead charges enable the unorganised sector to price the products low.

Fast Changes Changes in several facets of business have been increasingly faster. Product obsolescence is widespread. Brand, and even product, life cycles are becoming shorter and shorter. Product modifications and systems improvements are becoming increasingly important.

Segmentation Market segmentation is becoming more and more extensive**.** Customisation and individualised marketing are gaining more attention.

GOALS OF BUSINESS

The term business goal is used in two senses. Broadly, it refers to the long-term, ultimate purpose of the organisation. It is also often used to refer to the short-term specific targets.

The terms vision, mission, objectives, goals and targets are used many a times interchangeably. However, in corporate literatures, they are often used distinctively. Mission leads to objectives (which are designed to achieve the mission), objectives lead to goals (which are designed to achieve the objectives) and goals lead to targets (which are set to achieve the goals).

VISION/MISSION

Mission, also known as *vision, value statement, principles* and *credo*, is the pivot around which corporate strategy revolves.

Although mission and vision are often used as synonymous, sometimes a distinction is made in which case mission evolves from the vision. However, in this book, these terms are used interchangeably. However, sometimes vision and mission are used distinctively and in such cases the vision, *i.e.,* the long-term perception as to what should be the purpose and place of the organisation in the future business scenario leads to the mission.

Peter Drucker who observes that "that business purpose and business mission are so rarely given adequate thought is perhaps the most important single cause of business frustration and business failure," concludes that "defining the purpose and mission of the business is difficult, painful, and risky. But it alone enables a business to set objectives, to develop strategies, to concentrate its resources and to go to work. It alone enables a business to be managed by performance."[9]

"A mission statement is an enduring statement of purpose that distinguishes one business from other similar firms. A mission statement identifies the scope of a firm's operations in product and market terms."[10]

As Fred David observes, a mission statement reveals the long-term vision of an organisation in terms of what it wants to be and whom it wants to serve. It describes an organisation's purpose, customers, products or services, markets, philosophy, and basic technology. In combination, these components of a mission statement answer a key question about an enterprise: "What is our Business?" A good answer to this question makes strategy formulation, strategy implementation and strategy evaluation activities much easier.[11]

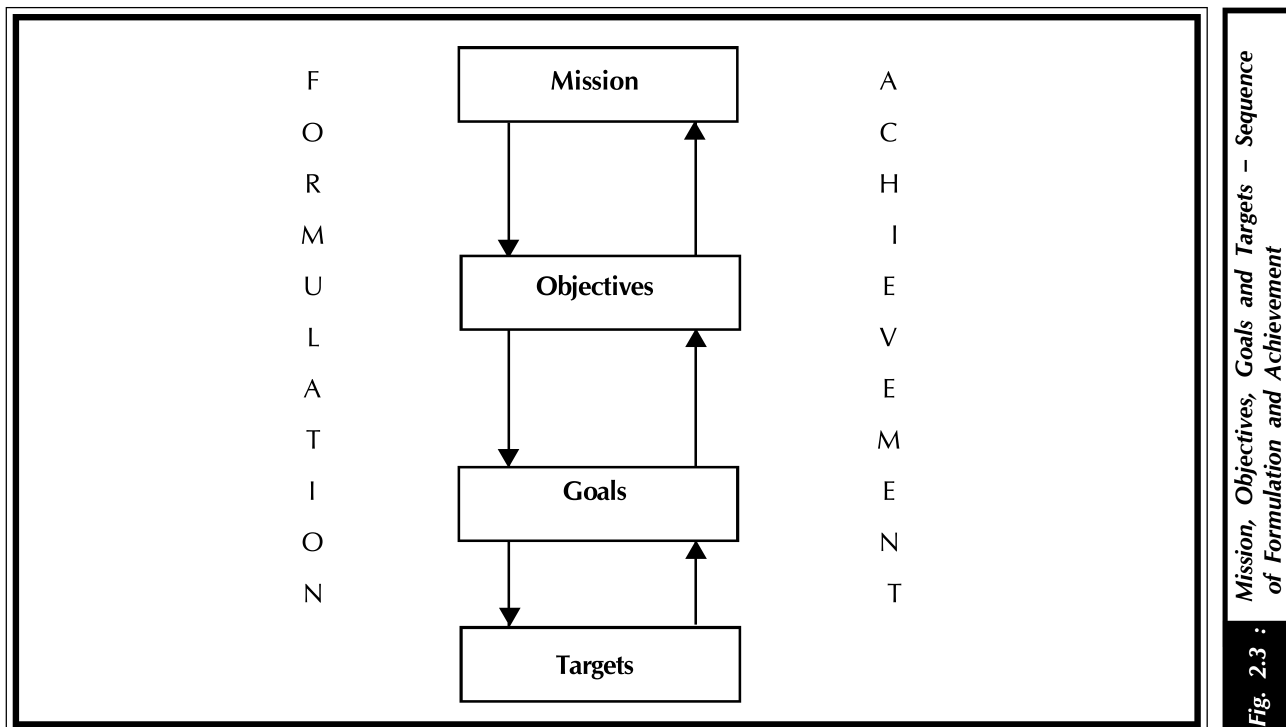

Fig. 2.3 : Mission, Objectives, Goals and Targets – Sequence of Formulation and Achievement

According to McGinnis,[12] a mission statement:

1. should define what the organisation is and what the organisation aspires to be;
2. should be limited enough to exclude some ventures and broad enough to allow for creative growth;
3. should distinguish a given organisation from all others;
4. should serve as a framework for evaluating both current and prospective activities; and
5. should be stated in terms sufficiently clear to be widely understood throughout the organisation.

It is suggested that answering following questions would help a company to arrive at its mission.[13]

1. What is the basic purpose of your organisation?
2. What is unique about your organisation?
3. What is likely to be different about your business five years down the road?
4. What is in your company that will make it stand out in a crowd?
5. Who are, and who should be, your principal customers?
6. What are, and what should be, your principal economic concerns?
7. What are the basic beliefs, values and philosophical priorities of your firm?

Rethinking the business should be a constant engagement.

The mission sets the direction for the strategic development of the organisation. As Drucker remarks in his *Managing for the Future,* the mission "focuses the organisation on action. It defines the specific strategies needed to attain the crucial goals. It creates a disciplined organisation. It alone can prevent the most common degenerative disease of organisations, especially large ones, splintering their always limited resources on things that are 'interesting' or look 'profitable' rather than concentrating them on a very small number of productive efforts".[14] There are several examples of organisations which substantially developed their business or improved their performance by refocusing their business. "Corporate mission statements are the operational, ethical and financial guiding lights of companies. They are not simply mottoes or slogans; they articulate the goals, dreams, behaviour, culture, and strategies of companies."[15]

One great advantage of formulation of the mission is that it also results in a clear definition of the business of a company. Mission statement and definition of the business are indeed two sides of the same coin.

Derek Abell has suggested[16] defining business along three dimensions, *viz.,* customer groups (*i.e.,* who is being satisfied), customer functions (*i.e.,* what need of the customer is being satisfied) and alternative technologies (*i.e.,* how the need is being satisfied). Such a three-dimensional definition of the business would clearly delineate the boundaries and nature of the business. However, not many mission statements are so clear and comprehensive.

As Drucker[17] suggests three fundamental questions would help to clearly define/redefine the business and formulate/reformulate the mission. These questions are:

- What is our business?
- What will our business be?
- What should our business be?

The question 'what is our business'? may lead to wonderful revelations and spectacular results. Drucker points out[18] that most managers ask this question when the company is in trouble – then it must of course, be asked; but the most important time to ask this seriously is when a company has been successful and not to have done so is the reason for the crisis of many organisations.

As the business environment is very dynamic, sooner or later even the most successful answer to the question "What is our business?" becomes obsolete. Therefore, it is not sufficient that a company determines what is its business but at the same time it should also ponder over what will it be? "What changes in the environment are already discernible that are likely to have high impact on the characteristics, mission, and purpose of our business? and How do we now build these anticipations into our theory of business, into its objectives, strategies and work assignments?"[19]

It is not adequate that a company identifies what will its business be? Because this aims at adaptation to anticipated changes – modifying, extending, developing the existing ongoing business, it does not explore the right firm-environment fit for the future. The future may have new or better opportunities outside the current business of the company. Or it may not be wise to continue in all or some of the current businesses. There is, therefore, a need to ask 'what should our business be?' This question is the central point of corporate strategy.

As Drucker aptly remarks, the ultimate objective of strategic planning is "to identify the new and different businesses, technologies, and markets which the company should try to create long range...Indeed, it starts with the question which of our present businesses should we abandon? Which should we play down? Which should we push and supply new resources to?"[20]

A mission by itself, however, does not ensure results. For its success, it requires that it is realistic, everybody in the organisation imbibes the spirit of it and is inspired by it, the management is committed to it and it is effectively strategised. These conditions do not exist in many organisations. As for some organisations, it is nothing more than a showpiece.

In many organisations, the mission is not fully ingrained in the minds of people. Mission is meaningless unless it is adequately supported by other essential inputs. It is very apt to record here Ambani's statement about what made the Reliance one of Asia's most competitive enterprises: "It has been a combination of vision, entrepreneurship and professionalism." In sum, as Drucker remarks, "Without an effective mission statement, there will be no performance...The mission statement has to express the contribution the enterprise plans to make to society, to economy, to the customer. It has to express the fact that the business enterprise is an institution of society, and serves to produce social benefits."[21]

OBJECTIVES, GOALS AND TARGETS

Objectives form the basis for the functioning of an organisation. Indeed, "objectives help define the organisation in its environment. Most organisations need to justify their existence, to legitimise themselves in the eyes of the government, customers, and society at large. And by stating objectives, they also attract people who identify with the objectives to work for the organisation. Thus, objectives define the enterprise."[22]

Objectives may be defined as "those ends which the organisation seeks to achieve by its existence and operations."[23]

Mission and objectives lay down the social justification of an organisation.

Used broadly, the word objectives covers "long-range company aims, more specific department goals, and even individual assignments. Thus, objectives may pertain to a wide or narrow part of an enterprise, and they may be either long or short range."[24] However, as stated earlier, used strictly, these terms have distinctive meanings.

A goal is defined as "an intermediate result to be achieved by a certain time as part of the grand plan. A plan can, therefore, have many goals."[25] Specific goals are sometimes referred to as targets. (For example, the sales target for a particular year or territory.)

In other words, objectives may be "defined as the long-term results that an organisation seeks to achieve in pursuing its basic mission."[26] "Goals are short-term (one year or less) milestones or benchmarks that organisations must achieve in order for longer term objectives to be reached. Goals should be measurable, quantitative, challenging, realistic, consistent and prioritised. They should be established at the corporate, divisional, and functional levels in a large organisation. Goals should be stated in terms of management, marketing, finance, production and research and development accomplishments. A set of goals is needed for each objective that is established in an organisation. Goals are specifically important in strategy implementation, whereas objectives are particularly important in strategy formulation. Goals represent the basis for allocating

resources"[27]. (It may also be noted that some authors use the term objectives to refer to short-term results and goals to refer to long-term results.)

As Newman and Summer point out, often objectives of a particular nature are given a special name. For instance, we may speak of sales quotas, expense ratios, budgets, absentee rates, or market positions. The use of such descriptive terms does not remove them from the broad category of objectives."[28]

To formulate clear objectives, it is essential to get definite answers to certain questions, viz., "what business the company is in?," "what should the company's business be?", "what will be the company's business?"

Objectives should not be static, they should be dynamic. That is, changes in the environment and/or changes in the organisational strengths and weaknesses may call for modifications to objectives. As Kotler remarks, "objectives can grow obsolete because of the continuous changes occurring in the company's marketing environment."[29] A company should, therefore, appraise how well its objectives tap the firm's opportunities and resources. Dynamic companies often conduct audit of their objectives and reformulate or reorient the objectives, if desirable, to ensure that the company's objectives are the most appropriate, given the environment and the company resources. It is such appraisal and the resultant reorientation of the business which have enabled many companies to achieve remarkable success which is often reflected in the prudent portfolio strategies and fast growth of business.

As stated earlier, objectives help define the organisation in its environment. Environmental analysis will help find answer to the question what should the company's business be? If 'what should be the business' is different from 'what is the business', there is certainly a need for redefining the business, matching the company resources to the environment. The question 'what will the company's business be?' exposes another dimension of business objective, namely, the long-term perspective. As Drucker succinctly puts it, 'what will the business be' is related to "what changes in the environment are already discernible that are likely to have high impact on the characteristics, mission, and purpose of our business? and how do we now build these anticipations into our theory of business, into its objectives, strategies and work assignments."[30]

While the important long-term overall objectives may remain without significant change, modifications to or change of some of the objectives and the definition of the business (what business the company should be in?) may be necessitated by environmental factors, as pointed out earlier under the section *Mission*.

IMPORTANCE OF OBJECTIVES

The following points elucidate the importance or usefulness of objectives.

1. ***Justify the organisation*:** The objectives indicate the purpose and aims and thereby the social justification for the existence of an organisation.

2. ***Provide direction:*** Objectives provide direction for the functioning of an organisation. When objectives are clear, the aims of the activities of different people in the organisation converge for the achievement of the common purpose.

3. ***Basis for management by objectives:*** Clearly formulated objectives form the basis for management by objectives which is a way of management for results.

4. ***Help strategic planning/management:*** Strategic planning/management is indeed a means to achieve the objectives. Objectives, thus, help effective functioning of the organisation in a given environment.

5. ***Help coordination:*** As Glueck points out, objectives help coordinate decisions and decision-makers by directing "the attention of employees to desirable standards of behaviour. It may reduce conflicts in decision-making if all employees know what the objectives are. Objectives become constraints on decisions."[31]

6. ***Provide standards for assessment and control:*** Objectives, by making clear what the results should be, provide the basis for control and assessment of organisational performance. "Without objectives, the organisation has no objective basis for evaluating its success."[32]

7. ***Help decentralisation:*** Objectives help decentralisation effective by making clear the organisational objectives to various elements in the organisation. Decentralisation, by assigning decision-making to lower level personnel, gives a subordinate executive or operator considerable leeway in deciding how to perform his work. "Turning people loose in this way will result in chaos unless the common objectives are well understood."[33]

Objectives provide a strong basis for efficient functioning of an organisation.

GUIDELINES FOR IDEAL OBJECTIVES

Objectives, to be successful, should possess certain qualities and there are, therefore, some important factors to be considered while formulating the objectives. Given below are important guidelines or principles for the formulation of objectives:

1. ***Participation:*** To the extent possible, formulation of objectives should involve the participation of important people responsible for the achievement of the objectives. The sense of participation will provide motivation and a moral responsibility for the achievement objectives.

2. ***Clarity:*** Objectives should not be vague and ambiguous. They should be spelt out clearly. Further, they should be made clearly known to the people who work for their accomplishment.

3. ***Realism:*** Objectives should be realistic *vis-à-vis* the internal and external environments. They should be reasonable in the sense that they should be achievable with the best efforts, given the environment. At the same time, they should be high enough to elicit the full utilisation of the company's resources and skills.

4. ***Flexibility:*** Objectives should not be very rigid, they should be flexible. That is, changes in the environment and/or changes in the organisational strengths and weaknesses may call for modifications to the objectives. For example, objectives can grow obsolete because of the continuous changes occurring in the company's environment. A company should, therefore, well provide for flexibility to suitably modify the objectives when changes in environment call for their modification.

Objectives should be clear and realistically formulated.

5. ***Consistency:*** Objectives should be mutually consistent throughout the organisation. That is, all objectives within the organisation should support the overall enterprise objectives.

6. ***Ranking:*** An organisation with multiple objectives should assign relative priorities and indicate the time horizon within which to attain each of the objectives.

7. ***Verifiability:*** Objective should be capable of being verified or measured. For example, an objective like reasonable profit may be subject to subjective interpretations and hence the actual performance cannot be verified specifically. On the other hand, an objective like a 15 per cent return on investment is verifiable.

8. ***Balance:*** There should be an appropriate balance between the different objectives of an organisation. For example, there should be a proper balance between profitability, employee welfare, customer welfare, community welfare etc. Undue emphasis on one may adversely affect others.

FACTORS AFFECTING OBJECTIVES

Objectives are influenced by internal and external factors.

Objectives are not formulated in a vacuum. According to Glueck,[34] who asserts that objectives are formulated by the top managers in a firm, the choice of objectives are affected by three factors, namely,

1. Forces in the environment.
2. Internal forces.
3. The value systems of the top executives.

There are a number of environmental factors which influence business decisions. For example, an external factor like the government policy may affect the objectives of a company.

Formulation objectives is affected also by the internal factors or the realities of the enterprise's resources and internal power relationships. Enterprise's resources are undoubtedly a factor which decides the objectives. Similarly, formulation of objectives are also influenced by the internal power relationships which include factors like the extent of shareholders' confidence and support the top management enjoys and employer-employee relations.

Thirdly, the value systems of the top executives affect the formulation of objectives. For example, the *Articles of Association* of the Tata Iron and Steel Company (TISCO) was amended at the initiative of the powers that be to incorporate the provision regarding the company's social and moral responsibilities to the customers, employees, shareholders, society and the local community. Profit objective, business practices, corporate citizenship etc. are, obviously, affected by the value systems of the top executives.

HIERARCHY OF OBJECTIVES

Organisations with a hierarchical structure (*i.e.*, with different levels of management like top level, middle level and lower level) normally have a hierarchy of objectives to be pursued at different levels.

At the zenith of the hierarchy is the organisational mission which is shaped by the vision and values of the promoters, expectations of the shareholders and environmental forces.

Below the mission is the overall objectives of the organisation, or the corporate objectives, which are long-range or strategic objectives. The corporate objectives are to be formulated and pursued by the Board of Directors and topmost managers.

The overall objectives lead to the next level of the hierarchy which consists of more specific objectives such as those in the key result areas such a certain per cent return or investment or a certain percentage increase in the market share over a certain period of time.

In a multi-SBU organisation, the next level in the hierarchy is the SBU objectives. The divisional objectives are then formed on the basis of the SBU objectives. (A strategic business unit – SBU – is "an operating divisions of a firm which serves a distinct product/market segment or a well-defined set of customers or a geographic area. The SBU is given authority to make its own strategic decisions within corporate guidelines as long as it meets the corporate objectives." There are different factors which decide SBUs. Each product line or a group of related product lines may form an SBU. Nature of SBUs may be influenced by factors such the volume of business, future plans, market characteristics etc.).

Below the divisional objectives are the departmental objectives, *i.e.,* the objectives for the different departments like production, marketing, finance, personnel, research and development, etc. which help to achieve the corporate objectives. A department may have several sections or

units under it. For example, the marketing department may have several geographical divisions like northern zone, southern zone, eastern zone and western zone or product/product group divisions like product A, product B, product C etc. Each such section will have its own objectives which will contribute to the achievement of the department objectives. Each section may have several personnel responsible for the achievement of the sectional objectives. For example, a marketing subdivision may have under it several salesmen each of whom will have to achieve a specific objective (like a sales target).

A hierarchical organisation, thus, has a hierarchy of objectives and the objectives of the different levels are designed to help achieve the overall organisational objectives.

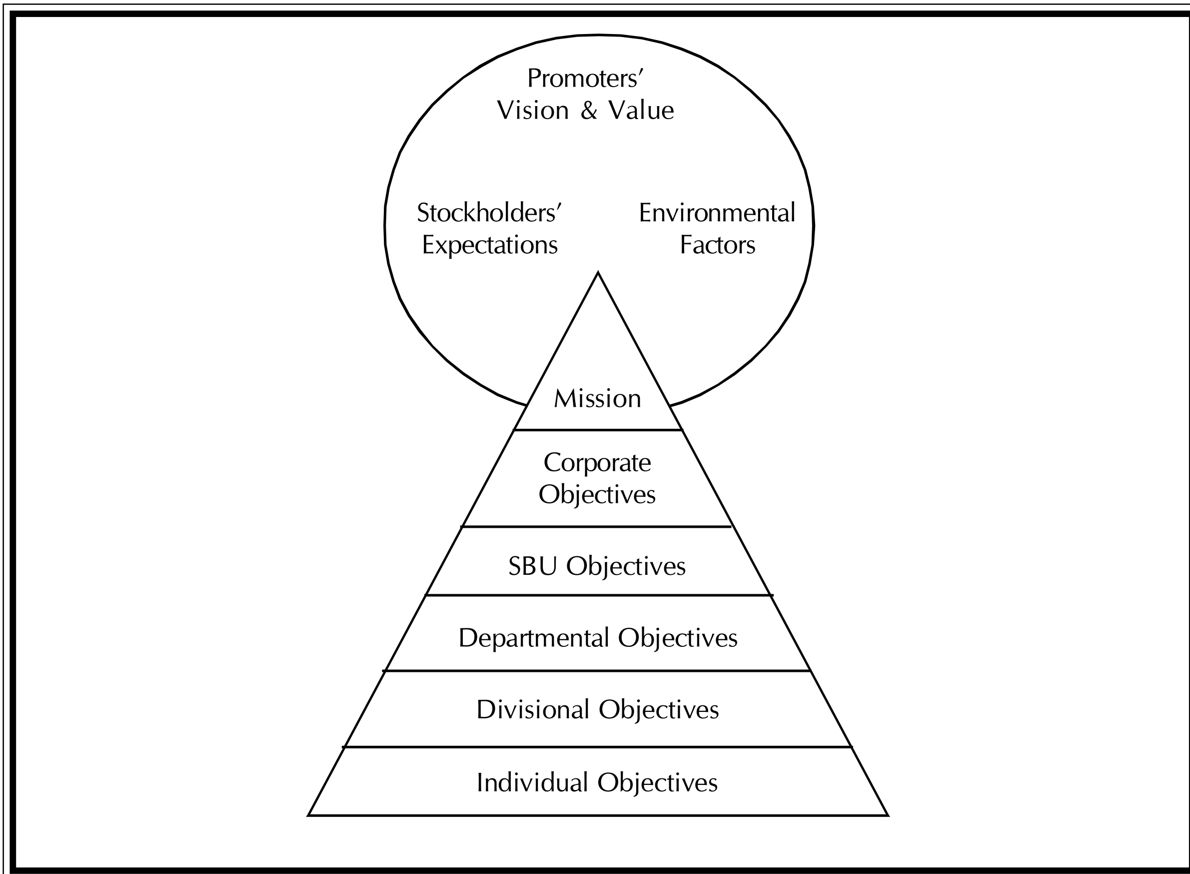

Fig. 2.4 : Hierarchy of Objectives

CLASSIFICATION OF OBJECTIVES

Broadly, there are two classes of objectives, *viz*., economic objectives and social objectives.

Economic Objectives

Some of the social and economic objectives are so interwined that it is difficult to separate them and it may be more appropriate to describe them as socio-economic objectives. However, the following may be regarded as the important economic objectives of business.

1. ***Survival***: "The primary business of the every business is to stay in business" is an often-quoted statement. The growing magnitude of industrial sickness is a clear indication of the need for primary thrust on this objective. Constant monitoring of the business environment and strategic planning are needed for survival in a competitive environment. A business cannot, obviously, achieve its objectives unless it survives and hence survival is a basic objective necessary to achieve other objectives.

Economic objectives aim at wealth creation for owners and society through efficient resource utilisation, innovation and growth.

2. ***Return on Investment*: A return on investment is, undoubtedly, an important economic objective not only for private enterprises but also for many public sector enterprises. Private business is often profit motivated. However, the level of profit a private enterprise aims at is likely to be influenced by its social outlook and a number of environmental factors like government policy, attitude of society, competitive and other conditions of the industry etc.

3. ***Growth*: Growth over time is also an economic objective of most of the business enterprises. A business may grow either vertically, horizontally or by diversification into unrelated areas. Growth may benefit not only the promoters and shareholders but also the consumers, suppliers and the national economy. Growth is not merely an objective but also a natural urge of a dynamic enterprise.

4. ***Innovation*: According to Peter Drucker, there is only one valid definition of business purpose: "to create a customer and because its purpose is to create a customer, the business enterprise has two – and only two – basic functions"[35] marketing and innovation. Marketing and innovation produce results: all the rest are "costs".

   Drucker, who interprets innovation as the provision of different economic satisfactions, argues that "it is not enough for the business to provide just any economic goods and services; it must provide better and more economic ones. It is not necessary for the business to grow bigger; but it is necessary that it constantly grows better".[36]

5. ***Market Share*: An increase in or maintenance of its market share is an important objective of many companies. Several companies also strive for market leadership. Sometimes, non-economic factors like the prestige and industry recognition associated with market leadership may be a more prominent factor than the economic factor which drives a company towards market leadership. Some companies also strive to attain market leadership even at the cost of profit maximisation.

SOCIAL OBJECTIVES

There has been a growing recognition of the social objectives and responsibilities of business. R.F. Barker aptly describes the situation as follows:

"Business traditionally has been responsible for quantities — for the supply of goods and jobs, for costs, prices, wages, hours of work, and for standards of living. Today, however, business is being asked to take on responsibility for the quality of life in our society. The expectation is that business — an addition to its traditional accountability for economic performance and results — will concern itself with the health of the society, that it will come up with the cures for the ills that currently beset us, and indeed, will find ways of anticipating and preventing future problems in these areas."[37]

Stern succinctly points out: "The more educated the society becomes, the more interdependent it becomes, and the more discretionary the use of its resources, the more marketing will become enmeshed in social issues. Marketing personnel are at interface between company and society. In this position, they have the responsibility not merely for designing a competitive marketing strategy, but for sensitising business to the social, as well as the product, demand of society."[38]

TABLE 2.1 : COMPARISON BETWEEN ECONOMIC AND SOCIAL OBJECTIVES

	Economic Objectives	*Social Objectives*
1	Economic objectives are primarily concerned with the economic health of the enterprise.	Social objectives are concerned with the needs and welfare of the society.
2	Economic objectives serve the economic motive of the stockholders.	Social objectives serve the interests of the society.
3	Economic objectives are mostly enterprise oriented or enterprise centred.	Social objectives are social oriented.
4	Economic objectives are important both in the short and long term.	The perspective of social objectives is mostly long term.
5	Achievement of economic objectives is necessary for the survival and growth of the enterprise.	Social objectives justify the survival and growth of the enterprise.
6	Achievement of economic objectives is necessary for effective discharge of social objectives.	Social objectives justify economic objectives.
7	There is general agreement as to what constitute economic objectives.	There are differences of opinion as to what constitute social objectives.
8	Economic objectives are tangible.	Several of the social objectives are not tangible.
9	Economic objectives by themselves may benefit society.	Some of the social objectives reinforce the achievement of economic objectives.
10	Economic objectives are cardinal.	Social objectives are ordinal.
11	Economic objectives are basic objectives.	Economic objectives provide the base for pursuing social objectives.
12	Economic objectives are clear and definite.	Social objectives may have ambiguity.

Social objectives of business may be grouped into three broad categories:

1. Objectives which protect consumer interests
2. Objectives which protect the interests of workers
3. Objectives which protect the interests of the society

RECONCILIATION OF SOCIAL AND ECONOMIC OBJECTIVES

We have seen above that the social and economic objectives encompass promoting the interests of different categories of people like the shareholders, workers, consumers, local population and the general public. The economic and social objectives may conflict with each other. Again, some of the social objectives may conflict with each other.

Furthering economic objectives may constrain some of the social objectives. For example, some of the efforts to increase the profit may adversely affect consumers if that results in price increase. Similarly, profit motive may harm workers' interests in some cases. Fulfillment of some of the social objectives may adversely affect the economic objectives. For example, enhanced expenditure on labour welfare, pollution control, social service etc. may eat into the profit. These could also affect consumer interest if they cause an increase in prices. It is, therefore, necessary to reconcile the conflicting objectives or to achieve a proper trade-off between the different

objectives. In other words, a proper balance between the conflicting interests of the different groups should be struck.

There is need for a proper trade-off between conflicting interests and objectives.

While we consider the reconciliation of the objectives, the following factors are worth noting.

1. Profit objective need not necessarily be against the social objective. The profit goes against the social objectives only when it is aimed to make profits at the expense of the social objectives. A reasonable level of profit is not only compatible with socially responsible business but also necessary for the discharge of social obligations and responsibility. As George Goyder, the champion of the idea of *social responsibility of business*, observes, "in a responsible company, profits will continue to be the criterion of financial health. As blood is the life of man, so are profits the life of industry, and just as man must maintain life before he can be free to pursue the life objects he has set before him...so profits are necessary to business and are in the proper sense of the work primary."[39] In short, a reasonable level of profit is necessary to enable a company to pursue the social objectives.

2. In several cases, it is possible to increase profits without hindering the social objectives. For example, an increase in productivity could increase profits without causing any increase in price. Not only that, substantial productivity gains could benefit the shareholders (by increased dividends), consumers (by reduced prices) and workers (by increased remuneration) if such productivity gains are shared between capital, labour and consumers.

3. Satisfactory level of wages and expenditure on labour welfare could contribute to the economic health of the enterprise if they help to increase labour productivity and improve industrial relations. It is appropriate to note the observation of the Social Audit Committee which conducted the social audit of TISCO that, "not only should the company carry out its various obligations to the employees as well as the larger community as a matter of principle but this has also led to a higher degree of efficiency in TISCO Works and an unparalleled performance in industrial peace and considerable team spirit and discipline which have all resulted in high productivity and utilisation of capacity. The cooperation and response of the larger community have also contributed to this. It is possible to argue that, but for such a climate of cooperation from all segments, and the maintenance of certain norms and standards by the company, it would not have been possible to maintain the reasonable rates of return on investment in the face of various constraints faced by the company. It is necessary that shareholders realise this and extend their full cooperation to the company's programmes of welfare and development and that they do so ungrudgingly."

The points mentioned above indicate that although several of the objectives may outwardly appear to be conflicting, they could be mutually supporting in several cases if properly envisioned and managed.

PRIMARY AND SECONDARY OBJECTIVES

Some companies establish two sets of objectives, *viz*., primary and secondary objectives. In many such cases, the secondary objectives resemble what are generally described as the social responsibilities of business.

George Goyder in his well-known book *The Future of Private Enterprise: A study in Responsibility*[40] set out the ultimate objects in the following four principal objects of a responsible company.

1. The extension, development and improvement of the company's business and the building up of its financial independence.
2. The payment of fair and regular dividends to the shareholders.

Primary objectives are fundamental objectives and secondary objectives are supplementary objectives.

3. The payment of fair wages under the best possible conditions to the workers.
4. The reduction of prices to consumers.

Referring to the Articles of the Carl Zeiss Foundations, Goyder points out four secondary objectives of the company:

1. to provide a bonus for the workers;
2. to assist in promoting the amenities of the locality (without thereby attempting to dominate it);
3. to assist in developing the industry of which the firm is a member;
4. to promote education, research and development in the techniques of the industry or any other purpose approved by the directors and members in general meeting.

SHORT-RUN AND LONG-RUN OBJECTIVES

A company may have short-run and long-run objectives.

The short-run objectives may be a means to achieve long-run objectives. For example, the short-run objective of market penetration may be a strategy to help achieve the long-run objective of market dominance or profit. For instance, a key characteristic of the Japanese companies' strategy of entering the foreign markets is to build up market share rather than early profits. The Japanese are patient capitalists who are willing to wait even a decade before realising their profits.

We have seen above the primary and secondary objectives of one organisation. A company will normally pursue the secondary objectives listed therein as long-term objectives. This shall not be interpreted to mean that long-run objectives are secondary objectives. Some of the long-run objectives, like profit, are essentially primary objectives of several companies.

However, some of the long-run objectives of several companies, like development of the local community, assisting the development of the industry of which it is a part, serving the society etc. are secondary objectives.

TOP-DOWN AND BOTTOM-UP APPROACHES

For the determination of the objectives of the different levels in the hierarchy, there are two approaches. In the top-down approach, the upper level managers determine the objective for their subordinates while in the bottom-up approach, the subordinates initiate the setting up of objectives for their positions and present them to the superior for consideration.

As Koontz and Weihrich remark,[41] either approach alone is insufficient. Both are essential but the emphasis should depend on the situation including such factors as the size of the organisation, the organisational culture, the preferred leadership style of the executive and the urgency of the plan.

SUMMARY

The term business is used in different senses. It may refer to the trade, occupation or profession; the activities of an enterprise; or to the whole gamut of commerce and industry. The old concept of business, confining it to commerce and private profit, has undergone a radical change. Today, business is regarded as a social institution forming an integral part of the social system. The modern concept of business is, thus, a very broad one. In such a view of business in a systems relationship with society, three ideas are significant in addition to the systems idea, *viz.*, values, viability and public visibility.

Fernstorm's classification of business gives a broad indication of the scope of business. This classification is: *(i)* business which produces goods; *(ii)* business which produces services; *(iii)* business which distributes goods; *(iv)* business which facilitates distribution of goods; and *(v)* business which deals in money and credit.

The business sector consists of two main sub-sectors, *viz.*, the industrial sector and the tertiary (services) sector. The industrial sector consists, mostly, of the manufacturing activities. The services sector includes trade and commerce, insurance, banking, professions, transport, repairs and maintenance and a host of other activities. A number of services are involved in the organisation of factors of production, procurement of inputs and marketing of the output. Innumerable number of business enterprises and individuals are involved in the provision of different services.

Industry consists of all those firms which produce goods and services. In other words, industry is that part of the business which creates *form utility* (*i.e.*, by converting the material from one form to another — for example by converting the raw material into finished product).

Industries may be classified on the basis of nature of activity (extractive industries, genetic industries, manufacturing industries, construction industries and service industries); use of the output (basic industries, capital goods industries, intermediate goods industries and consumer goods industries); ownership category (public, private, joint and co-operative sectors); the nature or source of the major input (agro-based, forest-based, marine-based, metal-based chemical-based, etc.); size (tiny, small, medium and large); market structure (monopoly, duopoly, oligopoly, monopolistic and perfect) etc.

Business, defined as any activity carried out with the intention of making financial benefit, has a number of characteristics such as exchange of goods or services for income, recurring nature of activities, profit motive, risk bearing etc.

Several characteristics of modern business are embedded in the emerging trends and other dynamics of the business environment. These include strategic orientation, global orientation, professionalisation; strategic operations management; increasing overlapping and integration of technologies in a growing number of products/industries; restructuring of business portfolio, product mix, markets, finance and organisation; focus and diversification; coexistence of different sectors like tiny, small, medium and large scale units; shortening brand and product life cycles; extensive market segmentation and so on.

A dynamic enterprise will have a vision/mission, objectives, goals and targets. Mission leads to objectives (which are designed to achieve the mission), objectives lead to goals (which are designed to achieve the objectives) and goals lead to targets (which are set to achieve the goals).

A mission statement "identifies the scope of a firm's operations in product and market terms." The mission sets the direction for the strategic development of the organisation. As Drucker remarks the mission "focuses the organisation on action. It defines the specific strategies needed to attain the crucial goals. It creates a disciplined organisation. It alone can prevent the most common degenerative disease of organisations, especially large ones, splintering their always limited resources on things that are 'interesting' or look 'profitable' rather than concentrating them on a very small number of productive efforts."

Objectives are "those ends which the organisation seeks to achieve by its existence and operations" and they form the basis for the functioning of an organisation. Objectives may be "defined as the long-term results that an organisation seeks to achieve in pursuing its basic mission." "Goals are short-term (one year or less) milestones or benchmarks that organisations must achieve in order for longer term objectives to be reached." Specific goals are sometimes referred to as targets. (For example, the sales target for a particular year or territory.)

Objectives may be tangible or intangible. Tangible objectives include achievement of materially quantifiable targets or goals. Intangible objectives include factors like brand or company image, employee morale etc.

Formulation of objectives are influenced by certain internal and external factors. A hierarchical organisation has a hierarchy of objectives and the objectives of the different levels are designed to help achieve the overall organisational objectives.

An organisation may have both economic objectives (such as survival, return on investment, growth and market share and innovation) and social objectives. Social objectives of business may be grouped into three broad categories, namely, objectives which protect consumer interests; objectives which protect the interests of workers; and objectives which protect the interests of the society. Some of the social and economic objectives are so intertwined that it is difficult to separate them and it may be more appropriate to describe them as socio-economic objectives.

As the social and economic objectives encompass promoting the interests of different categories of people like the shareholders, workers, consumers, local population and the general public, the economic and social objectives may conflict with each other. Again, some of the social objectives may conflict with each other. It is, therefore, necessary to reconcile the conflicting objectives or to achieve a proper trade-off between the different objectives.

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Chapter 3

ENVIRONMENTAL ANALYSIS AND FORECASTING

Structure

- Stages of Environmental Analysis
- Approaches to Environmental Analysis
- Techniques for Environmental Analysis
- Steps in Environmental Forecasting
- Types of Forecasting
- Techniques for Environmental Forecasting
- Benefits/Importance of Environmental Analysis
- Limitations of Environmental Forecasting
- Summary
- References

The purpose of environmental analysis is to identify the existing and emerging threats and opportunities to help formulate appropriate strategies.

Business decisions, particularly strategic ones, need a clear identification of the relevant variables and a detailed and in-depth analysis of them to understand their impact and implications for the organisation. *For example,* what is the impact of the different aspects of liberalisation on a company? What are the implications of the liberalisations for the company? In other words, what are the threats posed by the liberalisation and what are the opportunities unfolded by the liberalisation? A thorough analysis of the environment is necessary for finding answers to these.

STAGES OF ENVIRONMENTAL ANALYSIS

The process of environmental analysis may be divided into the following four stages:[1]

1. Scanning the environment to detect warning signals.
2. Monitoring specific environmental trends.
3. Forecasting the direction of future environmental changes.
4. Assessing current and future environmental changes for their organisational implications.

(Sometimes, the term *environmental scanning and monitoring* is used very broadly to encompass the environmental analysis.)

Scanning

Scanning is the process of analysing the environment for the identification of the factors which impact on or have implications for the business. Such factors may include those which have appeared suddenly or evolved over time. Identification of emerging/ensuing trends is a critical purpose of the environmental scanning. In this, "*prospective mode* scanning focuses on identifying precursors or indicators of potential environmental changes and issues. Environmental scanning is thus aimed at alerting the organisation to potentially significant external impingement before it has fully formed or crystallised. Successful environmental scanning draws attention to possible changes and events well before occurrence, allowing time for suitable strategic action."[2]

Monitoring

Monitoring entails perspective follow-up and a more in-depth analysis of the relevant environmental trends identified at the scanning stage. The effort here is more focused and systematic than in scanning. Scanning is essentially *exploratory* in nature and, therefore, it often involves a very wide examination of the environment. As the relevant factors have already been identified, monitoring lends itself for a focused and systematic approach. "The purpose of monitoring is to assemble sufficient data to discern whether certain patterns are emerging." However, "they are likely to be a complex of discrete trends. For example, an emergent lifestyle pattern may include changes in entertainment, education, consumption, work habits and domicile-location preferences. In the initial stages of monitoring, the patterns are likely to be hazy because they are the outputs of scanning: the analyst has only a vague notion of what to look for."[3]

The outputs of monitoring are threefold:[4] a specific description of environmental patterns to be forecast; identification of trends for further monitoring and identification of patterns requiring further scanning.

Forecasting

Anticipating the future is essential for identifying the future threats and opportunities and for formulating strategic plans. "Forecasting is concerned with the development of plausible directions

of directions, scope, speed, and intensity of environmental change, to lay out the evolutionary path of anticipatory change."[5]

The characteristics of the variables or their trends may undergo changes. Further, new variables may emerge as critical or the relevance of certain variables may decline. It is, therefore, necessary to monitor such changes. Sometimes, the changes may be very significant so as to call for a reforecasting.

Environmental analysis involves identifying relevant variables and collections, analysis and interpretations of data.

Assessment

The purpose of environmental analysis is to assess the impact of the environmental factors on the organisation's business or their implications for the organisation. Assessment, thus, involves drawing up implications/possible impacts. "In assessment, the frame of reference moves from understanding the environment — of the focus of scanning, monitoring and forecasting — to identifying what that understanding of environment means for the organisation."[6]

APPROACHES TO ENVIRONMENTAL ANALYSIS

There are broadly two approaches to environmental analysis:

1. Outside-in (macro) approach
2. Inside-out (micro) approach

The outside-in or macro approach takes a very broad view of the business environment (hence the term *macro* approach) with a long-term perspective and develops alternative scenarios of the future. The implications of the alternative scenarios for the industry and the organisation are drawn up with reference to the different scenarios.

Thus, "scenario analysis is a technique used to forecast the occurrence of complex environmental events. It is particularly useful for forecasting events in which many variables play a role. Scenarios allow the integrated consideration of these multiple variables in explaining the emergence of future conditions. A scenario is a detailed description of how certain events may occur in the future and their consequences for the organisation."[7]

The following steps have been suggested to develop scenarios.[8]

1. Identify strategic environmental issues that are likely to affect the industry/firm. Prioritise these issues in order of their importance to the firm.
2. Select the most important issues as the focus for scenario development. List the organisational assumptions with respect to these issues and identify the possible variations in these assumptions.
3. Prepare a preliminary description of these issues and how they evolved. Include the key economic, social, political, and cultural influences that affect them. Do this with the help of outside industry experts.
4. Draw out the implications of the issue for organisational performance. What has the organisation done and what can it do to cope with the issues? Identify those variables shaping the issue that the management can control and partially control. Also, identify those variables over which management has no control.
5. Develop detailed descriptions of the future in the form of scenarios. Scenarios are constructed under a worst case, best case, and most likely case set of assumptions. Draw out the implications of these scenarios for future performance of the company.

6. Discuss the scenarios with top management and refine them.
7. Develop contingency action plans for each scenario.

The inside-out (micro) approach, which takes a rather narrow view of the environment, forecasts the immediate future environment on the basis of the ongoing environmental monitoring and derives the implications of it for the industry and firm out of it.

TECHNIQUES FOR ENVIRONMENTAL ANALYSIS

There are different methods for gathering the relevant information for forecasting.

Techniques for environmental analysis refer to the methods of gathering the relevant information for appraising the environment.

William Glueck mentions four techniques for environmental analysis: Verbal and Written Information; Search and Scanning; Spying; and Forecasting and formal studies.[9]

Verbal and Written Information

A lot of documented information, published or unpublished, is available on many matters. However, people may not like to put on record certain types of information which they may be prepared to divulge orally, sometimes on condition of anonymity or confidentiality. Tact and proper approach are required to obtain such information. Verbal information is significant in several other situations. The situation might have changed after the documentation of the information, necessitating personally contacting knowledgeable people to get the latest information. Personal contacts will be helpful in getting more details of the written information. Personal contacts will also be useful in obtaining diverse views of different people.

There are indeed many matters on which written information is non-existent or scanty. All these highlight the importance of verbal information in environmental analysis.

While using written information, several factors such as the purpose for which it was prepared, the methodology used for collection of the information, reliability of the sources of information, the ideology/orientation of the individual/organisation that prepared the information etc. need to be evaluated. Such cautions should also be exercised while going in for verbal information.

Sources of verbal information also include electronic media, seminars, workshops etc.

Search and Scanning

Even when the required information exists somewhere, it may not become readily available. Search and scanning are, therefore, needed, many a time, to identify the sources of information and to manage the timely availability of the required information.

A number of organisations have *clipping service* which constantly scan newspapers, periodicals etc. and prepare clippings containing information required by different departments/executives of the organisation.

Many organisations have Management Information System for systematic gathering, processing, storing and disseminating information. An MIS is generally regarded as very useful.

Spying

Spying, albeit regarded unethical by many, is not very uncommon in business. This has been used to a considerable extent to obtain secret information regarding defence and space research.

There are many instances of industrial espionage also. This is used mostly to gather competitive information.

The fourth approach to environmental analysis is formal forecasting. This is described in the following section.

STEPS IN ENVIRONMENTAL FORECASTING

The important steps in environmental forecasting are the following.

Identification of Relevant Environmental Variables

The first most important step in environmental forecasting is identification of the environmental variables critical to the firm. All environmental variables do not have the same relevance to all the industries or firms. A variable that is relevant to one industry may not be relevant for another. Again, important developments in some market may not have any implications for some other markets. *For example,* the high level of penetration of microwave ovens in some of the developed countries like USA is a critical variable as far as food processing industry in that market is concerned; but it is not relevant in markets where the microwave ovens have not penetrated – if microwaveable packaging increases the cost of the product it could be a negative factor in such markets. Similarly, a factor relevant in one technological environment may not be relevant in a different environment. Diesel price is a critical factor for railways which use that energy source but not for those which depend on electricity (assuming that there is no competition between those depending on these two different energy sources).

The steps in environmental forecasting are similar to the steps in formulating and executing a research project.

Some demographic trends have implications for certain business. A falling birth rate is a threat to several businesses (*for example,* for companies like Johnson & Johnson, which depends heavily on the baby segment of the market). The increase in the longevity and the resultant increase in the number of aged generates good demand for several goods and services.

To envision the future environment, it is essential to identify the critical environmental variables and to predict their future trends. Omission of any critical variable will affect the assessment of the future environment and strategies based on that premise. Similarly, inclusion of variables which are not adequately relevant could have misleading effects.

Pearce and Robinson point out that the list of key variables that will have make or break consequences for the firm can be kept to manageable size by limiting key variables in the following ways.[10]

1. Include all variables that would have a significant impact although their probability of occurrence is low. Delete others with little impact and low probability.
2. Disregard major disasters, such as nuclear war.
3. Aggregate when possible into gross variables (*e.g.,* a bank loan is based more on the dependability of a company's cash flow than on the flow's component sources).
4. If the value of one variable is based on the value of the other, separate the dependent variable for future planning.[11]

Collection of Information

The key environmental variables having been determined, the next important step is the collection of the needed information. This involves identification of the sources of information, determination of the types of information to be collected, selection of methods of data collection and collection of the information.

The dependability and usefulness of the forecast depend a lot on the appropriateness of the forecasting technique used.

Selection of Forecasting Technique

The choice of forecasting technique depends on such considerations as the nature of the forecast decision, the amount and accuracy of available information, the accuracy required, the time available, the importance of the forecast, the cost, and the competence and interpersonal relationships of the managers and forecaster involved.[12]

One issue often debated is the *quantitative techniques versus qualitative techniques*. The fact is that each has its own merits and limitations. Some people have a mistaken notion that quantitative techniques are highly dependable and qualitative techniques are often too subjective that they are not reliable. The dependability of the quantitative techniques is affected by the accuracy/ reliability of the data used. It is pointed out that the difference in the predictions using each type of approach is often minimal. Additionally, subjective or judgement approaches may often be the only practical method of forecasting political, legal, social, and technological trends in the remote external environment. The same is true of several trends in the task environment, especially customer and competitive considerations.[13]

Monitoring

The characteristics of the variables or their trends may undergo changes. Further, new variables may emerge as critical or the relevance of certain variables may decline. It is, therefore, necessary to monitor such changes. Sometimes the changes may be very significant so as to call for a reforecasting.

TYPES OF FORECASTING

Forecasts of the important business environments, *viz.,* economic environment, social environment, political environment etc. would be useful in formulating plans and strategies.

Economic Forecast

The macroeconomic forecasts serve as a base for deriving industry and company forecasts.

The fact that economic environment is a very critical determinant of business prospects underscores the importance of economic forecasts.

Important economic factors often considered include general economic conditions, GDP growth rate, per capita income, distribution of income, structural changes in GDP, investment and output trends in different sectors and subsectors/industries, price trends, trade and BoP trends etc.

There are indeed a number of sources of short, medium and long-term forecasts. International organisations like World Bank, IMF, UNCTAD, UN, WTO etc. and regional organisations like Asian Development Bank have periodic and occasional publications which provide, *inter alia*, economic forecasts.

It becomes more useful when disaggregated details of the estimates/forecasts are available.

When reliable forecasts are not available from the secondary source, a firm has to make its own forecasts.

Reliable forecasts give very useful picture of the future scenario helpful to planning and strategy. *For example,* details of power development would indicate the scope of investment in the power sector itself and the prospects of related industries like generators, transformers, cables, switch gears, other electrical goods and materials used by power projects etc. Plans of rural electrification will give some indication of the additional demand for pump sets and certain categories of consumer durables and non-durables.

Short-term economic forecasts are very useful for demand and sales forecasting and marketing strategy formulation.

Both quantitative methods such as econometric methods, and time series models and qualitative techniques like judgement models can be used for economic forecasts.

Social Forecasts

There are a number of social factors which have profound impact on business. It is, therefore, very essential to forecast the possible changes in the relevant social variables. Important factors include population growth/decline, age structure of population, ethnic composition of population, occupational pattern, rural-urban distribution of population, migration, factors related to family, lifestyle, income levels, expenditure pattern, social attitudes etc.

As in the case of economic factors, there is a wealth of published and unpublished data of forecasts of social trends available. International organisations like the UN and its organs, World Bank etc., academic organisations and government organisations do considerable work in these areas. *For example,* a considerable amount of data is available regarding future trends in birth and death rates and population size, age structure, ethnic composition etc. of different nations. Certain aspects of this are dealt with in the chapters *Societal Environment* and *Demographic Environment*.

Social trends have significant implications for business strategy.

Quantitative techniques like time series analysis and econometric methods and qualitative methods like Delphi method or a combination of both quantitative and qualitative techniques may be used for social forecasts. One of the most popular methods is scenario building which involves drawing up alternative future scenarios, based on different assumptions or predictions of developments.

Political Forecasts

Political forecast has an important part in envisioning properly the future scenario of business. There are even chances of a country undergoing a drastic shift in the political system (Example: USSR and Eastern Europe in the late 1980s). Changes in the relative power of political parties, changes in the internal power structure of political parties (including changes in leadership and its implications), political alliances and political ideologies etc. may have implications for business. Some political factors may be embedded in social factors.

Some political changes are sudden and unpredictable. There are, however, several changes which are reasonably predictable. For example, the sweeping political and economic changes in the erstwhile USSR and Eastern Europe and the general liberalisation trend in many other countries could be regarded as an indicator that liberalisation would set in India too. The liberalisation ushered in 1991 indicated that there would be privatisation (which even at the end of 1990s has not assumed a serious intent and real earnest in India) and other liberalisation. The discussions on decentralisation and government pronouncement on this enabled the prediction of administrative decentralisation in several States in India. With the decentralisation, decision-making process in the government has changed and this has important implications for business.

Political forecasts also cover industrial policy, commercial policy and fiscal policy.

There are several factors which have international or global overtones. Sanctions, formal or informal, which have serious consequences for business are not very rare. Increasing world interdependence makes it imperative for firms of all sizes to consider the international political implications of their strategies.

Companies, research organisations and consultants have developed a variety of approaches to international forecasts of which political factors are an important component. Harner's Business Environmental Risk Index, for instance, monitors a number of economic and political variables

in many countries. The World Economic Forum brings out annually a *Global Competitiveness Report* based on eight set of factors including government, openness and institutions (see the chapter on *Global Competitiveness* for more details).

Technological Forecast

Innovation and other technological developments can drastically alter the business environment. Technological forecasts, therefore, assumes great significance.

Technological forecasts should help understand possible future technological developments and their impacts.

Technological forecast encompass not only technological innovations but also the pace and extent of diffusion and penetration of technologies and their implications. *For example,* what will be the pace and extent of penetration of PCs and the internet and their implications for business? How far can and will the existing and new technologies be applied in diverse areas and what are their implications?

It may be noted that one of the eight components of the world competitiveness index used in the *World Competitiveness Report* is technology which measures computer usage, the spread of new technologies, the ability of the country to absorb new technologies and the level and quality of Research and Development.

The Technology Information, Forecasting and Assessment Council (TIFAC) established in 1988 has done considerable work to draw up a Technology Vision 2020 for India. It is among the tasks of TIFAC to look ahead at the technologies emerging worldwide and pick those technology trajectories which are relevant for India and should be promoted.

Brainstorming and Delphi methods are popular in technology forecasting.

TECHNIQUES FOR ENVIRONMENTAL FORECASTING

Quantitative forecasts are generally based on empirical data.

As mentioned earlier, there are a number of quantitative and qualitative techniques used in environmental forecasting. Some important techniques are mentioned below.

Econometric Techniques

Econometric techniques involve casual models to predict major economic indicators.

When there is a well established relationship between two or more variables, that casual relationship can be used to forecast the future. *For example,* if demand is a function of consumer income, the impact of an increase in consumer income on demand can be predicted using the equation representing the relationship between these two key variables.

The econometric models may "utilise complex simultaneous regression equations to relate economic occurrences to areas of corporate activity. They are especially useful when information is available on casual relationships and when large changes are anticipated."[14]

The most commonly used econometric environmental forecasting techniques are multiple regression analysis and time series regression models.

Trend Extrapolation

Time series models assume that the past is a prologue to the future and extrapolate the historical data to the future. The technique may use simple linear relationship or more complex non-linear relationships to forecast trends.

Scenario Development

A very popular and useful forecasting method is development of alternative scenarios.

When it is not possible to accurately forecast the future, the alternative scenarios help managers to formulate strategies to cope with different possible future situations. As hinted earlier (under political forecasts), Royal Dutch Shell's anticipation of a possibility of a substantial crash in oil prices in future prompted it cut exploration costs by pioneering advanced exploration technologies, massive investments in cost-efficient refining facilities etc., so that by 1989 its exploration costs at $2 per barrel were less than half the industry average.

Scenario building helps companies to equip better to cope up with different uncertain situations.

"Scenario analysis is a technique used to forecast the occurrence of complex environmental events. It is particularly useful for forecasting events in which many variables play a role. Scenarios allow the integrated consideration of these multiple variables in explaining the emergence of future conditions. A scenario is a detailed description of how certain events may occur in the future and their consequences for the organisation."[15]

Shrivastava suggests the following steps to develop scenarios.[16]

1. Identify strategic environmental issues that are likely to affect the industry/firm. Prioritise these issues in order of their importance to the firm.
2. Select the most important issues as the focus for scenario development. List the organisational assumptions with respect to these issues and identify the possible variations in these assumptions.
3. Prepare a preliminary description of these issues and how they evolved. Include the key economic, social, political, and cultural influences that affect them. Do this with the help of outside industry experts.
4. Draw out the implications of the issue for organisational performance. What has the organisation done and what can it do to cope with the issues? Identify those variables shaping the issue that the management can control and partially control. Also, identify those variables over which management has no control.
5. Develop detailed descriptions of the future in the form of scenarios. Scenarios are constructed under a worst case, best case, and most likely case set of assumptions. Draw out the implications of these scenarios for future performance of the company.
6. Discuss the scenarios with top management and refine them.
7. Develop contingency action plans for each scenario.

Developing alternative scenarios is common in economic planning too. The Planning Commission of India, for example, have drawn up alternative scenarios regarding growth rates of different sectors, poverty ratios etc. under different assumptions.

Many forecasts which use the scenario method draw up three alternative scenario – a most likely scenario, a pessimistic scenario and an optimistic scenario. However, forecasts having more than three scenarios are not uncommon.

Methods of Scenario Building

Premising Method: In this method, a series of premises is drawn up from which projection of the future scenarios is made. The premises might consist of basic assumptions about certain important variables, current trends etc. Sometimes, extreme projections may also be made focusing on a few tendencies and exaggerating their evolution. *For example,* the extreme possible outcome of some ethnic issues in a country.

Systems Diagram Method: The systems diagram method seeks to explore policy and strategic options based on the present system of the organisation's activities. *For example,* a newspaper firm may think of entering other media, extending the publication business, starting information service business etc. using and developing its existing capabilities.

Critical Site Method: This method which bases the scenario projection on the policy making structure of an organisation identifies the key decision-making points and dynamics of the system focuses on the critical site where the key decisions are taken, such as the meeting of the Board of a company, the national convention or the meeting of the policy decision-making body of the relevant political party, critical meetings of organisations like OPEC or WTO etc. Scenarios are drawn up based on the anticipation of the possible critical decisions made at such sites and their future implications.

The Newspaper Headline Method: In this method, the scenario writer posits one or more hypothetical headlines for some future date such as: New Delhi, January 20, 2010: "The three surviving car manufactures in India intensify the battle for market share." The scenario writer then tries to map out the possible developments in the industry during the course and chart out a strategy for the company to successfully navigate through.

Logical Possibilities Method: This method which generates alternative scenarios based on those already developed is used as a supplement to other methods.

Judgement Models

Opinions of competent people often form valuable input for environmental forecasting.

Judgement models involve the use of opinion of people who have intimate knowledge of relevant factors. *For example, sales force's opinion* of the sales potential, competitive challenges, customer behaviour etc. Another method is *juries executive opinion* which "combine estimates made by executives from marketing, production, finance and purchasing and then average their views".[17]

The Delphi method described below is a refined judgement model.

Brainstorming

Brainstorming is a creative method of generating ideas and forecasts. Under this method, a group of knowledgeable people are encouraged to generate ideas, discuss them and to make forecasts on the basis of that. With a view to encouraging throwing up new ideas without any reservation, the discussion and evaluation of the ideas generated is often done only after the idea generation process is over.

Brainstorming is a popular technique of technological forecasting.

Delphi Method

The Delphi method, which is also a common technique of technological forecasting, is a more systematic technique than brainstorming.

This method uses a panel of experts on the subject from whom opinions are gathered, may be by using a semi-structured questionnaire and/or interview. The opinions of the experts are documented and consolidated and circulated among the panel members, preferably anonymously, for their evaluation and comments. The experts are requested to review their opinion in the light of the feedback. This process may be continued until a consensus view is arrived at.

The RAND Corporation which pioneered the use of this technique used it to predict the impact of the formation of the OPEC on oil supplies and oil prices. Other applications of this technique included assessing trends in terrorist activities and their influence on international businesses and prioritising domestic social programmes.

Strategic Issues Analysis

Strategic issue analysis is a qualitative technique that can be used for assessing emerging strategic environmental issues. It consists of systematic monitoring of social, regulatory and political changes that can affect corporate performance and identifying their impact on the company. *For example,* companies which were doing business in South Africa used this technique to assess the impact of racial tensions there on their worldwide business. Similarly, chemical companies, such as DuPont, Monsanto, and Stauffer Chemicals have used this technique for assessing the impact of environmental movement on the cost of doing business.[18]

BENEFITS/IMPORTANCE OF ENVIRONMENTAL ANALYSIS

Environmental analysis/forecasting is a search-light that helps to identify the problems, opportunities and challenges around so as to cut the right path forward.

Environmental analysis has several benefits like those mentioned below.

1. The very idea of environmental analysis makes one aware of the environment-organisation linkage.
2. A corollary of the above is that environmental analysis helps an organisation to identify the present and future threats and opportunities.
3. Environmental analysis will provide a necessary and very useful picture of the important factors which influence the business.
4. Environmental analysis helps to understand the transformation of the industry environment.
5. Technological forecasting will indicate some of the future opportunities and challenges.
6. A very important benefit of environmental analysis is its contribution to identification of risks.
7. Environmental analysis is a prerequisite for formulation of right strategies – corporate, business and functional.
8. Environmental monitoring helps suitable modifications of the strategies as and when required.
9. Environmental analysis keeps the managers informed, alert, and often dynamic.

LIMITATIONS OF ENVIRONMENTAL FORECASTING

Limitations of forecasting arise from the limitations of the methods used and errors affecting the reliability of the forecasts.

Environmental forecasting has several limitations. Some of the limitations arise from the forecasting techniques used.

Further, there are also chances of certain errors affecting the reliability of the forecasts. Errors may occur in:[19]

1. The selection of the variables included in the predictive model,
2. The selection of the functional form for linking these predictor variables to the variable(s) being predicted and
3. The estimation of the 'correct' values for the predictor variables.

Several techniques use opinions of people and they may be affected by subjectivity.

SUMMARY

Adequate and reliable information is a prerequisite for managerial decision-making. That strategic management is establishing the right 'firm-environment' fit and further that strategic decisions involve committing resources today for tomorrow make clear the importance of environmental analysis, including environmental forecasting, to strategic management.

The process of environmental analysis may be divided into four stages, *viz.*, scanning the environment to detect warning signals; monitoring specific environmental trends; forecasting the direction of future environmental changes; and, assessing current and future environmental changes for their organisational implications.

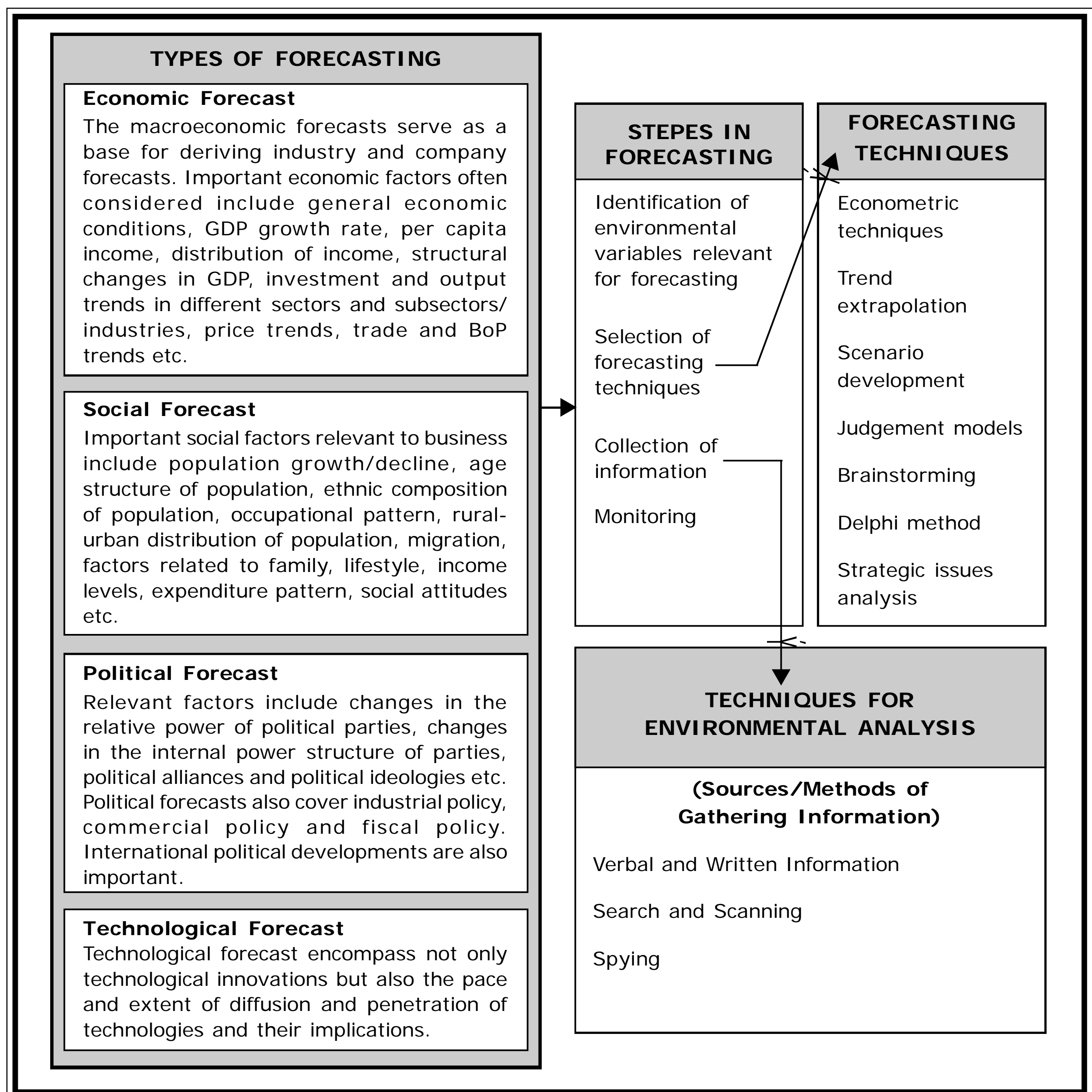

Fig. 3.1 : Epitome of Environmental Forecasting

There are broadly two approaches to environmental analysis: (1) Outside-in (macro) approach, which takes a very broad view of the business environment with a long-term perspective and develops alternative scenarios of the future. (2) Inside-out (micro) approach, which takes a rather narrow view of the environment, forecasts the immediate future environment on the basis of the ongoing environmental monitoring and derives the implications of it for the industry and firm out of it.

Figure 3.1 provides a summary view of the salient aspects of environmental analysis and forecasting.

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Chapter 4

ECONOMIC ENVIRONMENT

Structure

Nature of the Economy

Structure of the Economy

Economic Policies

Economic Conditions

Summary

References

Business fortunes and strategies are influenced by the economic characteristics and economic policy dimensions. The economic environment includes the structure and nature of the economy, the stage of development of the economy, economic resources, the level of income, the distribution of income and assets, global economic linkages, economic policies etc.

Important economic factors are described below.

NATURE OF THE ECONOMY

The general level of development of the economy has lot of implications for business – it has significant bearing on the nature and size of demand, government policies affecting business etc.

Countries, and even different regions within a country, show great differences in the level and pattern of economic development.

A widely used method of classification of the economies is on the basis of the per capita income (*i.e.,* the average annual income per person). Accordingly, countries are broadly classified as low income, middle income and high income economies by the World Bank.

Low Income Economies are economies with very low level of per capita income. All economies with per capita GNI (Gross National Income — new term for GNP) of $1,045 or less in 2014 are regarded as low income economies. There were 32 low income economies in 2012.

High Income Economies are countries with very rich income per capita. Those with a per capita GNI of $12,736 or above in 2014 fall in the category of high income economies. In 2012, there were 35 high income economies. There are mainly two categories of high income economies, namely, industrial economies and oil exporters.

The low income economies are sometimes referred to as the third world (the high income and middle income economies representing the first and second worlds). Low income economies which shelter about 37 per cent of the world population produce only 3 per cent of the global income. In 2005, India with 47 per cent of the population of the 54 LICs contributed 58 per cent of their GNI. High income economies with less than 16 per cent of the world population enjoy nearly 80 per cent of the global income.

Falling in between the low income economies and high income economies are the middle income economies.

Middle Income Economies are subdivided into lower middle income (those with per capita GNI between $1,046 and $4,086 in 2014) and upper middle income ($4,087 – $12,615) economies. In 2012, there were 66 middle income economies (33 upper and 33 lower middle income).

The numbers of countries given in this section includes only those with a populations of more than 3 million. There are about 80 countries with populations of less than 3 million or with sparse data.

Differences in the income levels between countries is not a true reflection of the purchasing powers or living standards of people. *For example,* international comparisons of GNP and per capita income in a nominal currency unit (say US dollar) do not reflect a realistic picture because the purchasing power of the national currencies vary. Further, exchange rate changes would give a misleading picture of the economic position of the country when the income is converted into dollars from the national currency. For instance, if the national currency has depreciated against the dollars at a rate higher than the GNI growth rate, when the GNI is converted into dollar, it will show a decline even though the GNI has actually increased in terms of the national currency. To overcome such problems, it has become common to estimate the GNI and per capita income at purchasing power parity (PPP) too. *For example,* in 2015, the per capita income of India was estimated at $1,688; in PPP terms it was estimated at $6,209. What it means is that a bundle of goods which costs $1,688 in India will cost $6,209 in USA. In other words; having $1,688 in India is equivalent to having $6,209 in USA.

TABLE 4.1 : LEADING ECONOMIES IN 2015 AND 2020 (ESTIMATES AND FORECASTS)

Country	*Nominal GDP ($ billion) & Rank*				*PPP GDP ($ billion) & Rank*			
	2015		*2020*		*2015*		*2020*	
	GDP	*Rank*	*GDP*	*Rank*	*GDP*	*Rank*	*GDP*	*Rank*
USA	17,968	1	22,294	1	17,968	2	22,294	2
China	11,385	2	17,100	2	19,510	1	28,921	1
Japan	4,116	3	4,747	3	4,842	4	5,512	4
Germany	3,371	4	4,005	4	3,842	5	4,514	5
United Kingdom	2,865	5	3,852	5	2,660	9	3,251	9
France	2,423	6	2940	7	2,647	10	3,160	10
India	**2,183**	**7**	**3,444**	**6**	**8,027**	**3**	**12,706**	**3**
Italy	1,819	8	2,144	8	2,174	12	2,520	12
Brazil	1,800	9	2,054	9	3,208	7	3,828	8
Canada	1,573	10	1,958	10	1,628	16	1,982	17
Korea	1,393	11	1,899	11	1,849	13	2,408	13
Australia	1,241	12	1,516	13	1,137	19	1,441	20
Russia	1,236	13	1,792	12	3,474	6	3,998	7
Spain	1,221	14	1,498	14	1,636	15	1,990	16
Mexico	1,161	15	1,496	15	2,220	11	2,844	11

Source: http://statisticstimes.com/economy

Note: Some countries within the first 15 ranks in 2020 do not figure in the Table as they were not within the 15 ranks in 2015.

Low income and middle income economies are developing economies. The developed economies as a group are sometimes referred to as the North as they, with some exceptions like Australia and New Zealand, are in the northern hemisphere and the developing economies are referred to as the South as most of them are in the southern hemisphere. The High Income OECD members (24) are industrial economies whereas most other HICs are oil exporters.

Developing and Developed Economies/Countries is an often used classification of countries.

The use of the terms developed and developing, though convenient, is not, however, intended to imply that all economies in the group of developing are experiencing similar; development or that other economies have reached a preferred or final stage of development. Classification by income does not necessarily reflect development status. In the group of the high income economies, the industrial economies are developed economies; all the oil exporters are not developed economies (*For example,* Kuwait and UAE, though high income economies, are regarded as developing economies). Besides income, some other criteria such as the sectoral distribution of the income and employment generation, social development indicators etc., are applied to consider whether an economy is a developed or developing one. Besides the income and social dimensions, there are a number of common characteristics of developed economies. They are characterised by widespread use of modern and sophisticated technology; continuous innovations; fast diffusion of new ideas and technologies; low share of the primary sector (mainly agriculture) and dominance of the tertiary (service) sector and secondary (mostly manufacturing) sector in the income and employment generation; market-friendly economic policies; comparatively open trade and investment policies; democratic rights; competition and consumer choice etc.

Sometimes, the terms *less developed* countries (LDCs) and *more developed* countries (MDCs) are used to refer to the developing and developed countries. The use of the term *underdeveloped* to refer to the developing countries is also common.

Low income is just an indication of deprivation people in developing countries. Low income prevents access to even basic necessities, not only better and modern amenities.

Further, in the developing economies, the inequality in the distribution of income is very high and as a result a large proportion of the population lives in object poverty. Although many countries have achieved considerable reduction in poverty, the incidence of poverty is very high in many countries. They are generally characterised by high birth and population growth rates. Death rates are also higher than in developed countries.

Developing countries are generally characterised by the prevalence of rudimentary and traditional methods and obsolete technology.

The group of developed as well as the developing countries is a heterogeneous mixture. Because of the large number, the developing countries exhibit a very diverse spectrum.

Within the category of low income economies, *for example,* sometimes a special category by name *least developed economies* is identified. Most of the least developed economies suffer from one or more of the following constraints: a very low GNP per capita, landlocked remote insularity, desertification and exposure to natural disasters. According to the *Human Development Report 2015*, there were 48 least developed countries including Bangladesh, Bhutan, Nepal, Maldives, Mali, Uganda, Myanmar, Sudan, Zambia, Zimbabwe, and Yemen.

There are, on the other hand, developing economies which have been experiencing rapid industrialisation such as Hong Kong, South Korea, Singapore and Taiwan (*i.e.,* Taipei, China) – the Asian Tigers. They are sometimes referred to as *newly industrialising economies*. Some publications use the term newly industrialised (instead of industrialising) to refer to them. Now, People's Republic of China is regarded as a newly industrialising economy. The newly industrialising economies show a very high growth rate, over a long period, of the economy and per capita income. They have also been presenting very impressive export performance.

Although the per capita income is very low, some developing countries are amongst the largest economies of the world. In terms of the size of the GNI, in 2005 China ranked 4th and India 10th. In PPP terms, China was the 2nd and India the 4th largest economy while their per capita income rankings were very poor. There are, however, many developing economies with very small per capita income and GNI.

Those economies which are in a transition from the centralised economic system to the market economy are referred to as *transition economies*. The transition economies, thus, are the former communist/socialist economies (erstwhile USSR, *i.e.,* the present CIS) and East European countries which are undergoing an economic (system) transition. They also represent a transition from authoritarianism to democracy.

As indicated earlier, income is not the only criterion to consider a country as developed. There is indeed some important difference between economic growth and development. An increase in income is an indication of economic growth. Economic development, besides growth, has some qualitative dimensions too, such as the distribution of income, standard of living, composition of output, character of working conditions and overall improvement in economic welfare.

The differences in the income and development levels have important implications for business.

In a developing country, the low income may be the reason for the very low demand for a product. The sale of a product for which the demand is income-elastic naturally increases with an increase in income. But a firm is unable to increase the purchasing power of the people to generate a higher demand for its product. Hence, it may have to reduce the price of the product to increase the sales. The reduction in the cost of production may have to be effected to facilitate price reduction. It may even be necessary to invent or develop a new low-cost product to suit

the low income market. Thus, Colgate designed a simple, hand-driven, inexpensive ($10) washing machine for low-income buyers in less developed countries. Similarly, the National Cash Register Company took an innovative step backward by developing a crank-operated cash register that would sell at half the cost of a modern cash register and this was well received in a number of developing countries.

In countries where investment and income are steadily and rapidly rising, business prospects are generally bright, and further investments are encouraged. There are a number of economists and businessmen who feel that the developed countries are no longer worthwhile propositions for investment because these economies have reached more or less saturation levels in certain respects.

In developed economies, replacement demand accounts for a considerable part of the total demand for many consumer durables whereas the replacement demand is negligible in the developing economies.

In most of the countries, the service sector is the largest and fastest growing sector. The services sector now contributes nearly 70 per cent of the world GDP.

STRUCTURE OF THE ECONOMY

The structure of the economy – factors such as contribution of different sectors like primary (mostly agricultural), secondary (industrial) and tertiary (secondary) sectors, large, medium, small and tiny sectors to the economy, and their linkages, integration with the world economy etc. – are important to business because these factors indicate the prospects for different types of business, certain factors which affect the business etc. *For example,* if an economy is highly integrated with the global economy it will be quickly affected by developments in the global economy.

Normally, as an economy develops, the share of the primary sector in the GDP and employment declines and those of the other sectors increase. After a certain stage, the share of the manufacturing sector may also decline.

The developed economies are primarily service economies in the sense that the service sector generates bulk of the employment and income. The contribution of services to GDP and employment is substantially high in, particularly, the developed economies.

TABLE 4.2 : CONTRIBUTION OF SERVICES TO VALUE ADDED AS PERCENTAGE OF GDP

Region/Country	*1980*	*1990*	*2010*
World	56	60	70
High Income Economies	59	64	73
Low & Middle Income Economies (Developing Countries)	42	46	55
India	39	42	55

Source: World Bank, *World Development Report*, 1999, 2000 and 2012.

The nature of each sector has business implications. *For example,* although India is one of the largest producer of several agricultural products, because of the small and fragmented nature of the land holdings, efficient collection and processing of the produce become difficult. The land holding pattern also makes productivity improvements difficult. It also has implications for the agricultural inputs business.

The tremendous growth of trade in services and, more recently, of electronic commerce, is part of a new trade pattern. Exports of commercial services have been growing on every continent (particularly Asia) throughout the 1990s and later. This change has its own special significance, as services are frequently used in the production of goods and even other services. Enhanced international competition in services means reductions in price and improvements in quality that will enhance the competitiveness of downstream industries. Both industrial and developing economies have much to gain by opening their markets. Developing countries would derive large gains from an easing of barriers to agricultural products and to labour-intensive construction and maritime services. Over the longer term, electronic business will loom large as an area where expanding opportunities for trade require an expanding framework of rules.[1]

Although the share of services in the GDP of developing economies is lower than in the developed ones, the service sector has been growing very fast in the developing world. The share of services in the GDP of India increased from 39 per cent in 1980 to 54 per cent in 2005.

ECONOMIC POLICIES

There are several economic policies which can have a very great impact on business. Important economic policies are industrial policy, trade policy, foreign exchange policy, monetary policy, fiscal policy, foreign investment and technology policy.

Some types or categories of business are favourably affected by government policy, some adversely affected, while it is neutral in respect of others.

Similarly, an industry that falls within the priority sector in terms of the government policy may get a number of incentives and other positive support from the government, whereas those industries which are regarded as inessential may have the odds against them.

Industrial Policy: Industrial policy can even define the scope and role of different sectors like private, public, joint and cooperative, or large, medium, small and tiny. It may influence the location of industrial undertakings, choice of technology, scale of operation, product mix and so on.

In India, until the liberalisation ushered in 1991, the scope of private sector, particularly of large enterprises, was very limited. The development of 17 of the most important industries was reserved for the state. In the development of another 12 major industries, the state was to play a dominant role. In the remaining industries, cooperative enterprises, joint sector enterprises and small-scale units were to get preferential treatment over large entrepreneurs in the private sector. Further, the production of a large number of items was reserved for the exclusive manufacture of the small-scale sector. Even in respect of industries which were open to the private sector, entry and growth were regulated by licensing and also by, in the case of certain categories of large firms, the MRTP Act. The government policy, thus, limited the scope of private business. However, the new policy ushered in July 1991 has wide opened all but a few industries for the private sector, dramatically changing the business environment. In the pre-liberalisation era, the government policy was a severe constraint on the portfolio and growth strategies of companies.

The liberalisation has enormously expanded the business opportunities. It has at the same time tremendously increased the competition tending to make survival of the fittest order. While many companies entered new businesses, many exited from some of their old businesses, unable to be competitive in the new environment. A number of companies have done both.

Trade Policy: The trade policy can significantly affect the fortunes of firms. *For example,* a restrictive import policy, or a policy of protecting the home industries, may greatly help the import competing industries, while a liberalisation of the import policy may create difficulties for such industries.

Trade policy is, often, integrated with the industrial policy. As part of the economic liberalisation and WTO compliance, India has very substantially liberalised imports. Domestic firms now face increasing competition from imports. In other words, they face a growing international competition in the domestic turf. This implies that in many cases Indian firms which do not come up to the international standards – in quality, cost, marketing, after-sales service etc. – will not be able to survive. And a firm which effectively fights foreign competition in the home market may be provoked to think 'why not compete with foreign firms in the foreign markets.'

Liberalisation of imports facilitate global sourcing and this could help many Indian firms to become more competitive.

Foreign Exchange Policy: Exchange rate policy and the policy in respect of cross-border movement of capital are important for business. The abolition/liberalisation of exchange controls all around the world since the late 1970s has encouraged cross-border movement of capital, for example.

TABLE 4.3 : INDIAN ECONOMIC REFORMS AND ENVIRONMENTAL CHANGE

Pre-1991 Situation	*Post-1991 Situation*	*Consequence/Implication of the Change*
Private sector excluded from many important industries. In a number of other important industries, public sector had priority to establish new undertakings.	All but a few industries are open to the private sector.	Enormous scope for private investment. Considerable freedom to decide the portfolio strategy. Competition increases substantially and public sector loses its monopoly/dominant positions.
Entry, involving investment above specified exemption limit, was restricted by licensing.	All but a few industries are free from licensing.	Reinforces the above factors.
Entry of large firms was subject to MRTP Act restrictions, besides licensing.	No MRTP Act restrictions on entry.	Reinforces the above factors.
Licensing and MRTP Act restrictions on growth of existing undertakings.	All but a few industries are free from licensing restrictions on growth. No MRTP Act restrictions on growth.	Companies can grow organically and by acquisitions. Firms will grow in size and several industries will witness consolidation of firms. A small number of firms would eventually dominate the industry in several cases.
Limited scope for foreign capital and technology.	Foreign capital and technology policies have been substantially liberalised.	Entry of many foreign firms by green-field projects and acquisitions. Opportunity for Indian firms for acquiring technology and establishing joint ventures. Substantial increase in competition.
Highly restrictive import policy.	Imports substantially liberalised.	User industries can benefit by global sourcing. Import competing firms face stiff competition. Global competition emerges in the Indian market. Indian firms will have to improve their competitiveness and become more innovative to face the global competition.

Foreign Investment and Technology Policy: Until the late 1980s, when the worldwide trend towards liberalisation set in, foreign capital and technology were under severe restrictions in many developing and socialist/communist countries.

Restrictions on foreign capital and technology constrain not only the foreign firms but also the domestic firms because it may come in their way of acquiring the technology of their choice from the best source. Restrictions on foreign capital may affect the growth plans of firms, including establishment of joint ventures. India has restrictions on foreign investment by Indian companies.

Huge investments in infrastructural and other vital sectors can significantly improve the environment for industrial development, as in the case of China.

A liberal foreign investment and technology policy will increase domestic competition and would put many domestic firms, which were shielded from foreign competition, in to problems. At the same time, it would benefit many domestic firms – by permitting global sourcing of capital and technology, by increasing the quantity and quality of domestic supply of many goods and services etc.

Fiscal Policy: Government's strategy in respect of public expenditure and revenue can have significant impact on the business. The pattern of public expenditure may affect the development of various regions, sectors and/or industries differently. Such is the case with the taxation policy. Governments often use tax incentives or disincentives to encourage or discourage certain activities. *For example,* when an industry suffers from recession, a reduction of taxes like excise duty or sales tax may help improve the demand. A reduction of rates of direct taxes like personal income tax and corporate tax may help increase, because of the resultant increase in the disposable income, the spending in the economy leading to an increase in demand. Governments, central as well as provincial, of many countries offer different fiscal incentives to woo industries.

Monetary Policy: The central bank, by its policy towards the cost and availability of credit, can significantly influence the savings, investments and consumer spending in the economy. Depending on the conditions of the economy and the general economic policy of the government, the central bank (called the Reserve Bank in India) may adopt an expansionary or contractionary or neutral monetary policy. *For example,* a one percentage point reduction in the Cash Reserve Ratio or Statutory Reserve Ratio (SLR) will significantly increase the loanable funds with the commercial banking system. An increase in these ratios will have the opposite effect. Monetary policy may also be pressed into action to influence the exchange rate of the currency.

ECONOMIC CONDITIONS

General economic conditions affect business. Economies pass through periods of boom and recession. A boom is characterised by high level of output, employment and rising demand and prices. A recession has the opposite of these characteristics.

If a region depends to a significant extent on any particular industry or sector, business in that region would be significantly affected by fortunes of that industry. The economic and business prospects in major oil exporting countries depend to a very great extent on the crude oil price. The economic condition of a region may be linked to the prices of major crops of the region. *For example,* because of the fall in the prices, the coconut farmers of Kerala were estimated to have lost about ₹ 10,000 crore between 1997-2000. Similarly, the rubber farmers lost an estimated ₹ 1,500 crore during the 5 year period ended 2000. The price of several other commercial crops also crashed. This situation has very adversely affected the general economic and business conditions in the State.

The US with less than 5 per cent of the world population generates about 28 per cent of the world income buys about 18 per cent of the goods exported by all other nations and supplies about 10 per cent of the goods other nations' import.

A particular economic condition may be widespread – international or national – or may be confined to a region. *For example,* during 1997-98 when several South East economies underwent a crisis, it affected the business of even firms in a number of other countries. The Indian steel exports to South East Asia, *for example,* suffered a severe setback. This prompted the Indian steel industry to very seriously consider the US and European markets and it was largely successful in its export to these markets – in 1998-99 steel exports to the US surged by over 100 per cent and to Europe nearly 90 per cent.

As Table 4.1 indicates, the US economy accounts for well over one-fourth of the global economy. This implies that the growth trend of the US economy can affect the overall growth trend of the global economy by more than 25 per cent. *For example,* in an year even if the rest of the global economy remains stagnant, on the whole, if the US economy grows by two per cent, it will have the effect of the world economy growing by about half a per cent. A recession in the US economy will have the opposite impact. As the US economy is highly integrated globally, the economic conditions in the US can have repercussions in other economies. See *Box* 1.3 (Chapter 1).

The current account and balance of payments positions of a country can significantly influence certain economic policies and business environment. *For example,* a sustained current account surplus may encourage the government to liberalise imports and capital movements.

Exports and imports of a country are generally affected by a number of domestic and international economic conditions. *For example,* analysis of empirical data reveals that India's export performance is affected by certain important factors. They include a set of external factors, a set of internal factors and the real exchange rate.

The external factors are:

- The rate of growth of the economies of the importing countries
- The rate of growth of the world trade
- The rate of change in the price level in the importing country

The internal factors are:

- The rate of growth of the Indian economy
- The rate of change in the domestic price level

Capital and trade flows and Balance of Payments are affected by both domestic and global economic and other factors.

The most favourable condition for the growth of Indian exports is a combination of the high growth rates for all the three external factors, a high growth rate with price stability for the Indian economy and a fall in the real exchange rate for exports (RERx). If some of the above conditions are satisfied and other conditions are not favourable, the export performance should be expected to be determined by the relative strengths of the favourable and unfavourable factors. We will have the worst situation when the reverse of the ideal combination of conditions occurs.

The analysis of the impact of the interrelationship of the above-mentioned variables on India's exports for a period of nearly two decades by G.C. da Costa has revealed the following:[2]

1. Good growth in the economies of the industrial countries has been associated with good growth in India's exports. This has been very pronounced in those years characterised by good growth in the world trade, sharp fall in the RERx and relative price stability in India.
2. Low growth or recessionary conditions in the economies of the industrial countries, along with depressed world trade together with even moderate increases in the RERx did not provide any competitive edge to the country's exports—the volume of India's exports broadly kept pace with the growth in the economies of the industrial countries.
3. In some years, even when the growth in the economies of the industrial countries was low, the country experienced good growth in the volume of exports because of the sharp decline in the RERx.
4. During certain periods, despite modest growth in the industrial countries and in world trade, the volume of India's exports fell because of the rise in the RERx.

Besides import regulations, the important factors which determine the volume of India's imports are:[3]

1. The rate of growth of the Indian economy—high rate of growth, *ceteris paribus,* is associated with rise in imports.
2. The relative price of imports (*i.e.,* the relative change in the prices of imports and domestic goods). An increase in the imports, *ceteris paribus,* is associated with a fall in the relative price of imports.

From the above two factors, it can be inferred that the volume of imports tends to be very high when there is a conjecture of high rate of economic growth and a sharp fall in the relative price of imports and *vice versa*.

There are, thus, a number of economic factors, many of which form a complex web, which affect the business.

SUMMARY

Business fortunes and strategies are influenced by economic characteristics and economic policy dimensions such as the structure and nature the economy, the stage of development of the economy, economic resources, the level of income, the distribution of income and assets, global economic linkages, economic policies etc. Important economic environmental factors are listed in Table 4.4.

TABLE 4.4 : IMPORTANT FACTORS OF ECONOMIC ENVIRONMENT

Structure and Nature of Economy	*Economic Conditions*	*Economic Policies*	*Global Linkages*
• Level of development of the economy • Sectoral composition of output • Inter-sectoral linkages	• Income levels • Distribution of income • GDP trends • Sectoral growth trends • Demand and supply trends • Price trends • Trade and BoP trends • Foreign exchange reserves position • Global economic trends	• Industrial policy • Trade policy • Monetary policy • Fiscal policy • Foreign exchange policy • Foreign investment and technology policy	• Magnitude and nature of cross-border: Trade flows Financial flows • Membership of WTO, IMF, World Bank, trade blocs etc.

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Chapter 5

POLITICAL AND GOVERNMENT ENVIRONMENT

Structure

Functions of State

Government and Legal Environment

Economic Roles of Government in India

Summary

References

The fact that it is often politics that determines economic and business policies highlights the critical importance of the political environment to business. Dimock observes: "The two most powerful institutions in society today are business and government; where they meet on common ground – amicably or otherwise – together they determine public policy, both foreign and domestic, for a nation".[1]

Major economic policy decisions often have political underpinnings. The adoption, in the early 1950s, of the principle of *socialist pattern of society* as the socio-economic philosophy by the Congress party, which ruled India until 1995 except for a brief period (1977-1980), was mainly responsible for the public sector dominated development strategy followed in India until the early 1990s. It is indeed the dramatic changes in the political environment in the erstwhile USSR and East European countries that gave rise to drastic changes in their economic policies in the late 1980s. And these developments have encouraged a revolutionary change in India's economic policies in 1991. See Box 5.1.

The political environment includes factors such as the characteristics and policies of the political parties, the nature of the Constitution and government system and the government environment encompassing the economic and business policies and regulations. These factors may vary very considerably between different nations, between different provinces of the same nation and also over time.

BOX 5.1 : POLITICAL ENVIRONMENT AND ECONOMIC REFORMS

Despite his pragmatic views, dynamism and the dream of the 21st century India, Prime Minister Rajiv Gandhi could not introduce any far-reaching changes even with the candid mandate that overwhelmed him in the election of 1984. But, the Congress government under Narasimha Rao did it in 1991 and the successive non-Congress Governments have carried further forward the economic liberalisation. Why? The changing global scenario, particularly the developments in the communist countries, provides the answer.

There were considerable differences between the Rajiv era and 1991. Rajiv Gandhi who assumed office in 1984 had given great hopes to the teeming millions of India. No wonder, the Congress party led by the young prime minister who promised to mould India for the 21st century was given a thumping victory by the grief-stricken electorate.

Rajiv who was well aware of the damages done by the unpragmatic regulations was eager to radically reform the economic regime. Hence, many in India and abroad naturally expected that he would introduce far reaching reforms. But alas, the great expectations were belied soon as he succumbed to what he thought, or was made to believe, was political prudence. The word socialism was still dominant on the political surface. The leftists were severely opposed to even minor economic liberalisations and deregulations. To speak against socialism or public sector was regarded a sin. Many in the Congress party, who thought that socialism and public sector still had a magic spell, thought that it was still necessary to swear by these ideas which were losing glamour in many other countries. Although the number of people who were in favour of deregulation and privatisation could be more than those who opposed it, the latter was very vociferous and therefore a determinant force.

In short, what was thought to be political expediency prevented even Rajiv from making any major departure from the old regime and, therefore, dogmatism continued to dominate pragmatism. And what started with a big bang ended with a whimper.

Of course, Rajiv carried further forward, with a little more vigour, the policy of piecemeal economic liberalisations started since the early 1980s. These have had favourable effects. These measures were, however, quite insufficient to rejuvenate the economy. Even the perestroika and glasnost in the USSR and the developments in the Eastern Europe and China, let alone the developments in several other countries, failed to make Indians socialist political genera either to openly admit the folly or to rethink. And Indians development continued to be handicapped by the irrelevant political dogmatism which was being discarded by others.

The environment in 1991, however, has been quite different and conducive for a major change. Mikhail Gorbachev and his perestroika and glasnost send a message to the people in the Eastern Europe that the USSR would not any more use its mighty power in these countries to suppress the democratic rights. People in these countries wanted to free themselves from the decades old deprivation and suppression. The fall of the Berlin Wall was symbolic. Despite the Tiananmen square tragedy in China (gunning down of students who demonstrated demanding democratic freedom), people in the Eastern Europe revolted against the wall of authoritarianism and oppression, demanding bread and freedom. Even the very words communism and socialism began to be opposed, tooth and nail, by the very people who were put under these regimes for quite a long time.

These nations have been seeking large financial, technical and managerial assistance not only from such institutions as the IMF and the World Bank, which had been described by many leftists in the past as organs of capitalist imperialism, but also from the capitalist governments for reconstructing the economies impoverished by decades of communist rule. Gorbachev has gone on knocking at the doors of capitalist countries, known as group of seven (G7), for help. Some of the debates in the G7 and in the Western media as to whether the USSR should be given assistance or what should be the extent and mode of help etc. should have been embarrassing for the aid seeker but Gorbachev consoled, quite rightly, that it was for the economic salvation of the millions of his countrymen that he has been doing it.

The communist countries had taken up privatisation at an amazing speed. Their economies have been opened up even for multinationals. Consequently, there has been an influx of investment. In short, in the communist countries, the clock turned a full round.

There was a time when certain political parties all over the world put the blame for the world economic disorder on the capitalist nations, particularly the USA. And now, nations or provinces which have been ruled by these very parties seek varied assistance of American capitalism and the like.

In short, the global political environment in 1991 was quite different from that during the Rajiv era. At the same time, economic crisis in India was assuming more serious proportions demanding effective measures for economic rejuvenation and survival in a highly competitive and transnationalising global environment. And the emerging global political environment made the political decision of a dramatic change in the economic policy easy in India. Thus, the economic and political factors acted and reacted upon each other resulting in a drastic change in the economic policy and direction of the nation.

Courtesy: *Francis Cherunilam, Economic Reforms in India and Abroad (Himalaya Publishing House, Mumbai, 1992).*

Important economic policies such as industrial policy, policy towards foreign capital and technology, fiscal policy and foreign trade policy are often political decisions.

Peter Drucker in the *Management Challenges for the 21st Century* observes: "Even within transnational economic units, national politics still overrule economic rationality. Despite the European Economic Community, for instance, it has proven all but politically impossible to close a totally redundant plant in Belgium and shift the work to a French plant of the same company only thirty miles away, but on the other side of a national border."[2]

Many political decisions have serious economic and business implications. The economic policy of the ruling party is very important. In the past, communists and other leftists favoured state capitalism and were against private capital, particularly foreign.

FUNCTIONS OF STATE

There are very divergent perceptions of the functions of the state. On the one extreme is the view that "the government that governs is the best" and on the other extreme is the demand for government ownership or control of almost everything. Further, the philosophy regarding the state's role in the society has undergone significant changes over time in many countries over time. A number of countries are, in fact, transitioning from Marx to the market.

The economic role of the state has been recognised for several centuries now. "States have come in all shapes and sizes, depending on a mix of factors including culture, natural endowments, opportunities for trade and distribution of power."[3] Seventeenth century mercantilists wanted the state to play a major role in guiding trade. Adam Smith's *Wealth of Nations,* published in the late eighteenth century, however, popularised the view that economic growth and welfare are best achieved by the free market mechanism and the state should confine itself to certain core functions such as law and order defence etc. and enforcement of contracts, essential for the proper functioning of the market economy. "But even then, state intervention went on to play a vital, catalytic role in the development and growth of markets in Europe, Japan and North America."[4] Even in the United States, which is regarded as the citadel of market economy, State has been playing an active role in the development of several industries/sectors.

BOX 5.2 : STATE AND GOVERNMENT : SOME CONCEPTS

State, in its wider sense, refers to a set of institutions that possess the means of legitimate coercion, exercised over a defined territory and its population referred to as society. The state monopolises rulemaking within its territory through the medium of an organised government.

The term government is often used differently in different contexts. It can refer to the process of governing, to the exercise of power. It can also refer to the existence of that process, to a condition of "ordered rule." "Government" often means the people who fill the positions of authority in a state. Finally, the term may refer to the manner, method, or system of governing in a society: to the structure and arrangement of offices and how they relate to the governed. While keeping these distinctions in mind, we also use the termsstate and government colloquially and sometimes interchangeably–as they are often used in discussion and writing around the world.

Government is normally regarded as consisting of three distinct sets of powers, each with its assigned role. One is the legislature, whose role is to make the law. The second is the executive (sometimes referred to as "the government"), which is responsible for implementing the law. The third is the judiciary, which is responsible for interpreting and applying the law.

Classifications of government are many but have tended to concentrate on two criteria; the arrangement of offices, which is more narrow in conception, and the relationship between government and the governed.

The first classification is based on the relationship between the executive and the legislature. In a parliamentary system the executive 's continuance in office depends on its maintaining the support of the legislature. Members of the executive are commonly also members of the legislature. A prime minister may be the most powerful member of the executive, but important decisions within the executive are usually made collectively by a group of ministers. In a presidential system the executive 's position is independent of the legislature. Members of the executive are not normally also members of the legislature, and ultimate decision making authority within the executive lies with one person, the president.

The second classification concentrates on the distribution of power between levels of government. In a unitary state, all authority to make laws is vested in one supreme legislature whose jurisdiction covers the whole country. Local legislatures may exist, but only with the sufferance of the national legislature. In a federal state, local legislatures are guaranteed at least a measure of autonomous decision making authority. In a confederation, a group of sovereign states combine for specified purposes, but each state retains its sovereignty.

Courtesy: *World Bank : World Development Report, 1997.*

In most modern economies, the state's regulatory role is now broader and more complex than ever before, covering such areas as the environment and the financial sector, as well as more traditional areas such as monopolies. The design of regulation needs to fit the capability of state regulatory agencies and the sophistication of markets, and give greater emphasis to personal responsibility.

The first half of the twentieth century witnessed an increase in the state intervention in the economy. The Russian Revolution of 1917 and the consequent establishment of communist rule in the USSR had great influence across the globe on the thinking of the state's role. The *Great Depression* in USA (which eventually spread to other countries), that set in with the *Wall Street* collapse of 1929 and assumed terrific proportions in the early 1930s, brought to the fore the important role the state has in a capitalist economy. Shortage of entrepreneurship and other development resources and ideological flavour encouraged many developing countries to assign a very important role to the state in the socio-economic system.

Even in market economies, important sectors are effectively regulated by the state.

The post second world war paradigm "coalesced around three basic themes, all of which commanded broad, if not uniform, agreement. This three-pillared consensus remained largely undisturbed until the first oil price shock of 1973. First was the need to provide welfare benefits to those suffering from transitory loss of income or other deprivation. Second was the desirability of a mixed public-private economy, which would often mean nationalising a range of strategic industries. Third was the need for a coordinated macroeconomic policy, on the grounds that the market alone could not deliver stable macroeconomic outcomes that were consistent with

The government expenditure forms a substantial percentage of the GDP in the developed and developing countries.

individuals' objectives. In time, the goals of macroeconomic policy were made explicit: full employment, price stability, and balance of payments equilibrium.

States, thus, took on new roles and expanded existing ones. By mid-century, the range of tasks performed by public institutions included not only wider provision of infrastructure and utilities, but also much more extensive support for education and health care."[5]

A reversal of this trend set in the 1980s. Communism collapsed in the USSR and East Europe. China started economic reforms in the late 1970s and widely opened the economy for foreign investment in the eighties. Privatisation caught on at an amazing speed in many developed market economies and developing economies.

CLASSIFICATION OF FUNCTIONS OF STATE

Functions of the state varies from basic minimum requirements to active participation in several other sectors. Figure 5.1 classifies the functions of government along a continuum, from activities that will not be taken at all without state intervention to activities in which the state plays an active role in coordinating markets or redistributing assets.

- The basic functions include the pure public goods such as the provision of property rights, macroeconomic stability, control of infectious diseases, safe water, roads, and protection of the destitute. In many countries, the state is not even providing these. Recent reforms have emphasised economic fundamentals. But social and institutional (including legal) fundamentals are equally important to avoid social disruption and ensure sustained development.
- Going beyond these basic services are the intermediate functions, such as management of externalities (pollution, for example), regulation of monopolies, and the provision of social insurance (pensions, unemployment benefits). Here, too, the government cannot choose whether, but only how best to intervene, and government can work in partnership with markets and civil society to ensure that these public goods are provided.

	Addressing market failure			Improving equity
Minimal functions	*Providing pure public goods* Defence Law and order Property rights Macroeconomic management Public health			*Protecting the poor* Antipoverty programmes Disaster relief
Intermediate functions	*Addressing externalities* Basic education Environmental Protection	*Regulating monopoly* Utility regulation Antitrust Policy	*Overcoming imperfect information* Insurance (health, life, pensions) Financial Regulation Consumer Protection	*Providing social insurance* Redistributive pensions Family allowances Unemployment insurance
Activist functions	*Coordinating private activity* Fostering markets Cluster initiatives			*Redistribution* Asset redistribution

Fig. 5.1 : *Functions of the State (Adopted from World Bank, World Development Report, 1997)*

- States with strong capability can take on more activist functions, dealing with the problem of missing markets by helping coordination. East Asia's experience has renewed interest in the state's role in promoting markets through active industrial and financial policy.[6]

Reinvigorating the State's Capability

Reinvigorating the state's capability can be achieved through the following:[7]

- ***Rules and Restraints:*** Mechanisms for enforcing the rule of law, such as an independent judiciary, are critical foundations for sustainable development. Along with appropriate separation of powers and the presence of watchdog bodies, they also restrain arbitrary behaviour.
- ***Competitive Pressure:*** Competitive pressure can come from within the state bureaucracy, through recruitment of civil servants on the basis of merit. It can come from the domestic private sector, through contracting out for services and allowing private providers to compete directly with public agencies. Or it can come from the international marketplace, through trade and through the influence of global bond markets on fiscal decisions.
- ***Voice and Partnership:*** The means to achieve transparency and openness in modern society are many and varied—business councils, interaction groups, and consumer groups, to name a few. Institutional working arrangements with community groups can contribute to greater state effectiveness by giving citizens a greater voice in the formulation of government's policies. And partnerships between levels of government and with international bodies can help in the provision of local and global public goods.

THE STATE, INSTITUTIONS, AND ECONOMIC OUTCOMES

The State sets the formal rules—laws and regulations—that are part and parcel of a country's institutional environment. These formal rules, along with the informal rules of the broader society, are the institutions that mediate human behaviour. But the state is not merely a referee, making and enforcing the rules from the sidelines; it is also a player, indeed often a dominant player, in the economic game. Every day, state agencies invest resources, direct credit, procure goods and services, and negotiate contracts; these actions have profound effects on transactions costs and on economic activity and economic outcomes, especially in developing economies. Played well, the state's activities can accelerate development. Played badly, they will produce stagnation or, in the extreme, economic and social disintegration. The state, then, is in a unique position: not only must it establish, through a social and political process, the formal rules by which all other organisations must abide; as an organisation itself, it, too, must abide by those rules.[8]

ECONOMIC ROLES OF GOVERNMENT

The Government plays an important role in almost every national economy of the world.

Even in the countries described as capitalist economies or market economies, "a substantial share of the nation's product goes to satisfy public wants, a substantial part of the private income originates in the public budget and public tax and transfer payments significantly influence the state of private income distribution. Moreover, the budget policy affects the level of employment and prices in the private sector."[9]

In the predominantly private enterprise economies, government interference is necessitated by the fact, besides the socio-political ideological reasons, if any, "that the market mechanism alone cannot perform all economic functions. Public policy is needed to guide, correct and supplement it in certain respects. It is important to realise this fact since it implies that the proper size of the public sector is, to a significant degree, a technical rather than ideological issue."[10]

The scope of government regulation of business can extend from entry into business through conduct of the business and final results to exit.

TABLE 5.1 : IMPACT OF STATE

Ways of State Promoting Development	*Harmful Impact of State*
• By providing a macroeconomic and a microeconomic environment that sets the right incentives for efficient economic activity • By providing the institutional infrastructure–property rights, peace, law and order, and rules–that encourages efficient long-term investment, and • By ensuring the provision of basic education, health care, and the physical infrastructure required for economic activity, and by protecting the natural environment.	• The wrong kind of rules can actively discourage the creation of wealth. For example, the state may penalise private wealth by distorting prices–through an overvalued currency, for example, or by creating agricultural marketing boards that tax farmers' output and give them little in return. • Even if the rules themselves are benign, they may be applied by public organisations–and their employees–in harmful fashion. They may, for example, impose huge transactions costs, in the form of red tape or bribery, on entrepreneurs setting up new businesses or restructuring old ones. • But potentially the largest source of state-inflicted damage is uncertainty. If the state changes the rules often, or does not clarify the rules by which the state itself will behave, businesses and individuals cannot be sure today what will be profitable or unprofitable, legal or illegal, tomorrow. They will then adopt costly strategies to insure against an uncertain future–by entering the informal economy, for example, or sending capital abroad–all of which impede development.

Courtesy: World Bank, *World Development Report, 1997*

While the state control of economy is a universal phenomenon, the extent and nature of the control vary widely between nations, depending upon the nature and stage of development of the economy, the behaviour of the private sector, the political philosophy, social attitudes, administrative system etc.

Governments normally play four important roles in an economy, *viz.,* regulation, promotion, entrepreneurship, and planning.

As stated above, the extent and nature of these roles in a given situation depend on a number of factors. Some salient features of these roles are outlined below:

Regulatory Role

Government regulation of the business may cover a broad spectrum extending from entry into business to the final results of a business. The reservation of industries to small-scale, public and cooperative sectors, licensing system etc. regulate the entry. Regulations of product mix, promotional activities etc. amount to regulation of the conduct of business.

Results of business operations may be regulated by such measures as ceilings on profit margins, dividend etc. The State may also regulate the relationship between enterprises. Examples of this include restrictions on intra-corporate investments, interlocking of directors and appointment of sole selling agents.

Government regulation of the economy may be broadly divided into direct controls and indirect controls.

Indirect controls are usually exercised through various fiscal and monetary incentives and disincentives or penalties. Certain activities may be encouraged or discouraged through monetary and fiscal incentives and disincentives. For instance, a high import duty may discourage imports and fiscal and monetary incentives may encourage the development of export-oriented industries.

The direct administrative or physical controls are more drastic in their effect. The distinguishing characteristic of direct controls is their discretionary nature. They can be applied selectively from firm to firm and industry to industry, at the discretion of the State.

Regulation of the business had been rampant in the developing countries. Since the late 1980s, however, a deregulation trend has set in. This has drastically transformed the competitive environment and has given an impetus to globalisation.

Promotional Role

The promotional role played by the Government is very important in developed countries as well as in the developing countries. In developing countries, where the infrastructural facilities for development are inadequate and entrepreneurial activities are scarce, the promotional role of the Government assumes special significance. The State will have to assume direct responsibility to build up and strengthen the necessary development infrastructures, such as power, transport, finance, marketing, institutions for training and guidance and other promotional activities.

The promotional role of the State also encompasses the provision of various fiscal, monetary and other incentives, including measures to cover certain risks, for the development of certain priority sectors and activities.

Entrepreneurial Role

In many economies, the State also plays the role of an entrepreneur – establishing and operating business enterprises and bearing the risks. A number of factors such as socio-political ideologies; dearth of private entrepreneurship; neglect of certain sectors, like the unprofitable sectors, by the private entrepreneurs; absence of or inadequate competition in certain segments and the resultant exploitation of consumers, etc. have contributed to the growth of State owned enterprises (SOEs) in many countries.

There was a tendency in many developing countries to assign a dominant place to the public sector. Public sector dominance was usually established in capital-intensive projects like steel, capital goods, petrochemicals and fertilisers for which investment requirements were very large and the expected private returns, at least in the short-run were too low to provide an incentive for private profitability. In many cases even when the private sector was prepared to undertake the risk and invest, State ownership of such industries existed for one reason or other.

However, recently, many governments have resorted to privatisation in varying degrees, and have redefined the role of the public sector.

Planning Role

Especially in the developing countries, the State plays a very important role as a planner.

The importance of planning to a less developed economy was often emphasised by Jawaharlal Nehru, the chief architect of Development Planning in India. He rightly observed: "Whatever it may be in other countries, in underdeveloped countries like ours, which have to develop fairly rapidly, the time element is important and the question is how to use our resources to the best advantage. If our resources are abundant, it will not matter how they are used. They will go into a common pool of development. But where one's resources are limited, one has to see that they are directed to the right purpose so as to help to build up whatever one is aiming at".

ECONOMIC SYSTEMS

The scope of private business depends, to a large extent, on the economic system which indeed is rooted in political philosophy. At one end, there are the free enterprise/market economies or capitalist economies, and at the other end are the centrally planned economies or communist countries. In between these two are the mixed economies. Within the mixed economic system itself, there are wide variations. The freedom of private enterprise is the greatest in the market economy, which is characterised by the following assumptions:

1. The factors of production (labour, land, capital) are privately owned, and production occurs at the initiative of the private enterprise.

Different economic systems are distinguished on the basis of the economic role of the government and the scope and freedom of private enterprise.

2. Income is received in monetary form by the sale of services of the factors of production and from the profits of the private enterprise.
3. Members of the free market economy have freedom of choice insofar as consumption, occupation, savings and investment are concerned.
4. The free market economy is not planned, controlled or regulated by the government. The government satisfies community or collective wants, but does not compete with private firms; nor does it tell the people where to work or what to produce.

The completely free market economy, however, is an abstract system rather than a real one. Today, even the so-called market economies are subject to a number of government regulations. Countries like the United States, Japan, Australia, Canada and member countries of the EEC are regarded as market economies.

The communist countries have, by and large, a centrally planned economic system. Under the rule of a communist or authoritarian socialist government, the state owns all the means of production, determines the goals of production and controls the economy according to a central master plan. There is hardly any consumer sovereignty in a centrally planned economy, unlike in the free market economy. The consumption pattern in a centrally planned economy is dictated by the state.

China, East Germany Soviet Union, Czechoslovakia, Hungary, Poland, etc., had centrally planned economies. However, recently, several of these countries have discarded communist system and have moved towards the market economy.

In between the capitalist system and the centrally planned system, falls the system of the mixed economy, under which both the public and private sectors co-exist, as in India. The extent of state participation varies widely between the mixed economies. However, in many mixed economies, the strategic and other nationally very important industries are fully owned or dominated by the state.

The economic system, thus, is a very important determinant of the scope of private business. The economic system and policy are, therefore, a very important external constraint on business.

TRENDS IN POLITICAL/ECONOMIC PHILOSOPHIES/OUTLOOK

While there are not radical differences in the philosophies of major political parties in some countries, the situation is quite different in some others. The government system in a number countries, including several countries which are making rapid economic progress and having liberal policies towards foreign capital and technology, is not very democratic. That does not mean that they are not good to make business with. As a matter of fact, in several such countries, the procedures are simpler and decisions are quicker than in some of the democratic countries.

Until the political and economic changes ushered in the late 1980s and in the early 1990s in the Eastern Europe, and erstwhile USSR, these countries were a separate block by themselves with several common characteristics. Private enterprises were very limited and State trading, particularly counter trade, was the rule. There were a lot of restrictions on imports and foreign business. This did not, of course, mean that the communist system was insurmountable for multinationals or other foreign firms. Under such a system, in several instances, winning over the top brass of the party or government was a strategy to obtain business. It may be noted that although companies like PepsiCo were kept out of India they were going better with countries like USSR.

In the past, public sector was assigned a very important role in many non-communist, particularly the developing, countries too. In India, *for example,* where the industrial policy wanted the public sector to gain *control over the commanding heights* of the economy limited the scope of the private enterprise, both domestic and foreign. Even in areas where foreign capital was allowed, there was ceiling on the foreign equity participation.

Further, in the past, foreign firms in many developing countries were under the fear of nationalisation.

The clock, however, has turned a full circle in most of the communist and many other countries. Privatisation has progressed at an amazing speed. The erstwhile communist countries and the People's Republic of China where the communist party is still in power, are on the rapid road from Marx to the market.

As against the past suspicion of and antagonism against foreign capital and technology, a large number of the developing countries, including the former communist ones, are in a competition to woo foreign capital and technology. As a result, there has been an influx of foreign investment to these countries.

Although the trend of the direction of government policies across the world appears to be broadly one of convergence, there are lots of differences in the restrictions and regulations of business, scope of foreign business, trade policies, procedures, incentive systems and so on.

Coalition governments of different political parties are becoming common. Sometimes the constituents of the coalition are parties with very different economic ideologies, making the scenario complex or confusing/uncertain.

Some political leaders are so powerful that they wield enormous control over the party. The vision and ideology of such leaders have stupendous implications for business.

Changes in the nature of State's role or extent of State's involvement in the economy can affect the business environment. When public sector was assigned a major role in the industrial development and industrial licensing was very widely applicable, the Central Government in India had an imposing position in deciding the location of projects and type and size of enterprises. However, the substantial reduction in the role of the public sector and delicensing drastically changed the situation and now State Governments have a much greater role and freedom than in the past in the industrial development, including promotion of FDI.

People across the word are becoming more ethnic-centred which may lead of break up of many nations and formation of new independent nations. It is predicted that by middle of this century there could by nearly 1000 countries.

There is a universal trend towards political decentralisation. This indicates some shifts in the power centres firms have to deal with.

The number of politically independent nations has been on the increase as a result of the splitting up of what was once a single country in to several ones. A major reason for this is the rise of what Naisbitt calls tribalism which is defined as "the belief in fidelity to ones' own kind, defined by ethnicity, language, culture, religion, or, (now) the profession."[11] Universally, the desire of ethnic groups to become independent of the supremacy of others is growing. Naisbitt observes that democracy greatly magnifies and multiplies the assertiveness of the tribes; repression does the opposite. And the anguished drama of the tribalism is most pronounced where they are repressed the most brutally. According to Naisbitt, it may be a long time before there are 1,000 countries in this world, but by the middle of this century we should be close to that number.[12]

Hostilities between some countries affect business of firms even in third countries. Arab nations, *for example,* did not do business with firms having dealings with Israel. These countries even insisted that third country firms who wanted to do business with them must produce an Israel boycott certificate. Because of the political ties with Israel, the US government had adopted countervailing laws to prevent the US firms from complying with this boycott. Sometimes, there are also economic sanctions.

GOVERNMENT AND LEGAL ENVIRONMENT

In most countries, apart from those laws that control investment and related matters, there are a number of laws that regulate the conduct of the business. These laws cover such matters as standards of product, packaging, promotion, competition, ethics, ecological factors etc.

Several aspects of the government environment have already been referred to in the previous chapter and preceding section of this chapter. A detailed description of the government's role in the economy is given in a subsequent chapter.

In many countries, with a view to protecting consumer interests, regulations have become stronger. Regulations to protect the purity of the environment and preserve the ecological balance have assumed great importance in many countries.

Some governments specify certain standards for the products (including packaging) to be marketed in the country: some even prohibit the marketing of certain products. In most nations, promotional activities are subject to various types of controls. Several European countries restrain the use of children in commercial advertisements. In a number of countries, including India, the advertisement of alcoholic liquor is prohibited. Advertisements, including packaging, of cigarettes must carry the statutory warning that "cigarette smoking is injurious to health". Similarly, baby foods must not be promoted as a substitute for breast feeding. In countries like Germany, product comparison advertisements and the use of superlatives like *best* or *excellent* in advertisements is not allowed. In the United States, the Federal Trade Commission is empowered to require a company to provide sufficient evidence to substantiate the claim concerning the quality, performance or comparative prices of its products.

There are a host of statutory controls on business in India. Although the controls have been substantially brought down as a result of the liberalisation, a number of controls still prevail.

Many countries, today, have laws to regulate competition in the public interest. Elimination of unfair competition and dilution of monopoly power are the important objectives of these regulations.

Certain changes in government policies such as the industrial policy, fiscal policy, tariff policy etc. may have profound impact on business. Some policy developments create opportunities as well as threats. In other words, a development which brightens the prospects of some enterprises may pose a threat to some others. *For example,* the industrial policy liberalisations in India have opened up new opportunities and threats. They have provided a lot of opportunities to a large number of enterprises to diversify and to make their product mix better. But they have also given rise to serious threat to many existing products by way of increased competition; many seller's markets have given way to buyer's markets. Even products which were seldom advertised have come to be promoted very heavily. This battle for the market has provided a splendid opportunity for the advertising industry.

ECONOMIC ROLES OF GOVERNMENT IN INDIA

THE CONSTITUTIONAL ENVIRONMENT

The Indian Constitution incorporates a number of matters that are economically very significant and have far-reaching implications. The socio-economic and political objectives of the Indian Republic and the basic guiding principles of state functioning have been clearly laid down in the *Preamble* to the Constitution, the *Fundamental Rights* and in the *Directive Principles of State Policy*. The Constitution also outlines the economic powers and responsibilities of the Union Government and the State Governments.

The economic responsibility bestowed on the state by the Indian Constitution is so enormous that it calls for great government interference in the functioning of the economy. In fact, a

number of constitutional amendments, including the first amendment, were effected to enable the state to implement its economic policies and programmes.

It is indeed paradoxical that though the government, in the past, had proclaimed that certain policy measures had been taken and laws had been enacted to give effect to certain Constitutional provisions, some of these very policies have been given up or reversed and Acts repealed since the liberalisation ushered in 1991 while those Constitutional provisions continue unchanged.

The Preamble

The Preamble to the Indian Constitution states that,

THE PEOPLE OF INDIA have solemnly resolved to constitute India into a SOVEREIGN SOCIALIST, SECULAR,* DEMOCRATIC REPUBLIC to secure to all its citizens:

JUSTICE, social, economic and political;

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

EQUALITY of status and of opportunity;

and to promote among them all —.

FRATERNITY assuring the dignity of the individual and the unity and integrity* of the Nation.

[*The words "Socialist Secular", and "and integrity" were inserted by the Constitution (42nd Amendment) Act, 1976.]

The Preamble of a statute conveys the general object and intention of the legislature in enacting it. Although not an essential feature, whenever a Constitution contains a Preamble, it expresses the political, religious and socio-economic values which it envisages to promote. But, it does not control the meaning and scope of the other provisions of the Constitution. However, the Preamble may be a guide when the statute is vague. Otherwise, full effect should be given to the express words of the enactment.

The Preamble to the Indian Constitution lays down that the attainment of social, economic and political *justice,* and *equality of* status and of opportunity should be among the most important basic guiding principles of the functioning of the State. As if this were not enough, the Constitution was amended in 1976 to add, among other things, that India should be a socialist state. In fact, as early as December 1954, the Indian Parliament had accepted the *socialist pattern of society* as the objective of social and economic policy. As if to give this objective more prominence, it was incorporated in the Preamble to the Constitution in 1976 under the controversial 42nd Amendment.

As the Preamble conveys the general object and intention of the Constitution and would be a guide in the interpretation of a statute when it is vague, the above-mentioned aspects of the Preamble to the Constitution give some indications of the need and scope for state intervention in the functioning of the economy with a view to discharging its duties and responsibilities for the realisation of economic and associated objectives.

The Fundamental Rights

The theory of fundamental rights implies limited government. It aims at preventing the government and the legislature from becoming totalitarian, and in doing so it affords the individual an opportunity for self-development.

It has been claimed that the Indian Constitution offers all citizens, individually and collectively, the best fruits of democracy and those basic freedoms and conditions of life which alone make life significant and productive. The rights enumerated in Part III of the Constitution cover a wide range and are declared to be fundamental and justiceable.

But these rights are not absolute; they are subject to limitations imposed by the state in order to secure rights for all individuals or to promote the greater interests of the community or the state, or to serve the ends of a planned society.

The Fundamental Rights enumerated in Part III of the Constitution are:

1. Right to Equality
2. Right to Freedom
3. Right against Exploitation
4. Right to Freedom of Religion
5. Cultural and Educational Rights
6. Right to Constitutional Remedies

The Constitution had also guaranteed, under Article 19(1)*(f),* the Fundamental Right to Property; and Article 31 had prohibited the deprivation of property of any person save by authority of law; and for the deprivation of property compensation had been payable. But, in 1976, the 44th Amendment of the Constitution abolished the fundamental right to property by deleting Articles 19(1)*(f)* and 31. However, Article 300A of the new Chapter IV added to Part XII of the Constitution provides that "no person shall be deprived of his property save by authority of law". Thus, though the right to property is no longer a fundamental right, it has been retained as a Constitutional Right.

The Fundamental Rights also have economic significance.

The Right to Equality prohibits discrimination against any citizen on grounds of religion, race, caste, sex or place of birth. In public employment, it ensures equality of opportunity to all citizens. This is, however, subject to certain limitations, such as the right of the state to reserve posts for backward classes which, in the opinion of the state, are not adequately represented in the services.

The Constitution guarantees the citizens the fundamental right to freedom to practise any profession, carry on any occupation, trade or business. This right is subject to reasonable restrictions in the interest of the general public. Under the First Amendment to the Constitution (1951), the State is empowered to make laws relating to professional or technical qualifications necessary for practising any profession or carrying on any trade, business, industry or service, whether to the exclusion, complete or partial, of citizens or otherwise.

The Fundamental Right against Exploitation prohibits traffic in human beings, and beggary and other forms of forced labour; and any contravention of this provision shall be an offence punishable in accordance with the law. However, this does not prevent the state from imposing compulsory service for public purposes. In imposing such service, the state shall not make any discrimination on grounds only of religion, race, caste or class, or any of them.

Thus, the Fundamental Rights enumerated in the Constitution guarantee a number of economic rights to the citizens; but at the same time, the State has the power to impose reasonable restrictions on such rights in the public interest. A very important thing to be noted is that this power of the state to impose reasonable restrictions in the public interest had resulted in a remarkable increase in the statutory control over the business and a substantial expansion of the entrepreneurial or participative activities of the state. Consequently, there has been an abridgement of the economic liberty of the citizens embodied in Article 19(l)(g).

BOX 5.3 : FUNCTIONS AND POWERS OF PARLIAMENT

As in other parliamentary democracies, Parliament of India has the cardinal functions of legislation, overseeing of administration, passing of budget, ventilation of public grievances and discussing various subjects like development plans, international relations and national policies. The distribution of powers between the Union and the States, followed in the Constitution, emphasizes in many ways the general predominance of Parliament in the legislative field. Apart from a wide range of subjects, even in normal times Parliament can, under certain circumstances, assume legislative power with respect to a subject falling within the sphere exclusively reserved for the States. Parliament is also vested with powers to impeach the President and to remove the Judges of Supreme Court and High Courts, the Chief Election Commissioner and the Comptroller and Auditor General in accordance with the procedure laid down in the Constitution. All legislations require consent of both the Houses of Parliament. In the case of money bills, however, the will of the Lok Sabha prevails.

Delegated legislation is also subject to review and control by Parliament. Besides the power to legislate, the Constitution vests in Parliament the power to initiate amendment of the Constitution. A list of laws made by Parliament during 1998 is given in Appendices.

The functions of Parliament are not only varied in nature, but considerable in volume. The time at its disposal is limited. It cannot make very detailed scrutiny of all legislative and other matters that come up before it. A good deal of its business is, therefore, transacted in committees.

Both Houses of Parliament have a similar committee structure, with a few exceptions. Their appointment, terms of office, functions and procedure of conducting business are also more or less similar and are regulated under rules made by the two Houses under Article 118(1) of the Constitution.

Broadly, parliamentary committees are of two kinds – standing committees and ad hoc committees. The former are elected or appointed every year or periodically and their work goes on, more or less, on a continuous basis. The latter are appointed on an ad hoc basis as need arises and they cease to exist as soon as they complete the task assigned to them.

Among standing committees, the three financial committees – Committees on Estimates, Public Accounts and Public Undertakings – constitute a distinct group and they keep an unremitting vigil over Government expenditure, and performance.

***Courtesy:** Government of India, India 2000.*

Fundamental Duties

By the 42nd Amendment of the Constitution, adopted in 1976, Fundamental Duties of the citizens have also been enumerated. These enjoin upon a citizen among other things, to abide by the Constitution, to cherish and follow noble ideals which inspired our national struggle for freedom, to defend the country and render national service when called upon to do so and to promote harmony and spirit of common brotherhood amongst all people of India transcending religious, linguistic and regional or sectional diversities.

The Directive Principles

The Directive Principles of State Policy is a unique feature of India's Constitution. The Directive Principles are in the nature of directions to the legislature and executive that they should exercise their authority in such a manner as to ensure due respect for, and observance of, these principles. Although these directives are not justiceable, the courts cannot altogether avoid taking cognizance of them. They are the imperative basis of state policy and the Constitution directs the state to apply these principles in making laws.

The Directive Principles that are economically very significant are quoted below:

(a) The State shall strive to promote the welfare of the people by securing and protecting as effectively as it may be a social order in which justice, social, economic and political, shall inform all the institutions of the national life [Article 38(1)].

(b) The State shall, in particular, strive to minimise the inequalities in income, and endeavour to eliminate inequalities in status, facilities and opportunities, not only among individuals but also amongst groups of people residing in different areas or engaged in different vocations [Article 38(2)].

(c) The State shall, in particular, direct its policy towards securing:

1. That the citizens, men and women equally, have the right to an adequate means of livelihood.
2. That the ownership and control of the material resources of the community are so distributed as best to subserve the common good.
3. That the operation of the economic system does not result in the concentration of wealth and means of production to the common detriment.
4. That there is equal pay for equal work for both men and women.
5. That the health and strength of workers, men and women, and the tender age of children are not abused and that citizens are not forced by economic necessity to enter a vocation unsuited to their age or strength.
6. That children are given opportunities and facilities to develop in a healthy manner and in conditions of freedom and dignity and that childhood and youth are protected against exploitation and against moral and material abandonment (Article 39).

It may be noted that sections of Article 39 were quoted as the basis of certain policies and Acts.

(d) The state shall ensure that the operation of the legal system promotes justice, on a basis of equal opportunity, and shall, in particular, provide for legal aid, by suitable legislation of schemes or in any other way, to ensure that opportunities for securing justice are not denied to any citizen by reason of economic or other disabilities (Article 39-A).

(e) The state shall take steps to organise village panchayats and endow them with such powers and authority as may be necessary to enable them to function as units of self-government (Article 40).

(f) The state shall, within the limits of its economic capacity and development, make effective provision for securing the right to work, to education and to public assistance in cases of unemployment, old age, sickness and disablement, and in other cases of underserved wants (Article 41).

(g) The stale shall make provision for securing just and humane conditions of work and for maternity relief (Article 42).

(h) The state shall endeavour to secure, by suitable legislation or economic organisation or any other way, to all workers, agricultural, industrial or otherwise, a living wage, conditions of work ensuring a decent standard of life and full enjoyment of leisure and social and cultural opportunities and in particular the state shall endeavour to promote cottage industries on an individual or cooperative basis in rural areas (Article 43).

(i) The state shall take steps, by suitable legislation or in any other way, to secure the participation of workers in the management of undertakings, establishments or other organisations engaged in any industry (Article 43-A).

(j) The state shall promote with special care the educational and economic interests of the weaker sections of the people, and, in particular, of the scheduled castes and the

scheduled tribes, and shall protect them from social injustice and all forms of exploitation (Article 46).

(k) The state shall regard the raising of the level of nutrition and the standard of living of its people and the improvement of public health as among its primary duties and, in particular, the state shall endeavour to bring about prohibition of the consumption, except for medicinal purposes, of intoxicating drinks and of drugs which are injurious to health (Article 47).

(l) The state shall endeavour to organise agriculture and animal husbandry on modern and scientific lines and shall, in particular, take steps for preserving and improving the breeds, and prohibiting the slaughter of cows and calves and other milch and draught cattle (Article 48).

(m) The state shall endeavour to protect and improve the environment and to safeguard the forests and wild life of the country (Article 48-A).

These Directive Principles make quite clear how important is the economic responsibility bestowed on the state by the Constitution.

Through constitutional amendments, new directives were added to provide a greater socialist orientation to development. For instance, in 1978, by the 44th Amendment, a new clause was added to Article 38; and this new clause contains a directive to strive to minimise the inequalities in status, facilities and opportunities. The 42nd Amendment incorporated a new Article, 43-A, to direct the state to take suitable steps to secure workers' participation in management.

There have been many occasions when the Directive Principles and Fundamental Rights have been in conflict with each other. In the early days, the Supreme Court held that the Fundamental Rights were a sacrosanct part of the Constitution and nothing, including the Directive Principles, could override them. But the view that the Fundamental Rights should be subordinated to the Directive Principles gained ground in later years.

While asking the *Lok Sabha* to refer the Constitution (Fourth Amendment) Bill to the Select Committee, Prime Minister Nehru declared that the Fundamental Rights must subserve the Directive Principles. In the *Keshwanand Bharti vs. State of Kerala,* Justice Mathew observed that "in building up a just social order, it is sometimes imperative that the Fundamental Rights should be subordinated to Directive Principles. Economic goals have an uncontestable claim for priority over ideological ones on the ground that excellence comes only after existence. It is only if men existed that there can be fundamental rights."

The Directive Principles of State Policy enunciated in the Indian Constitution provide an enormous scope for Government intervention in the functioning of the economy. However, quite interestingly, although state control of the economy had been deepened and widened as if it were a Constitutional requirement, this trend has been reversed since 1991 while the same Preamble and Directive Principles are held sacrosanct.

Freedom of Trade, Commerce and Intercourse

According to Article 301 of the Constitution of India, trade, commerce and intercourse throughout the territory of India shall be free. This freedom, however, is not without restrictions.

The Indian Constitution guarantees freedom to carry out trade and commerce throughout India subject to reasonable restrictions.

The freedom guaranteed by Article 301 is in the widest terms and applies to all forms of trade, commerce and intercourse. It is subject only to restrictions specified in Articles 302 to 305 and the freedom to carry on trade, commerce and intercourse throughout India guaranteed under Article 301 cannot be taken away by an executive action.

According to Articles 302 to 305, the State can impose reasonable restrictions on the freedom expressed by Article 301. Accordingly, Parliament may impose such restrictions on the freedom of trade, commerce or intercourse between one States and another or within any part of the territory of India as may be required in the public interest. The State governments are empowered to impose any tax on goods imported from other States if similar goods in the State are subject to similar tax so as not to discriminate between goods so imported and goods manufactured or produced in that State.

Separation of Powers

The contribution of India provides for a tripartite division of powers between legislature, executive and judiciary. They shall not step out of their respective jurisdictions.

Separation of powers is an important feature of the Indian Constitution. "the separation of powers contemplates the idea that the governmental functions must be based on a tripartite division of legislature, executive and judiciary. Each organ should be separate, distinct and sovereign in its own allocated sphere and it should not exercise the functions assigned to another."[13] As Chief Justice Subba Rao observed in the *Golak Nath v. State of Punjab*, the Constitution demarcates the jurisdiction of these organs minutely and expects them to exercise their respective powers without overstepping their limits. They should function within the spheres allotted to them. No authority created under the Constitution is supreme; the Constitution is supreme and all the authorities function under the supreme law of the land."[14]

Division of Power

India's Constitution distributes the items for legislation among three lists:

- Union List
- State List
- Concurrent List.

The respective jurisdictions of the Union and the States and their mutual relations have been clearly defined.

The Union has exclusive power to make laws on all matters in the Union List and the States have exclusive powers to make laws in the State List. Except for the Union Territories, the Centre cannot normally legislate on any matter included in the State List. Parliament can, however, do so if the Council of States recommends by at least two-thirds majority that such legislation is in national interest; if two or more States mutually agree that this should be done for such States and to implement treaties or international agreements or conventions.

Both the Union and States can legislate on matters in the Concurrent List. However, in case of any conflict between the Union laws and State laws, the Union laws shall prevail. Further, the Union has exclusive power to make laws on any matter not enumerated in the Concurrent List or State List.

Expansion in State Intervention

The first four decades of planning witnessed an expansion of state intervention in the economy. The Constitution was amended a number of times. The Constitution of India, which came into force in 1950, was first amended in the very next year. By the First Amendment of the Constitution, the State has been empowered to impose restrictions on the right of citizens to carry on any trade, business, industry or service with a view to enabling the state to undertake any scheme of nationalisation or prescribing the professional or technical qualifications necessary for practicing any profession or carrying on any occupation, trade or business.

The state has, from time to time, acquired increasing powers to control private activity and enlarge its own ownership and management of the economy.

The brief account of the economic significance of the Indian Constitution given above makes it abundantly clear that the state has to shoulder a very heavy responsibility to attain the egalitarian goals set forth in the Constitution. Any responsibility should have commensurate authority also. Over the years, the Government has assumed enormous powers of control over the economy. How effectively and judiciously these powers have been exercised, and how satisfactorily the problems have been solved are different questions.

The Government has been very active in playing all the four important economic roles.

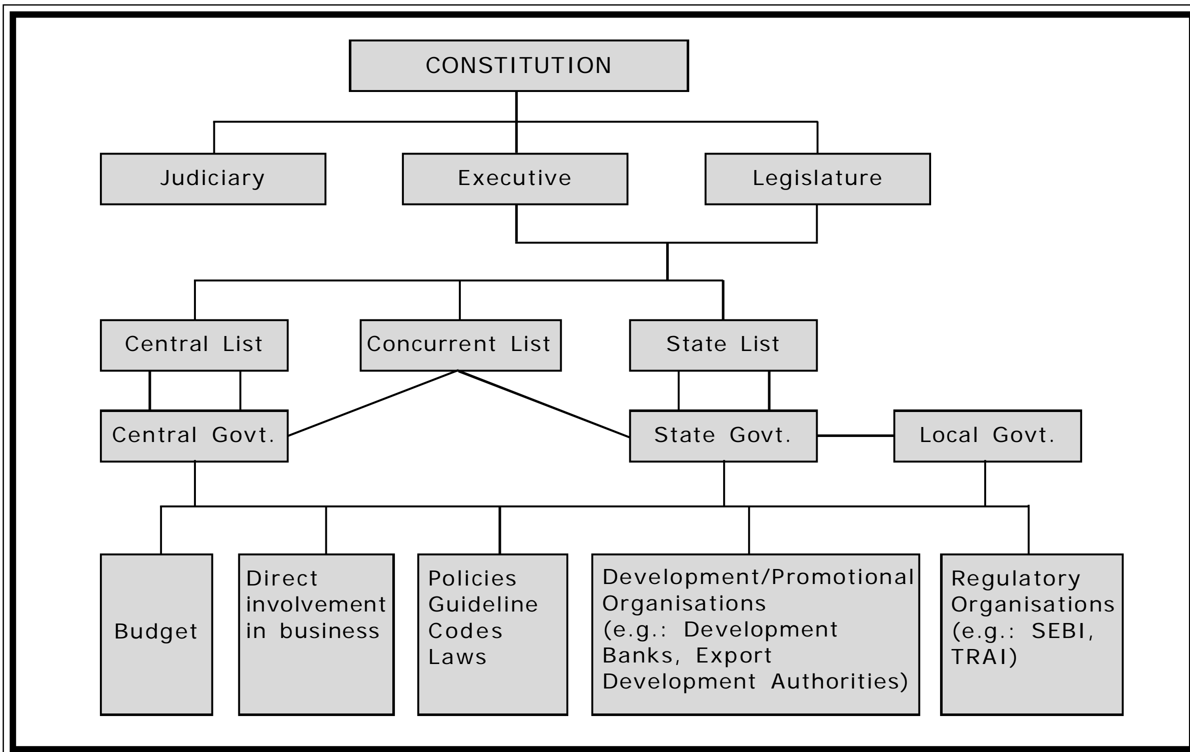

Fig. 5.2 : The Constitutional Environment

The first four decades have witnessed a clear trend towards an expanding control of the state over the various segments of the economy. With the increase in the problems, there has also been a tendency on the part of the Government to arm itself with more and more powers of control over the functioning of the economy. The Industries (Development and Regulation) Act, the Companies Act, Capital Issues Control Act (repealed following the liberalisation), Securities (Contracts Regulation) Act, Monopolies and Restrictive Trade Practices Act, Essential Commodities Act, Prevention of Blackmarketing and Maintenance of Supplies of Essential Commodities Act, Conservation of Foreign Exchange and Prevention of Smuggling Activities Act, Foreign Exchange Regulation Act (replaced by the Foreign Exchange Management Act in 2000), Imports and Exports (Control) Act [replaced by the Foreign Trade (Development and Regulation) Act in1992] etc., provide the Government with sweeping powers of control over industry and commerce, so much so that Government cannot escape the responsibility for any shortfalls, drawbacks, or imperfections in these sectors of vital importance to the economy.

There are quite a good number of industrial and labour laws which regulate employer-employee relations, working conditions, wages, bonus, labour welfare and social security, etc.

The commercial banking sector was brought under the effective control of the Reserve Bank of India by the Banking Companies Act of 1949 and the Amendment Acts of 1956 and 1962, the Banking Laws (Miscellaneous Provisions) Act, 1963, etc. The Securities and Exchange Board of India (SEBI) regulates the capital market.

Indirect controls have also been playing their part in serving the national development goals. Various quantitative and qualitative monetary weapons have been deployed from time to time to regulate the economy, mainly to control prices. A number of fiscal and monetary incentives have been offered to encourage the growth of such priority sectors as the export industry, small industry and small business. Monetary, fiscal, financial and physical incentives have been provided for the accelerated development of the backward regions. Fiscal and monetary policies have also

been employed, as disincentives to discourage certain undesirable or inessential activities. The direct controls had considerably grown in importance.

No less important than the regulatory role is the promotional role of the Government in India. Being a mixed economy, the state has to provide the necessary facilities for the growth of the private sector. Our industrial policy has assigned an important role to the private sector in a number of industries. State's promotional role include development of infrastructural facilities, fostering of institutions to provide financial aid developmental support to business.

BOX 5.4 : HURDLES OF CONTROLS

The control regime that prevailed in India in the past was described by the chief executive of a large company as follows.

"One of the most important roles of the Chief Executive in many parts of the world today is the management of the relationship with the external environment which consists of government, the media, the trade unions, industry associations and various interest groups.. a major difference is that in India, the government is such an overwhelmingly dominant factor that I can confine myself to what has become the most important task of a Chief Executive of any large company in our country; viz., the management of relationship with government. Government in India has such an all-pervasive and predominantly restrictive influence over various aspects of business, e.g., industrial licensing, which decides location, capacity and process; import licensing for machinery and materials; size and price of capital issue; loan. Finance; pricing; managerial remuneration; expansion plans distribution restrictions and a host of other enactments. Therefore, a considerable part of the attention of the Chief Executive and his senior colleagues has to be devoted to continuous dialogue with various government agencies to ensure growth and profitability within the framework of controls and restraints...A notable trend has been the manner in which decision-making has moved up the ladder of government. Decisions which were taken in the early sixties by Joint Secretaries became decisions for Secretaries and decisions for Secretaries became decisions for Ministers as the decade progressed. In the seventies, these became decisions for Cabinet Committees and even for the whole Cabinet. This movement has bad a significant effect, not only in slowing down decisions, but also in increasing the chances of negative decisions...Trying to set up a new industrial unit in India is like running an obstacle race, except that in this case, as you go along, the obstacles are increased both in numbers and complexity without warning. We have estimated that it takes 7 years from the conceptual stage to the production stage for any significant investment to take place in India. Out of this, at least 50 per cent of the time is spent in procedures to satisfy government regulations. In any 3-year period of such delay, the cost escalation in modern times will be almost 50 per cent. In our protected economy, the Indian consumer ultimately pays the price for this cost escalation. At the same time, our exports become less competitive. A further consequence of the delay is that in many cases, we are compelled to import or lose the potential for longer periods."

–From "Managing a Business in India", speech delivered by T. Thomas, Chairman, Hindustan Lever Limited, at the Annual General Meeting of the Company held at Bombay on 20th February, 1980.

For more than four decades since independence, the Indian system had been characterised by a highly controlled regime. Since 1991, it has been an era of progressive relaxation of controls ushering in more scope and freedom for private enterprise.

The expansion in the entrepreneurial/participative role of the state was been very spectacular. The public sector has grown substantially, both vertically and horizontally. The total investment in the Central Government industrial enterprises has grown from ₹ 29 crore spread over 5 units on April 1, 1951, to ₹ 2,23,000 crore in over 236 units in 1998. In some industries, the public sector gained an absolute or near monopoly, and it had a commanding position in a number of basic and heavy industries.

Both fresh investments and nationalisation have contributed to the growth and expansion of the public sector. More than 90 per cent of the commercial banking sector came to be in the hands of the state. Successive nationalisations — the nationalisation of the Imperial Bank and the establishment of the State Bank of India out of it in 1955, the nationalisation of 14 major private banks in 1969 and another six in 1980 — have been mainly responsible for it. The insurance business in the country, too, had been nationalised. The dawn of the present century has witnessed the move towards privatisation/divestment.

Apart from monopoly in the field of railway transport, communications and air transport, the public sector accounted for a considerable share in shipping and road passenger transport. In the energy sector, the public sector had virtual monopoly in coal mining, exploration and refining of petroleum and in the generation and supply of electricity.

At one time, the public sector corporations accounted for about one-tenth of the country's total foreign trade. Imports and exports of certain important items are *canalised* through public sector agencies.

As a consequence of the liberalisation, however, privatisation/divestment has been spreading.

The public distribution system has been expanded to remove the imperfections in the distribution of essential goods and to protect the interests of the vulnerable sections. The Government has been playing a major role as a planner. The Planning Commission was set up in 1950 and the First Five Year Plan was launched in 1951 with the objective of achieving a rapid rise in the standard of living of the people by, an efficient exploitation of the resources of the country, increasing production and offering opportunities to all for employment in the service of the community. Our Five-Year Plans place special emphasis on improvements in the living conditions of the poor. The objective of distributive justice has been given added emphasis in the later Plans.

A significant aspect of Indian planning is the respect for democratic and property rights, unlike in the centrally planned economy. In Indian planning, there has been the balancing of the various economic elements and a sort of a fusion of the public, private and joint sectors, heavy and light industries, and big, medium, small and cottage industries.

In short, as Rosan observed,[15] unquestionably, the Indian government held the levers that determined the levels of output of all large and medium-sized firms by: (1) its own direct production of a wide variety of inputs and final products; (2) its grant, or refusal, of permission to private firms to produce new items or to expand production; (3) its provision of capital funds – to, and control of security issues by, private firms; (4) its control of access to foreign exchange; and, (5) its control of imports.

There has, however, been a very significant relaxation of these controls since 1991.

BOX 5.5 : THE EVOLUTION OF THE ROLE OF THE STATE IN INDIA

When India became independent in 1947, income per capita had been stagnating for half a century, and modern industry was minimal.

The Nehru years, 1947-64. *India`s first Prime Minister, Jawaharlal Nehru, saw industrialisation as the key to alleviating poverty; and a powerful state with a planned economy as essential if the country was to industrialise rapidly; accelerate public saving and investment, and reduce the role of foreign trade and achieve self-sufficiency. Unlike many East Asian countries, which used state intervention to build strong private sector industries, India opted for state control over key industries. Believing the potential of agriculture and exports to be limited, Indian governments taxed agriculture by skewing the terms of trade against it and emphasizing import substitution. They saw technical education as vital for industrialisation.*

Garibi hatao, 1966-77. *Under Prime Minister Indira Gandhi, two major shifts took place in the role of the state. First, the neglect of agriculture was reversed through state activism in subsidising new seeds and fertilisers, agricultural credit, and rural electrification. The green revolution took off, and by the mid 1970s India was self-sufficient in grain. The second shift was the tightening of state control over every aspect of the economy. Under the slogan of* garibi hatao *("abolish poverty"), banks were nationalised, trade was increasingly restricted, price controls were imposed on a wide range of products, and foreign investment was squeezed. The state achieved a stranglehold on the economy. Yet growth of gross domestic product (GDP) failed to accelerate, remaining during this period at 3.3 per cent a year.*

The spending boom and rising fiscal deficits, 1977-91. *Between 1977 and 1991, most stringent controls on imports and industrial licensing were gradually relaxed, stimulating industrial growth. The government*

expanded antipoverty schemes, especially rural employment schemes, but only a small fraction of the rising subsidies actually reached the poor. Competition between political parties drove subsidies up at every election. The resulting large fiscal deficits (8.4 per cent of GDP in 1985) contributed to a rising current account deficit. India`s foreign exchange reserves were virtually exhausted by mid-1991, when a new government headed by Narasimha Rao came to power.

The reform phase, since 1991. *Rising interest payments on India`s foreign debt meant that neither the central government nor the state governments could continue to finance both subsidies and heavy public investment. The former won out, and the government began to woo private and foreign investment. Thus, impending bankruptcy drove the reform process and changed the state`s role from that of principal investor to that of facilitator of entrepreneurship. This shift was expected to free up government finances for more social spending, but in practice the fiscal crunch prevented a significant increase.*

Rao`s government abolished most industrial and import licensing, devalued the rupee, drastically reduced import tariffs, liberalised the financial sector and foreign investment, and allowed private investment in areas previously reserved for the government.

The new coalition governments that came to power in 1996 and thereafter has by and large sustained these reforms.

Thus the old national consensus on socialism has given way over the course of a few years to a new consensus on liberalization. But formidable challenges remain. Most parties agree on the need for reform, yet no party is eager to retrench surplus labour, close unviable factories, or reduce subsidies. The reforms so far are a positive step but must be extended and accelerated if India is to catch up with the East Asian tigers.

Courtesy: World Bank, *World Development Report*, 1997.

SUMMARY

The State, *i.e.*, the government, plays a very active role in all economies, including the market economies, *albeit*, the extent and nature of State intervention vary widely between nations.

Functions of the state varies from basic minimum requirements to active participation in several other sectors. The functions of government may be classified along a continuum, from activities that will not be taken at all without state intervention to activities in which the state plays an active role in coordinating markets or redistributing assets.

The economic roles of Government may be classified into four categories. *Figure 5.3* gives a summary view of the important functions and economic roles of the state.

The role the Government in India is guided and governed by the principles and provisions of the Indian Constitution. Of particular significance are the *Preamble* to the Constitution which indicates the objects and intention of the Constitution, the *Fundamental Rights* which imposes limitations on State's power, the *Directive Principles of State Policy* which suggest numerous socio-economic welfare responsibilities for the State, *separation of powers* of judiciary, executive and legislature and *division of power* and responsibility between the Union and the States.

The Government control over the Indian economy grew enormously in the first four decades since Independence. Since 1991, India has been passing through a process of decontrols and economic reforms. This implies a redefinition of the role of the state.

There has been a global trend towards decentralisation of power and responsibility. It has been true of India too to some extent. The Central Government's role in industrial development has significantly diminished as result of the delicensing and substantial reduction in the role of the public sector. Now, it is left to the States to play an active role in the industrial development by creating a conducive environment for the development of industries, including attracting foreign investment.

Functions of Government	Economic Roles of Government
Basic Functions These include the pure public goods such as the provision of property rights, macroeconomic stability, control of infectious diseases, safe water, roads, and protection of the destitute.	**Regulatory Role** Regulation may cover a wide spectrum extending from entry into a business through the conduct of the business to final results of the business, and also the exit. Regulation is very important for the proper functioning of a market economy.
Intermediate Functions These, include matters such as management of externalities (e.g.: pollution), regulation of monopolies, and the provision of social insurance (pensions, unemployment benefits).	**Entrepreneurial Role** Direct participation of government in business was very common particularly in the socialist and developing countries. Reasons included ideological and dearth of private entrepreneurship and capital. Privatisation, however, has become widespread since the mid-1980s.
Activist Functions These involve measures to stabilise and promote markets and to redistribute assets/income.	**Planning Role** The national necessity for proper utilisation of scarce resources and prioritisation of development objectives and ideological reasons have made this an important role of governments in the developing and socialist countries.
	Promotional Role This is also more important in developing countries than in the developed because speedy development of the industry and commerce and the economy requires the development of the infrastructure, including facilitating organisations.

Fig. 5.3 : Functions and Economic Roles of Government

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Chapter 6

NATURAL AND TECHNOLOGICAL ENVIRONMENT

Structure

Natural Environment

Technological Environment

Innovation

Technological Leadership and Followership

Technology and Competitive Advatages

Sources of Technological Dynamics

Time Lags in Technology Introduction/Absorption

Appropriate Technology and Technology Adaptation

Impact of Technology on Globalisation

ICT and Marketing

Transfer of Technology

Summary

References

The natural and technological environments present the impulsive potential for development while the other environments like the economic, social, and political and government factors represent the propulsive potential for development.

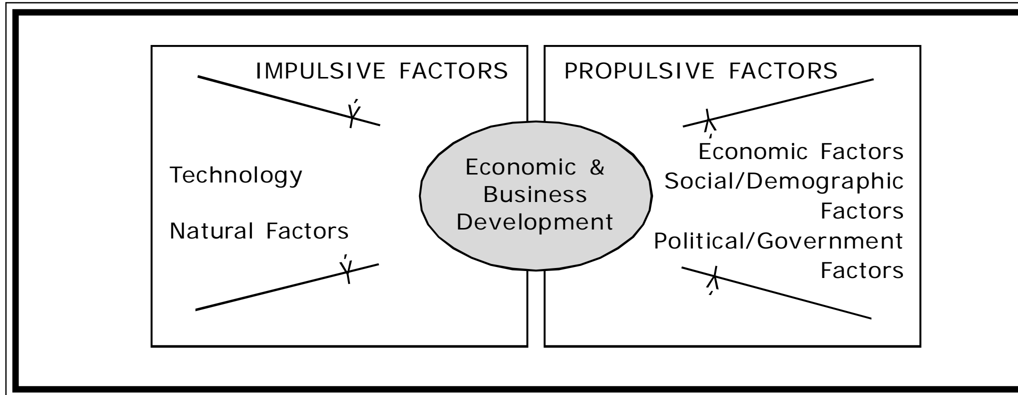

Fig. 6.1 : Impulsive and Propulsive Factors Affecting Business

The natural and technological environments determine the development/business potential of an economy.

Box 6.1 describes the interrelationship between the natural and technological environments.

BOX 6.1 : THE CORE OF SOCIAL SYSTEM

At the core of any social system is the natural environment and the available technology. Both define the possibilities for human action in the society – the natural environment through its resources and constraints, technology through the tools and processes available for human use. To some extent the ecology and technology are inter-dependent; technology is always built upon what is physically possible in the natural environment, and the natural environment can be degraded or enhanced, made more productive for human uses or depleted for any use, by the application of technology.

– S.L. Wartrick and D.J. Wood, International Business and Society, Blackwell Publishers Inc., Massachusetts, 1998.

Given the natural and technological environments, the propulsive factors determine the extent of exploitation of the development potential and the direction, pace and pattern of development.

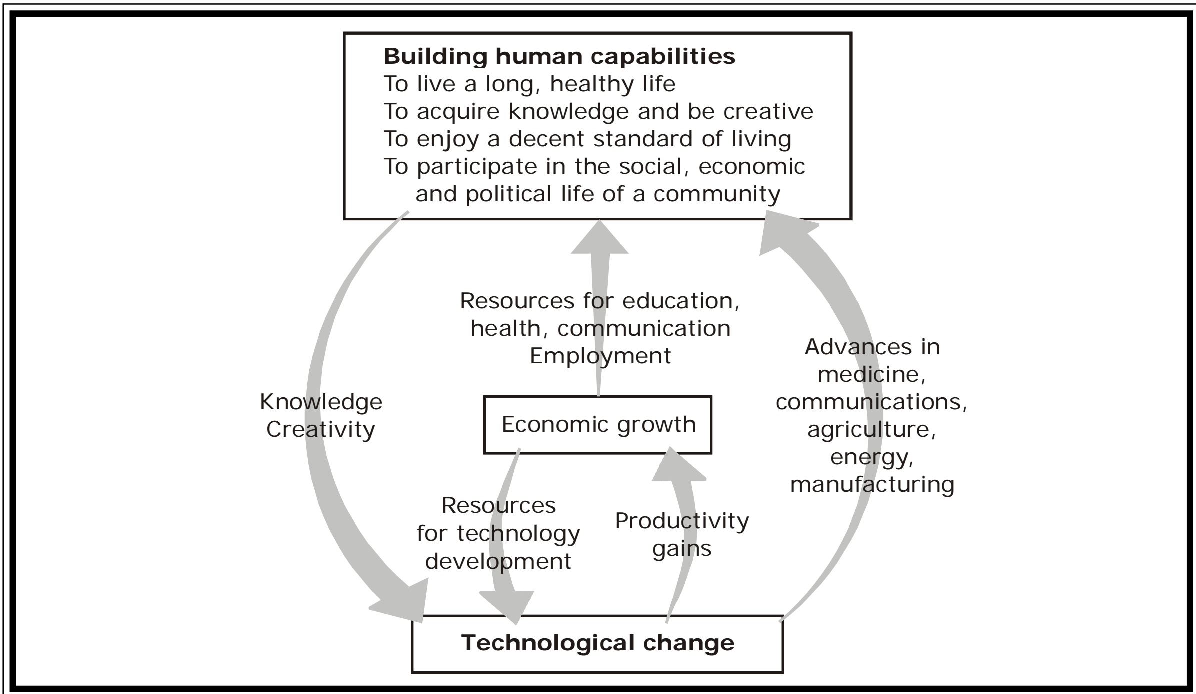

Fig. 6.2 : Links between Technology and Human Development (Adopted from UNDP, *Human Development Report, 2001*)

NATURAL ENVIRONMENT

The geographical and ecological factors, such as natural resource endowments, weather and climatic conditions, topographical factors, locational aspects in the global context, port facilities, etc., are all relevant to business.

As Watrick and Wood observe, "*the natural environment ultimately is the source and support of everything used by businesses (and almost any other human activity)* – every raw material, every energy source, every life-sustaining factor, even every waste disposal site.

The natural environment determines what can be got done in a society and how institutions can function. Resource availability is the fundamental factor in the development of business in societies."[1]

Differences in geographical conditions between markets may sometimes call for changes in the marketing mix. Geographical and ecological factors also influence the location of certain industries. *For example*, industries with high *material index* tend to be located near the raw material sources.

The dreadful earthquakes that ravaged several areas of Gujarat in early 2001 and the potential for such occurrences in a number of other places would influence the decision-making in respect location of business. It is also likely to affect the demand for flats and accommodation in high rise buildings. It could also influence the choice of building technology, design, material etc.

Climatic and weather conditions affect the location of certain industries like the cotton textile industry. Topographical factors may affect the demand pattern in some cases. *For example*, in hilly areas with a difficult terrain jeeps may be in greater demand than cars.

Weather and climatic factors affect the demand for certain type of products. *For example*, in several regions where the temperature is very high in summer, there is good demand for desert coolers; but they are not at all used in some of the States in India. In regions characterised by very cold climate in winter and very hot climate in summer, both room heaters and air conditioners may be in good demand in the respective seasons.

Weather and climatic factors can affect the demand pattern for clothing, building materials and designs, food, medicines etc. Further, weather and climatic conditions may call for modifications to the product, packaging, storage conditions etc.

Ecological factors have recently assumed great importance. The depletion of natural resources, environmental pollution and the disturbance of the ecological balance have caused great concern. Government policies aimed at the preservation of environmental purity and ecological balance, conservation of non-replenishable resources, etc., have resulted in additional responsibilities and problems for business, and some of these have the effect of increasing the cost of production and marketing. Externalities have become a very important problem the business has to confront with.

TECHNOLOGICAL ENVIRONMENT

The type of technology in use, the level of technological developments, the speed with which new technologies are adopted and diffused, the type of technologies that are appropriate, the technology policy etc. are important to business.

Technology is one of the important determinants of success of a firm as well as the economic and social development of a nation.

"Technology includes the tools – both machines (hard technology) and ways of thinking (soft technology) – available to solve problems and promote progress between, among and between societies."[2]

According to the UNCTAD's Draft TOT Code, Technology should be described as "systematic knowledge for the manufacture of a product, for the application of a process or for the rendering of a service and does not extend transactions involving mere sale or lease of goods."

"Technology includes not only knowledge or methods that are necessary to carry on or to improve the existing production and distribution of goods and services, but also entrepreneurial expertise and professional know-how."[3] The latter two elements may often prove to be the essential competitive advantage possessed by the technology owner.[4] The MNCs are often in a particularly advantageous position in this regard.

Technology is one of the eight factors considered by the World Economic Forum to evaluate the global competitiveness of nations. The 1999 *Global Competitiveness Report* of the Forum, which continued to increase its focus on information technology as a new source of competitiveness, observes that there are at least three aspects to this. First, e-mail has greatly expanded the possibilities for interpersonal, inter-firm, and international communication. Second, the Internet has allowed for much more extensive and rapid dissemination of information. Third, the emerging area of e-commerce offers a potentially huge increase in the customer base for companies and huge savings in marketing costs and search costs in finding low-cost suppliers. Competitiveness in all of these areas is closely linked with the competitiveness of the local telephone infrastructure and with the penetration of the computer culture in the local economy. The Report also observes that for a successful internet culture, the population needs to have computers, telephones need to work, and the country's telecommunications hardware needs to support high bandwidth for Internet traffic.

Technology is one of the important determinants of global competitiveness.

INNOVATION

Innovation is a very important factor that provides competitive advantage and, consequently, determines success.

Joseph Schumpeter, a well-known economist, has given a lot of importance to innovation in economic development. According to him, significant advances in the economy occur by disharmonious leaps and spurts as entirely new investment horizons are exploited. The entrepreneur, who is the innovator is the central figure in the Schumpeterian analysis. Innovation may take any of the following forms: the introduction of a new product; the use of a new method of production; the opening of a new market; the conquest of a new source of raw material supply; and the reorientation of an industry. Our concern here is technological innovation; some of the above, obviously, do not represent technological innovation.

In the business context, innovation may be defined as "the technical, industrial and commercial steps which lead to the marketing of new manufactured products and to commercial use of new technical processes and equipment."

Betz classifies innovations into the following types or what is called scales.[5] This is based on how big an impact does a technology change make on the applications.

1. *Radical Innovation*—a basic technological innovation that establishes a new functionality (*e.g.,* steam engine or steamboat).
2. *Incremental Innovation*—a change in an existing technology system that does not alter functionality but incrementally improves performance, features, safety, or quality or lowers cost (*e.g.,* governor on a steam engine).
3. *Next-generation Technology Innovation*—a change in an existing technology system that does not alter functionality but dramatically improves performance, features, safety, or quality or lowers cost *and* opens up new applications (*e.g.,* substitution of jet propulsion for propellers on airplanes).

Innovations may help companies to increase market share, capture new markets, create new market segments or even to create entirely new industries and markets. Although innovation is expected to give a company a competitive advantage or success in the market, it is not uncommon that some other company or substitute product steals away the show.

From the innovator. *For example*, in the US, the steel tin plate manufacturers developed the market for cans for soft drinks and the like. However, it was later taken away by the aluminium industry.

All innovations need not be commercially successful. *For example*, many new products fail commercially due to a variety of reasons. From a study of a wide variety of industrial product winners and losers, Calantone and Cooper have identified six major reasons for the new product failures.[6] They are as follows:

1. *The better mousetrap no one wanted:* These are products which have some uniqueness or some superiority but which failed to generate enough demand. It is not because of any technical problem with the product or inadequacy of marketing effort. These products often represent technical R&D efforts not guided by proper marketing research or identification of customer requirements and preferences. Industrial customers, particularly, want products that can serve their purpose to their full satisfaction and they are not prepared to pay a higher price for a product, however superior the product may be, if it does not bring in additional income larger than the additional cost.

2. *The me-too product meeting a competitive brick wall:* Products which are mere imitations of competitors' products may find it difficult to succeed in the market because of intense competition from entrenched firms with established market shares and customer loyalty. The established firms often fight heavily the new entrants, sometimes even sacrificing their profits, so that the new entrant will find it very difficult to penetrate the market and establish a foothold.

3. *Competitive one-upmanship:* New product failures of this type result from factors such as deficiencies of the marketing management. Even if a product is good, it may not succeed in the market if not marketed effectively. The promotion, including the launch, positioning, distribution, and pricing play their role in the marketing of the product. Competitors would initiate the product. Often they try to come out with better products and steal the march away from the pioneer firm. Even if the product is not superior, more efficient marketing may make a difference. The company which introduces the new product should, therefore, constantly try to improve the product and marketing.

4. *Environmental ignorance:* Product failures may also emanate from the ignorance of marketing environment leading to wrong decisions. Ignorance, neglect of environmental factors such as regulatory factors (encompassing, *for example*, performance standards, materials permitted to be used, safety norms, environmental aspects, technology etc.), technological factors, customer preferences and demands, competitive environment etc. Such factors should be considered since conception of the product idea to its launch.

A combination of factors is often required for the success of a new product – the product itself, R&D support, allocation of required finance and effective marketing. Deficiencies in respect of any of these can cause failure.

5. *Technological dog products:* These are products which fail to increase up to the expectations of the customers. In most of these cases, it is not that the companies have not understood what the market wants but they fail to deliver the product of the required quality or other attribute.

6. *The price crunch:* New products also fail because of mismatch between price of the product and value of the product as perceived by the customers. This may arise because of the eagerness of the companies to recoup all the investment at the earliest by charging a high price. Overestimation of the value of the product to the customer often results in pricing the product high.

PRODUCT AND PROCESS INNOVATIONS

William Abernathy and James Utterback have pointed out that usually, the pattern of early innovations in a new-technology-based industry will be, first, product innovations (improving the

performance and safety of the product); later, innovations shift to improving the production process to make the product cheaper and with better production quality.[7] This is depicted in Figure 6.3. The rate of product innovations peaks about the time of introduction of a design standard for the new-technology product. Thereafter, the rate of innovations to improve the product declines, and the rate of innovations to improve production increases. This occurs because until the product design has been standardised manufacturer cannot focus on improving the production processes that produce such a design.

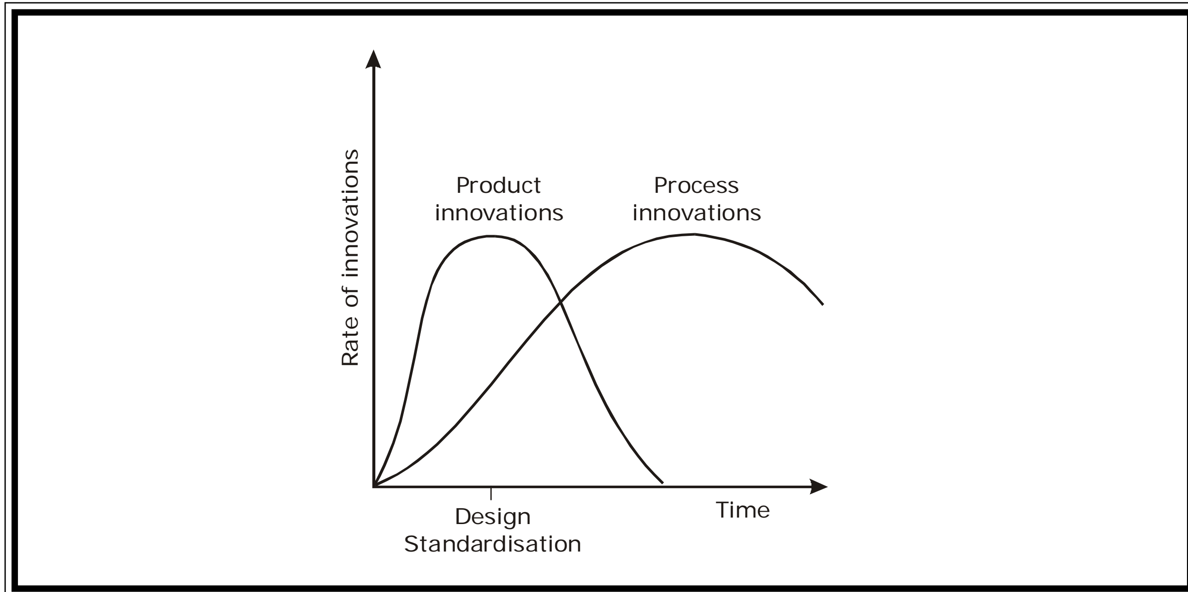

Fig. 6.3 : Rates of Product and Process Innovations

After the key technologies of the industry mature, the market for the industry will eventually saturate. This level of market for the industry will continue, unless the key technologies for the industry become obsolete by technology substitution. Then, the market volume of the industry based on the older key-technology product will decline to zero or to a market niche.

TECHNOLOGY S-CURVE

According to the commonly observed pattern in the development of technologies, the rate of progress in a new technology follows an **S**-shaped curve, with an initial exponential rate, slowing to a linear rate, and turning off toward a natural limit.

As Betz points out[8] at first, all new basic inventions for a new technology show poor performance, are awkward and dangerous to use, and are costly to produce. Yet the opportunities for technical improvement begin as inventors and engineers seek ways of overcoming the limitations of the original invention. There is usually a rapid flush of new ideas that provides exponential increase in performance. Eventually, and rather soon, all the obvious ideas get tried. Further progress in the new technology gets harder. Thus, begins the linear phase of technology progress on the S-curve. As Pearson observes,[9] in due course, the rate of improvement slows down as it approaches its limit, which may be technological (*e.g.,* some physical limit on performance), economic (*e.g.,* diminishing returns from further research and development) or social (*e.g.,* production of undesirable by-products). At this point, there will be considerable economic and competitive benefit in changing to an alternative technology to which the limit does not apply, and consequently in due course a new technology will emerge and be adopted.

The different rates of progress of technology over time through technology stages of invention, improvement and maturity generally produce a S-shaped curve.

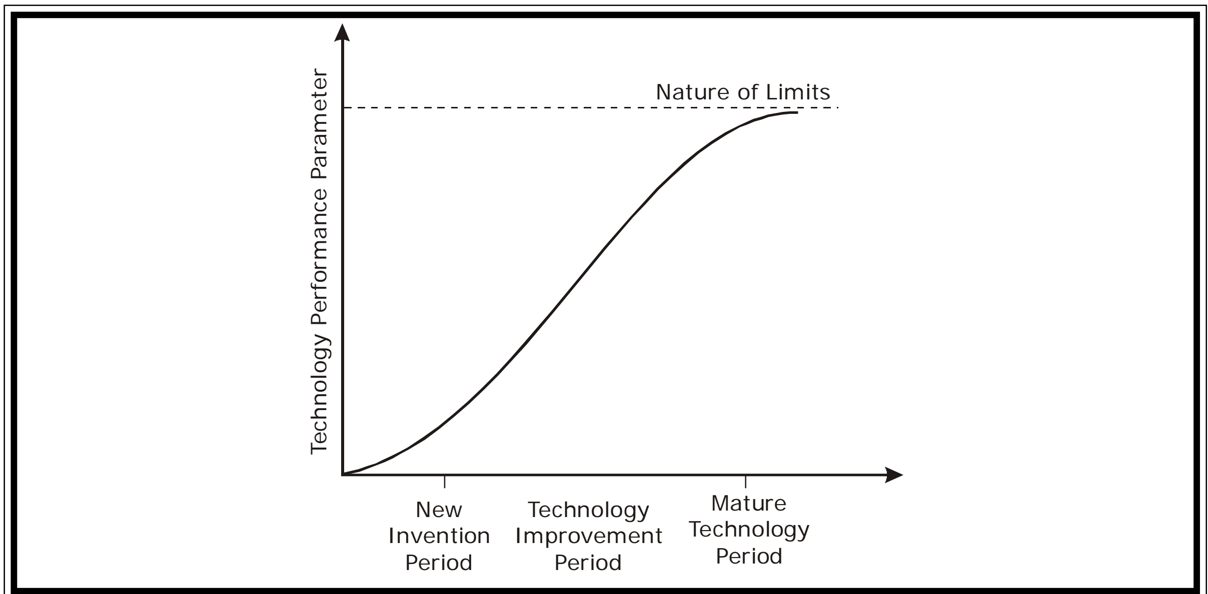

Fig. 6.4 : **Technology S-Curve**

TECHNOLOGICAL LEADERSHIP AND FOLLOWERSHIP

An important broad issue a firm must address in technology strategy is whether to seek technological leadership. According to the notion of technological leadership, "a firm seeks to be the first to introduce technological changes that support its generic strategy. Leadership can be established in technologies employed in any value activity." Technological followership refers to a conscious and active strategy in which a firm explicitly chooses not to be first on innovations."[10]

The decision to become a technological leader or follower can be a way of achieving either low cost or differentiation. Porter points out that the choice of whether to be a technological leader or follower in an important technology is based on the following three factors.[11]

Technological uniqueness and sustained innovative competence are essential for technological leadership.

Sustainability of the Technological Lead, i.e., the degree to which it can sustain its lead over competitors in a technology.

First Mover Advantages, i.e., the advantages a firm reaps from being the first, such as reputation, preempting a positioning, swithcing costs, unique access for a new product, proprietory learning curve, favourable access to facilities, inputs or other scarce raw materials; definition of standards; institutional barriers against imitations; and early profits.

First Mover Disadvantages, i.e., the disadvantages a firm faces by being first rather than waiting for others, such as pioneering costs (like costs of gaining regulatory approvals, achieving code compliance,. educating buyers, high costs of early inputs because of scarcity of supply or small-scale needs); demand uncertainty, changes in buyer needs, specificity of investments to early generations or factor costs; technological discontinuities and low cost imitation.

Technological leadership can be sustained only if the competitors cannot duplicate the technology, or the firm innovates as fast or faster than competitors can catch up.

TECHNOLOGY AND COMPETITIVE ADVANTAGE

As Michael Porter points out in his well-known *Competitive Advantage*, technological change is "one of the principal drivers of competition. It plays a major role in industry structural change,

as well as in creating new industries. It is also a great equaliser, eroding the competitive advantage of even well-entrenched firms and propelling others to the forefront. Many of today's great firms grew out of technological changes that they were able to exploit. Of all the things that can change the rules of competition, technological change is among the most prominent."[12]

According to Gorden Pearson, "innovation is the key weapon in achieving a sustaining competitive advantage. To compete successfully, it is vital to use the most appropriate technology to produce and distribute your product or service. Generally, this means using the latest technology, which will mean using the latest technology, which will incorporate more features, higher performance, greater quality or lower costs. In some cases, this may involve invention as well as innovation. Innovations may be based on inventions or discoveries, but their importance rests on their commercial exploitation."[13]

Technology can help influence all the five competitive forces, viz., inter-firm rivalry, threats of new entrants and substitutes and bargaining power of suppliers and buyers.

Porter who observes that the relationship between technological change and competition is widely misunderstood, points out that "technological change is not important for its own sake, but is important if it affects competitive advantage and industry structure. Not all technological change is strategically beneficial; it may worsen a firm's competitive position and industry attractiveness. High technology does not guarantee profitability. Indeed, many high-technology industries are much less profitable than some "low-technology" industries due to their unfavourable structures."[14] It is very important to understand that technology "pervades a firm's value chain and extends beyond those technologies associated directly with the product. There is, in fact, no such thing as a low technology industry if one takes this broader view. Viewing any industry as technologically mature often leads to strategic disaster. Moreover, many important innovations for competitive advantage are mundane and involve no scientific breakthroughs. Innovation can have important strategic implications for low-tech as well as hi-tech companies."[15]

As Porter points out, technology can alter the nature and basis of rivalry among existing competitors in several ways. Technology affects competitive advantage if it has a significant role in determining relative cost position or differentiation. It can also alter the bargaining power of the suppliers and buyers. Technology, in several instances, is an entry barrier. Thus, technology can influence all the five competitive forces.

If the technology employed in a value activity becomes widespread, it would be an important determinant of overall industry structure. "Technological change that is diffused can potentially affect each of the five competitive forces, and improve or erode industry attractiveness. Thus, even if technology does not yield competitive advantage to any one firm, it may affect the profit potential of all firms. Conversely, technological change that improves a firm's competitive advantage may worsen structure as it is imitated. The potential effect of technological change on industry structure means that a firm cannot set technology strategy without considering the structural impacts."[16]

According to Porter, technological change by a firm will lead to sustainable competitive advantage under the following circumstances, which he calls the tests of a desirable technological change.[17]

- The technological change itself lowers cost or enhances differentiation and the firm's technological lead is sustainable.
- The technological change shifts costs or uniqueness drivers in favour of a firm.
- Pioneering the technological change translates into first mover advantages besides those inherent in the technology itself.
- The technological change improves overall industry structure.

Porter cautions that technological change will destroy competitive advantage if it not only fails the tests but has the opposite effect contemplated in the tests, such as skewing cost or uniqueness drivers in favour of competitors. A firm may also find itself in the situation where a technological change may meet one test but worsen a firm's position via another.

BOX 6.2: INDIA'S INNOVATIVE POTENTIAL

Although the R&D spend in India, both as a percentage of GDP and company sales, is very low, India is fast emerging as an R&D hub for the multinationals because of the human resource factor. Indian firms too have been increasing their R&D budget thanks to the new patent regime, increasing competition and strategic orientation of the firms. The Global Competitiveness Report 2007, which has ranked India 48th on overall competitiveness gives 28th ranking for the innovative potential. On innovation, the country is ranked an impressive 4th in the availability of scientists and engineers and 22nd in the quality of its scientific and research institutions. Although China is ranked much higher (34th) than India on overall competitiveness, on innovation and business sophistication factors India is much ahead of China (26th and 50th). The respective ranks of India and China are 26 and 57 in business sophistication and 28 and 38 in innovation.

SOURCES OF TECHNOLOGICAL DYNAMICS

Innovation can result from the internal drive of the company or from external forces

There are a number of factors which determine the technological dynamics of a company. The source of technological change may be internal or external. As Porter suggests, technological leaders in industries with key external sources of technology must capture the best of those sources through coalitions or exclusive arrangements in order to sustain their lead, or have a superior ability to adapt externally developed technology to the industry.[18]

The important factors which determine the technological dynamics of a company include the following.

Innovative Drive of the Company

Many companies view technology as a driving force of competitiveness and development and give great importance to R&D. Recognising the critical role of R&D in the pharmaceutical industry, Ranbaxy, for instance, has positioned itself as a research-based international company. Several other firms, such as Dr. Reddy's Laboratories, have also been investing considerably on R&D and they have been significantly benefiting out of it. It is a policy of some companies that a certain percentage of their sales every year shall come from new products.

Customer Needs/Expectations

Technological orientation and R&D efforts of a company may also be influenced by the customer needs and expectations. In several cases, the customer and the supplier have a collaborative relationship to develop products or solutions. If the consumers are highly demanding, companies would be compelled to be innovative.

Demand Conditions

Besides customer needs/expectations, there are certain demand related factors which influence the technology choice. *For example*, the size of the demand influences the choice of the technological scale. Expected future trend could also be important. *For example*, a fast growing trend of demand would encourage adoption/development of technology of large scale. It would also encourage R&D efforts. The situation may be different in a declining industry.

Suppliers' Offerings

Many a time, technological changes are encouraged by the suppliers of a company, like capital goods suppliers and other technology suppliers etc. In many process industries, *for example*, the key source of technology is construction engineering firms that design production processes and build plants. The competitiveness of the Italian tile industry, *for example*, owes a lot to the dynamic and innovative technology suppliers.

Competitive Dynamics

Competition compels the adoption of the best technology and constant endeavour to innovate. Japanese companies have, generally, a high degree of technological orientation. According to Akio Morita, the glory and the nemesis of Japanese business, the lifeblood of the industrial engine, is good old-fashioned competition. And this makes the consumer in Japan a king. In Japan, there are more makers of civilian industrial products than in any other country, including the United States.[19]

Absence of/lack of competition was a major reason for the technological backwardness of corporate India. The impact of competition on technological improvement is very evident in many industries in India after the liberalisation.

Substitutes

Emergence of new substitutes or technological improvements of substitutes which alter a firm's/industry's competitive advantage *vis-à-vis* the substitutes is a compelling reason for technological change. Porter points out that perhaps the most commonly recognised effect of technology on industry structure is its impact on substitution. Substitution is a function of the relative value to price of competing products and the switching costs associated with changing between them. Technological change creates entirely new products or product uses that substitute for others, such as fiberglass for plastic or wood, word processors for typewriters, and microwave ovens for conventional ovens. It influences both the relative value/price and switching costs of substitutes. The technological battle over relative value/price between industries producing close substitutes is at the heart of the substitution process.[20]

Social Forces

Certain social forces like protest against environmental pollution or other ecological problems, demand/preference for eco-friendly products, the need to tackle certain social problems etc. may prompt efforts to technological developments in certain direction.

The technological environment has some other social/cultural dimension too. For instance, Morita points out that the Japanese have always been eager to develop their own technology from abroad, and blend them to make suitable objects or systems.

Research Organisations/Technical Facilities

The technological environment of the business is enriched by research organisations, including research departments of universities, which develop new technologies and provide other technical inputs. Research establishments like Indian Council for Scientific Research (ICSR), Central Food Technological Research Institute (CFTRI), Defence Food Research Laboratory etc. are well known in India. The technology developed by the CFTRI for making baby food from buffalo milk and its commercialisation by Amul, *for example*, was a milestone development.

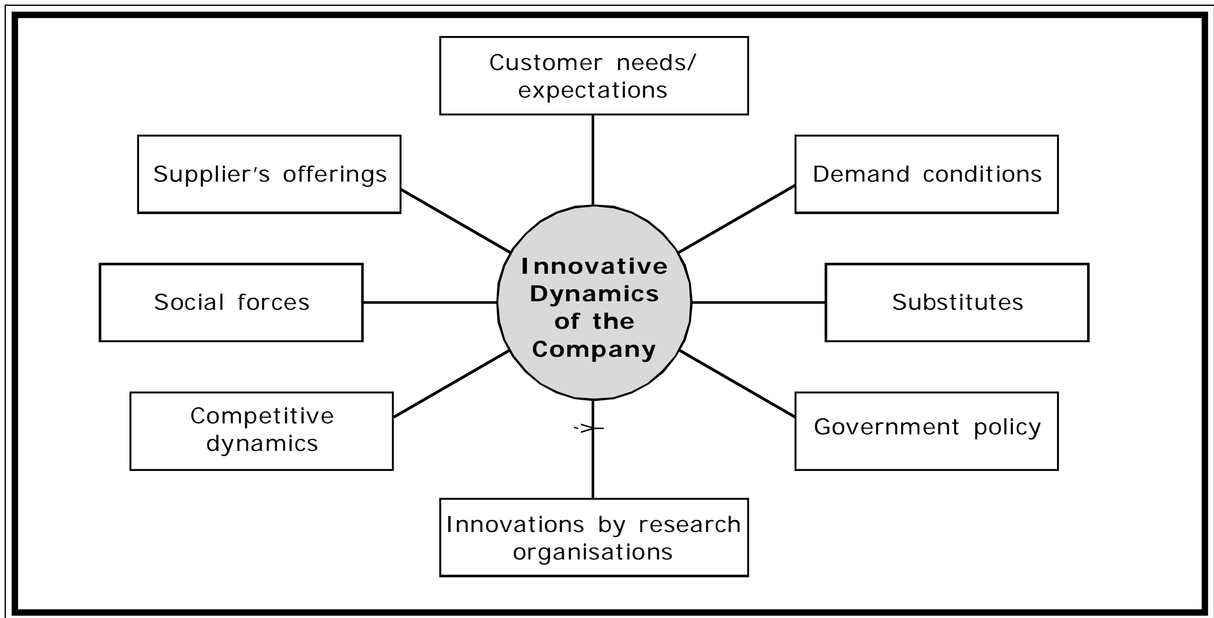

Fig. 6.5 : Innovative Drivers

Another supportive technological environment is the availability of common technical facilities like testing facilities or facilities to do certain jobs.

Government, often, is an important actor in the technological environment. Government can contribute to the development of technology by its own direct involvement by establishing research organizations and funding R&D. It may also encourage private R&D by various incentives, like tax incentives, subsidies etc. Technology policy of the government is also very important.

Government Policy

Technology policy of the government is a very important element of the technological environment. *For example*, a government may favour or disfavour certain types of technologies. Government's policy towards foreign technology is also a critical factor.

Some labour-abundant countries have a preference for labour-intensive technology. Mechanisation and automation may be opposed in such countries. Such a situation may adversely affect the business.

Lack of adequate patent protection in many countries was a serious problem for multinationals. The absence of product patent facilitated several Indian pharmaceutical firms to copy patented products by employing processes different from the patented one. The new patent regime stipulated under the WTO is ushering in a different environment. This has prompted companies like Ranbaxy and Reddy's Laboratories to give a thrust to R&D. Ranbaxy has positioned itself as a research-based international company.

In the past, the restriction of foreign technology followed by some governments had an inherent bias against domestic firms because while in many cases domestic firms were not permitted to go for foreign technology, foreign firms in those countries could bring in foreign technology. This could affect the comparative competitiveness of these firms. Access to global technology could help firms to improve their competitiveness. *For example*, this has enabled the Reliance to establish world-class production facilities. This along with the project implementation skills, debottlenecking capabilities and low labour costs held Reliance to gain a competitive edge globally.

In countries like India, the overemphasis on indigenous technology had led to high costs and distorted developments. Again, the policy bias in favour of small business has resulted in production units of uneconomic size in a number of industries. Further, the reservation of certain products exclusively for the small-scale sector promoted several companies, including multinationals, to resort to such strategies as franchising and contract manufacturing in some of these industries in

India. The reservation of products for the small-scale sector sometimes comes in the way of adoption of modern technology if it involves capital investment higher than the specified limit. The failure to absorb modern technology swiftly has adversely affected the exports of several import items like leather goods, textile items etc.

The nature technology can affect the location of production base and global trade flows. *For example*, when the television technology was labour-intensive, this encouraged the location of television manufacturing in the developing countries. Advances in technology may also cause relocation of production. However, when further technological developments reduced the labour content of the T.V., some firms relocated their production back to the developed countries.

BOX 6.3 : S&T POLICY

Science and Technology Interface with Industry

The domestic R&D system and the industrial enterprises are the two main players in the S&T-industry interface which had been functioning so long had been functioning so long in distinct and distant compartments without much interaction, as the former is generally in the strategic and non-competitive areas of R&D whereas industrial R&D, which was concerned more with investigating incremental production problems, was notgeared to new process/product development and was having little interaction with the national and international S&T community. But now the move towards a market economy is compelling both to establish a dialogue andwork together for mutual advantage. Indeed in the emerging competitive environment, cooperation and coordination between Indian enterprises and R&D institutions is not a matter of choice but rather of compulsion derived by competitive pressures.

The increasing complexity of technology makes it difficult for the individual enterprises, especially the small and medium enterprises (SMEs), to engage themselves in the competitive R&D and technological development efforts due to high financial risks. In the emerging competitive environment, cooperation and coordination between Indian enterprises and R&D institutions is not a matter of choice but rather of compulsion derived from competitive pressures. The initial emphasis and endeavour should be on developing synergies and alliances to enhance India industry`s competitive advantage and on gaining greater share of global markets.

The need for cooperation is to bring about value addition to the products through endogenous resources/ skills; environmentally clean and economically viable processes; closely held technologies that are commercially denied to Indian industry; strategic/dual-use technologies; technology packages as available from commercially operating units; process/product upgradation and incremental productive improvements; and strategic alliances with partners abroad for gaining market/technology advantage/dominance.

The initial emphasis and endeavour should be on developing synergies and alliance to enhance Indian industry`s competitive advantage and on gaining a greater share of global markets in such areas like speciality chemicals, drugs and pharmaceutical; footwear and leather products, automotive and light engineering components, customized software, textiles and garments, gems and jewellery, agro-based products etc. This is already visible in the drugs and pharmaceuticals sector. Several Indian pharmaceutical companies have already forged strategic alliances with the domestic R&D institution; The Drugs & Pharmaceuticals Research Scheme of the DST, the Home Grown Technologies of the TIFAC and the PATSER scheme of the DSIR are some examples of successful Government intervention in shaping the cooperative endeavours.

The Government will have to provide an economic environment favourable not only for the conduct of different kinds of business but also to catalyse the arrangements and the institutional mechanisms that would facilitate synergistic technological development, its absorption and upgradation.

The efficiency and effectiveness of the R&D institutions can be significantly enhanced by providing them adequate flexibility and freedom to function in a market economy.

The increased participation and involvement of the industry in the decision making bodies of R&D institutions will make their programmes not only more attractive to industry but also to the financial institutions offering venture/risk capital.

Courtesy: Planning Commission, Government of India, *Ninth Five Year Plan, 1997-2000, Vol. II.*

TIME LAGS IN TECHNOLOGY INTRODUCTION/ABSORPTION

The time and pace of absorption/penetration of technology may differ significantly between markets.

Considerable time lags have been observed between countries in respect of introduction or absorption of technologies. This lag is not explainable in terms of the developed versus developing countries difference alone.

In many developing countries, including India, the T.V. arrived very late. Although the colour T.V. had become quite common in the advanced and even in some developing countries when the telecast started in India, in the early period there was only black and white telecast. The cable T.V. came to India only by about the beginning of the 1990s. The late introduction and the slow expansion of the telecast affected not only the T.V. business but also the advertising industry and product promotion.

The time lags in the introduction of technologies may even result in some products not being able to reap the market. The electronic typewriter became popular in India before the electric typewriter could penetrate the market. The electronic typewriter could not achieve growth because of the advent of the computer.

Many companies in advanced countries have considered the developing countries as a market for their obsolete technology. Several developing countries even import second hand plant and machinery.

There is often a time lag between countries in the adoption and diffusion of technologies. The developing countries generally lag behind the developed ones. Even among the developed countries the technology absorption is not simultaneous and similar. The time lag has, however, been diminishing in several cases.

Technological environment of the use facilities etc. also have very important implications for business. *For example*, advances in the technologies of food processing, packaging and preservation, transportation etc. have facilitated product improvements and introduction and have considerably improved the marketability of products.

APPROPRIATE TECHNOLOGY AND TECHNOLOGY ADAPTATION

The appropriateness of the technology depends on the characteristics of the environment.

When different technologies are available, it needs to be ensured that the technology chosen is the most appropriate for the company/country. The technology suitable in one environment may not be appropriate in a different environment. This could be due to reasons like differences in natural factors such as topographical conditions, climatic/weather condition, soil conditions etc.; differences in income levels, scale of operation, demand conditions, use facility characteristics, and customer characteristics.

It is pointed out that much of Japan's successful growth has been due to her systematic purchase of appropriate technologies from abroad. The choice of technologies was aided by the fact that Japan possessed a body of competent scientists and engineers who for the most part were employed by the government and worked in government laboratories.[21]

The latest or highly sophisticated technology may not be the appropriate technology in several environments. Thanks to writers like Schumacher, the concept of appropriate technology (which, in this context, often implies intermediate technology) became popular in the developing world. Intermediate technology, which often means a technology which combines elements of traditional technology with elements of modern technology, gained importance in the developing countries. Thus, the sophisticated capital-intensive technologies in use in the developed countries are not acceptable in some sectors in several of the developing countries. An Indian company,

Mekins Agro Products Ltd., with designs from International Crop Research Institute for Semi Arid Tropics (ICRISAT), Hyderabad, introduced easy to maintain bullock-drawn agricultural equipments in India. It has been exporting them to other developing countries with comparable agrarian environments.

One multinational found that the reason for low demand for its washing powder in a developing economy was the low washing machine ownership. The low income and lack of electrification/unreliability of power supply came in the way of increasing the washing machine ownership. So, the company asked its R&D department to develop a low cost, manually operated (*i.e.,* which does not use electricity) washing machine. The 'innovation backward' resulted in the introduction of such a washing machine. Similarly, another company took an innovative step backward by developing a crank-operated cash register that would sell at half the price of a modern cash register. It found a good demand in a number of developing countries.

Technological appropriateness can vary between different environments. Further, many situations require adaptations of or modifications to technology. Modifications many a time help companies to do better than users of the technology in its original form.

IT REVOLUTION AND BUSINESS ENVIRONMENT

The computer, considered "the machine that changed the world," and the rapid changes in the related technologies have been making the business environment immensely dynamic.

As Lucas observes,[22] IT:

- Provides new ways to design organisations that can lead to structure like the T-Form organisation.
- Creates new relationships between customers and suppliers who electronically link themselves together.
- Enables tremendous efficiencies in production and service industries through electronic data interchange to facilitate just-in-time production.
- Changes the basis of competition and industry structure, *for example*, in the airline and securities industries.
- Provides mechanisms through groupware for coordinating work creating a knowledge base of organisational intelligence.
- Contributes to the productivity and flexibility of knowledge workers.
- Provides the manager with electronic alternatives to face-to-face communications and supervision.

As Lucas points out, there are a number of recent trends that have drastically altered the way organisations use technology. These trends make it imperative that a manager becomes familiar with both the use of technology and how to control it in the organisation. He pinpoints the following five major trends:[23]

1. ***The use of technology to transform the organisation:*** The cumulative effect of what all the technology firms are installing is to transform the organisation and allow new types of organisational structures. This ability of information technology to transform organisations, to create the T-Form firm, is one of the most powerful tools available to a manager today.

2. ***The use of information processing technology as a part of corporate strategy:*** Firms that prosper in the coming years will be managed by individuals who are able to develop creative, strategic applications of the technology.

3. ***Technology as a pervasive part of the work environment:*** From the largest corporations to the smallest business, technology is used to reduce labour, improve quality, provide better customer service, or change the way the firm operates. Factories use technology to design parts and control production.

4. *The use of personal computers as managerial workstations:* The personal computer, when connected to a network within the organisation and to external networks like the Internet, it provides a tremendous tool for knowledge workers.

5. *The evolution of the computer from a computational device to a medium for communications:* For many people today, the communications aspects of computers are more important than their computational capabilities.

IMPACT OF TECHNOLOGY ON GLOBALISATION

Globalisation has been fostered by, among other things, different technological developments.

Technological advances have tremendously fostered globalisation. Technology has, in fact, been a very important facilitating factor of globalisation.

Several technological developments become a compelling reason for internationalisation. Technological breakthroughs are substantially increasing the scale economies and the market scale required to break-even.

BOX 6.4 : GLOBAL VILLAGE

Because of the shrinking time and shrinking space thanks to the technological revolution and the disappearing borders thanks to the liberalisation and technological factors the world is evolving into a global village, in several respects.

Contacts between the world`s people are widening and deepening as natural and artificial barriers fall. Huge declines in transport and communication costs have reduced natural barriers. Shipping is much cheaper: between 1920 and 1990 maritime transport costs fell by more than two-thirds. Between 1960 and 1990 operating costs per mile for the world`s airlines fell by 60 per cent.

Communication is also much easier and cheaper. Between 1940 and 1970 the cost of an international telephone call fell by more than 80 per cent, and between 1970 and 1990 by 90 per cent. In the 1980s, telecommunication traffic was expanding by 20 per cent a year. The Internet, the take-off point for the information superhighway, was used by 50 million people in 1998, with the number of subscribers tapping into it doubling every year.

Some of the changes in international trade and finance reflect advances in technology. The lightning speed of transactions means that countries and companies now must respond rapidly if they are not to be left behind.

Technological change is also affecting the nature of investment. Previously, high-technology production had been limited to rich countries with high wages. Today technology is more easily transferred to developing countries, where sophisticated production can be combined with relatively low wages.

The increasing ease with which technology can accompany capital across borders threatens to break the links between high productivity, high technology and high wages. Further, the availability of higher levels of technology all over the world is putting pressure on the wages and employment of low-skilled workers.

Who really benefit from the IT and communication revolution?

Financial Dealers are at the pinnacle of connections. Instant communications, free flows of capital and constant updates from around the world enable money markets from London to Jakarta, from Tokyo to New York, to act as a unit in real time.

Multinational Corporations, too are roaming global markets and integrating production, Cross-border mergers and acquisitions (majority – foreign-owned) account for a large chunk of the total foreign direct investment.

NGOs online can campaign around the world, with their messages travelling across borders in seconds. Through e-mail and media networks, people are giving their support to associations across borders–from informal networks to formal organisations.

Skilled Labour also travels the global village. With Internet access in nearly every country, the highly educated are increasingly online and in touch around the world. In 1998, more than 250,000 African professionals

were working in the United States and Europe, Immigrants with skills in computing technologies are in high demand – in the European Union alone, 500,000 information technology jobs go unfilled because of lack of national skills. The United States offers a special visa to professional immigrants to keep high-tech industries staffed.

Unskilled Labour, by contrast, runs up against hurdles. Many families are divided across international borders as a result of the increasingly tight restrictions in the rich countries in the immigration of unskilled labour. Millions of people do not even have passports–difficult to get. In some countries–let alone the visas required to travel abroad.

The collapse of space, time and borders maybe creating a global village, but not everyone can be a citizen. The global, professional elite faces low borders, but billions of others find borders as high as ever.

Courtesy: *UNDP, Human Development Report, 1997 and 1999.*

Global sourcing was encouraged not only by trade liberalisation but also by technological developments which reduced transport costs. Advent of containerisation and supertonnage cargo ships drastically reduced transport costs.

Technology monopoly, like possession of patented technology, encourages internationalisation because the firm can exploit the respective demand without any competition.

The pace of globalisation has been accelerated by several enabling technologies. Technological revolution in several spheres, like transport and communication, has given a great impetus to globalisation by their tremendous contribution to the reduction of the disadvantages of natural barriers like distance and cost. The IT revolution has made an enormous contribution to the emergence of the global village. The developments in the field of air cargo transportation has fostered globalisation by enabling quick and safe transportation of sensitive goods (like perishables and goods subject to quick changes in fashion/taste). Developments of containerisation and refrigeration have also been of high significance. The steep fall in the cost of transportation and communication have considerably accelerated pace of globalisation. All these have contributed to the drastic transformation of the logistical and global distribution of the value chain system. The world wide web has a stupendous impact on globalisation.

BOX 6.5: TECHNOLOGY, GLOBALISATION AND INEQUALITY

Some studies show that technology is contributing to the widening of the income gap within countries.

Research by IMF using newly available data shows that inequality (measured using the Gini coefficient) has risen over the past two decades in most regions, including developing Asia, emerging Europe, Latin America, and the newly industrialised economies of Asia, as well as in the advanced economies. In contrast, it has declined in sub-Saharan Africa and the Commonwealth of Independent States. The data, however, reveals that most people are better off now. Despite this observed rise in inequality, per capita incomes have risen across virtually all regions for all segments of the population, including the poorest. As a result, the poor are now better off in absolute terms, although in most cases incomes have risen at a faster pace for those who are already better off.

This research has come out with the following four main findings.

First, the main factor driving the recent increase in inequality across countries has been technological progress. This factor alone explains most of the increase in the Gini coefficient from the early 1980s, supporting the view that new technology, in both advanced and developing countries, increases the premium on skills.

Second, globalisation has had a much smaller effect relative to technological change, reflecting the opposing influences of trade and financial globalisation on inequality.

Third, contrary to common belief, trade globalisation has helped reduce inequality rather than increase it. In developing countries, both rising agricultural exports and tariff liberalisation have contributed to improving income distribution. In advanced economies, rising imports from developing countries are associated with declining income inequality, presumably through the substitution of lower-paying manufacturing jobs with higher-paying service sector jobs.

Fourth, FDI has had a mainly negative effect on the distribution of income. Higher FDI inflows have increased the demand for skilled labor in developing countries, whereas outward FDI in advanced economies has reduced the demand for lower-skilled workers in these countries.

In brief, technological advances have made the biggest contribution to widening income inequality. The contribution of globalisation is less important. Whereas trade globalisation has helped reduce inequality, financial globalisation–in particular foreign direct investment (FDI)–has tended to increase it.

The implication of these findings for policymakers is that technological change and FDI are associated with higher incomes and should therefore be encouraged rather than suppressed. But because they increase the returns on acquiring skills, it is felt that increased access to education and training is the key to sharing the fruits of economic growth in a more equitable way. Policies that broaden the access to finance of the poor would also help, as would further trade liberalisation.

Courtesy: *"Technology Widening Rich-Poor Gap" by Florence Jaumotte and Subir Lall, IMF Research Department, IMF Survey, November, 2007.*

ICT AND MARKETING

Advances in information and communications technology are revolutionalising the *modus operandi* of marketing and the business system. The business horizon is humming with buzzwords like *internet, world wide web (www), cyberspace, information superhighways* etc. which are changing the way of contacting customers; order receiving and processing; and networking and integrating business system. The revolutionary changes being ushered in by the internet are indeed exciting.

Technology experts are anticipating that the internet and the www would become the centre of commercial universe. Electronic markets will eliminate the need for intermediaries and that direct contact between manufacturer and customer will bring down the cost of transaction and the cost of the final product. The internet has the potential to evolve into an interconnected electronic marketplace (cyberspace) bringing buyers and sellers together to facilitate commercial exchanges. The internet is fast becoming an important new channel for commerce in a range of business – much faster than anyone who would have predicted in the past. The opportunities presented by this new channel seem to be readily apparent; by allowing for direct ubiquitous links to anyone anywhere, the internet allows companies build interactive relationships with consumers and suppliers and deliver new products and services at low cost.

Revolutionary changes in information technology have been sweeping across the global business. Developments in telecommunications and information technologies have reduced the barriers to time and place in doing business. It is now possible for customers and suppliers to transact business at any time in any part of the globe, without having to come together physically, thanks to the developments in optical fiber technology, videophone and teleconferencing facilities. The net has changed face and pace of business-to-business marketing and retailing.

ICT has brought about sweeping changes in the marketing scenario.

Effective use of information technology helps a company to identify and profile customers, reach out to customers quickly and more effectively, and make inventory management and distribution system more efficient.

If Indian firms do not keep pace with such contemporary developments, global business, and even domestic business in due course, will be largely out of their reach.

ICT has been significantly transforming the distribution system. Xavier points out that effective use of ICT in distribution can help companies:[24]

- Reduce inventories
- Reduce delivery time/unproductive waiting time
- Reduce stock-outs/lost sales
- Respond faster to market changes
- Reduce rush orders
- Cut down overproduction
- Reduce unnecessary movement (forwarding and back-tracking)
- Reduce paperwork and wasteful processing
- Plan production better

All the above benefits result in improved service at a lesser cost. In the West, IT is drastically changing the distribution systems. Electronic networking has become all-pervasive. The boundary of the organisation is blurring, as it becomes more of a network, with electronic links forward into customers, backwards to suppliers and sideways to business partners. Looking at the enormous benefits, one may wonder as to why Indian companies have not computerised their distribution as yet.[25]

As Xavier points out, IT has also greatly contributed to the retail revolution, which is sweeping the entire world. What used to be a fragmented industry has got consolidated due to the sophisticated use of IT systems. Large retail chains are gobbling up small-town retailers. Retailing has now become a global business, thanks to the sophisticated IT systems being used by them. Typically, the retail stores were all along operated by owners, but currently the shift is towards systems-driven stores.[26] The major shifts that are taking place in the retail industry are summarised in Table 6.1.

TABLE 6.1 : RETAIL REVOLUTION

From	*To*
Fragmented	Consolidated
Local	Global
Low technology use	High technology use
Owner-operated	Systems-driven
Traders	Retail brand managers
Mass marketing	Individualised relationship customisation
Marketplace	Market space

Source: M.J. Xavier, *Marketing in the New Millennium*, p. 142.

Retailing in developed markets is increasingly becoming *net-tailing* or *e-tailing*. Developing countries will follow the trend sooner or later.

The place in the marketing mix is gradually being replaced by (net) space. The channel system is being drastically restructured. The number of intermediaries is falling. An e-tailer may directly deal with the manufacturer and ultimate buyer. Direct marketing will also get a boost.

A large number of *match maker* or *infomediary* has sprung up. *Infomediaries* can have a beneficial role even when there are established dealers for a product, with no need for the match maker to stock the goods. The match maker model of e-commerce connects buyers on one side with sellers on the other. *For example*, the *Jaldi.com* has set up an online mall for white goods which enables potential buyers to compare price and features across all brands of white goods. The customer can post an inquiry for a model at the site and all the dealers registered with the net marketer will quote the price for it. The customer can then choose the dealer he wants to

buy from. Although the dealer will make the sale to the customer, the net marketer will get a commission from the dealer.

The net facilitates quick, easy and wider reach across the globe both for the seller and the buyer. This implies that firms which do not have websites will simply be bypassed by many (in future by most) of the potential customers. E-commerce is becoming more quickly prevalent in business-to-business marketing.

Information and communication technology is becoming all embracing efficiently networking the whole business system, making a shift from e-commerce to e-business. E-commerce becomes e-business when a company connects its business system directly to its critical constituencies – customers, employees, vendors and suppliers – via intranet, extranet and over the internet.

When a company has properly linked its business system comprising intranet, extranet and over the internet, when a customer places an order by the internet, it gets communicated to the company, distributors and the bankers. Goods are shipped by the distributor on intimation to the company and the banker who will collect the money and credit the supplier. When the stock with the distributor falls to a specified level, the company replenishes it. All these transactions take place on the real time.

TRANSFER OF TECHNOLOGY

Technology transfer refers to the formal process of transfer of technology from the proprietor to other firms.

Technology transfer is the process by which commercial technology is disseminated. This will take the form of a technology transfer transaction, which may or may not be a legally binding contract,[27] but which will involve the communication, by the transferor, of the relevant knowledge to the recipient. Among the types of transfer transactions that may be used, the Draft TOT Code by UNCTAD has listed the following:[28]

(a) The assignment, sale and licensing of all forms of industrial property, except for trade marks, service marks and trade names when they are not part of transfer of technology transactions;

(b) The provision of know-how and technical expertise in the form of feasibility studies, plans, diagrams, models, instructions, guides, formulae, basic or detailed engineering designs, specifications and equipment for training, services involving technical advisory and managerial personnel, and personnel training;

(c) The provision of technological knowledge necessary for the installation, operation and functioning of plant and equipment, and turnkey projects;

(d) The provision of technological knowledge necessary to acquire, install and use machinery, equipment, intermediate goods and/or raw materials which have been acquired by purchase, lease or other means;

(e) The provision of technological contents of industrial and technical cooperation arrangements.

The list excludes non-commercial technology transfers, such as those found in international cooperation agreements between developed and developing states. Such agreements may relate to infrastructure or agricultural development, or to international; cooperation in the fields of research, education, employment or transport.

Broadly, there are two forms of TT, *viz.,* internalised and externalised forms of technology transfer. Internalised forms refer to investment associated TT, where control resides with the

technology transferer. The transferer, normally, holding the majority or full equity ownership. Externalised forms refer to all other forms, such as joint ventures with local control, licensing strategic alliances and international subcontracting.

The modes operandi of TT is influenced by the decision of proprietor of technology to internalise or externalise the technology.

The distinguishing feature between these two modalities of resource transfer is that in internalised TT, the transferor has a significant and continuing financial stake in the success of the affiliate, allows it to use its brand names and to have access to its global technology and marketing networks, exercises control over the affiliate's investment, technology and sales decisions, and sees the affiliate as an integral part of its global strategy. Externalised forms lack one or all of these features, with repercussions on the TT process. Over time, the array of TT arrangements has diversified and particular modes have also become more flexible. Thus, the dividing lines between externalised and internalised modes are becoming less easy to draw.[29]

LEVELS OF TT

A simplified treatment of the subject would suggest four levels of TT.[30]

Operational Level: At the bottom level are the simplest ones, needed for operating a given plant. These involve basic manufacturing skills, as well as some more demanding troubleshooting, quality control, maintenance and procurement skills.

Duplicative Level: At the intermediate level are duplicative skills, which include the investment capabilities needed to expand capacity and to purchase and integrate foreign technologies.

Adaptive Level: At this technological self-reliance level, imported technologies are adapted and improved, and design skills for more complex engineering learned.

Innovative Level: This level is characterised by innovative skills, based on formal R&D, that are needed to keep pace with technological frontiers or to generate new technologies.

Channels of Technology Flow

The most important channels for the flow of technology are Foreign Investment and Technology Licence Agreements and Joint Ventures.

Foreign Investment: Traditionally, the flow of technology to developing countries has been an integral part of direct foreign investment. Multinational corporations and other firms have resorted to foreign direct investment for a variety of reasons like protection and development of foreign markets, utilisation of local resources (in the host country) including cheap labour, overcoming or lessening of the impact of tariff restrictions and tax laws. The flow of sophisticated technology, in particular, has thus been associated with direct investment.

Technology Licence Agreements and Joint Ventures: Technology transfer has been taking place on a significant scale through licensing agreements and joint ventures. There has been a fairly rapid growth of joint ventures, encouraged by government restrictions on foreign investment and foreign trade or the perceived advantages of such ventures. When foreign capital participation in joint ventures is below 50 per cent, technological agreements assume considerable significance.

Methods of Technology Transfer

Transfer of technology takes a variety of forms depending on the type, nature and extent of technological assistance required. The following are the important methods of technology transfer:

1. *Training or Employment of Technical Expert:* Fairly simple and unpatented manufacturing techniques/processes can be transferred by imparting the requisite training to suitable personnel. Alternatively, such technology can be acquired by employing foreign technical experts.

2. ***Contracts for Supply of Machinery and Equipment:*** Contracts for supply of machinery and equipment, which normally provide for the transfer of operational technology pertaining to such equipment, is often quite adequate for manufacturing purposes not only in small-scale projects but also in a number of large-scale industries where the nature of technology is not particularly complex.

3. ***Licensing Agreements:*** Licensing agreements, under which the licensor enters into an agreement with a licensee in another country to use the technical expertise of the former, is an important means for the transfer of technology. Licensing agreements are usually entered into when foreign direct investment is not possible or desirable.

4. ***Turnkey Contracts:*** Transfer of complex technology often takes place through turnkey project contracts, which include the supply of such services as design, creation, commissioning or supervision of a system or a facility to the client, apart from the supply of goods.

Many times, a combination of two or more of the above-mentioned methods is used. Turnkey contracts, obviously, are the most comprehensive of such combinations.

Issues in Transfer of Technology

Cost, appropriateness, dependence and obsolescence are the four important issues associated with the transfer of technology.

In many cases, the developing countries obtain foreign technology at unreasonably high prices. In a number of cases of foreign direct investment associated with technology transfer, the net outflow of capital by way of dividend, interest, royalties and technical fees has been found to be much higher than the corresponding inflow.

The appropriateness of the foreign technology to the physical, economic and social conditions of the developing countries is an important aspect to be considered in technology transfer. It has been argued that there are a large number of cases where the foreign technology transferred has been irrelevant or inappropriate to the recipient country's socio-economic priorities and conditions.

Further, heavy reliance on foreign technology may lead to technological dependence.

It is pointed out that the import of modern sophisticated technology has tended to displace the traditional indigenous technology which have been improved under a different set of policies. The steady stream of new products and processes introduced by multinationals into developing countries has been unfavourable to the promotion of domestic technological capacities and has discouraged local scientists and technicians from devoting themselves to practical development problems. It creates an attitude of subservient dependence, which may inhibit the capacity to do even relatively minor adaptive research or to adopt processes which are developed locally.

It has also been observed that there is a tendency to transfer outdated technology to the developing countries. Thus, they would not enjoy the advantages of the latest technology and would still technologically lag behind. It is unfortunate that the owners of modern technology view the developing countries as a means to salvage technology that is obsolescent in the advanced countries, even when they possess more advanced technology.

PROMOTION AND REGULATION

Several regulatory and promotional measures are required to take advantage of the TT opportunities.

Despite the problems or shortcomings of foreign technology, it is widely recognised that if properly regulated and promoted it can play a positive role, particularly in the technologically backward LDCs. The Government of India and a number of other countries have, therefore, taken a number of regulatory and promotional measures to take advantage of foreign technology without sacrificing national interests.

Areas of Regulation

A number of regulatory measures have been taken by different countries to ensure that the technology chosen is the best available, appropriate to domestic conditions and that indiscriminate and unnecessary import of foreign technology is not undertaken. The following are the aspects of technology commonly regulated.

The Extent and Terms of Equity Participation: These are generally determined by the priorities of the technology-using industry in the nation's economy, supply conditions of the technology and its type and nature.

Phasing of Domestic Manufacturing: Where foreign technology is employed, many governments, including that of India, insisted upon indigenisation on a phased manner. The Government of India in the past also insisted that suitable provisions should be made for the training of Indians in the field of production and management. Further, there should be adequate arrangements for research and development, engineering design, training of technical personnel and other measures for the absorption, adaptation, and development of the imported technology.

The Appropriateness of the Technology: Permission to import a particular technology is generally based on considerations such as suitability of the technology to the socio-economic and ecological conditions in the country and the priority of the technology using industry in the national economy. According to the guidelines issued by the Government of India, the entrepreneurs should, to the fullest extent possible, explore alternative sources of technology, evaluate them for a techno-economic point of view and furnish reasons for preferring the particular technology and source of import.

Payment Terms and Foreign Exchange Outflow: Most governments take measures to ensure that disproportionately high payments are not paid for any technology. Restrictions were imposed also on dividend payments and pricing.

The Government of India's guidelines clearly laid down that there should be no requirement for the payment of minimum guaranteed royalty, regardless of the quantum and value of production.

Restrictive Terms in the Agreement: Technology imports with highly restrictive terms on the importing parties are not generally favoured. For instance, according to the Government of India's policy, to the fullest extent possible, there should be no restrictions on free exports to all countries. Further agreements or clauses which in any manner bind the Indian party with regard to the procurement of capital goods, components, spares, raw materials, pricing policy and selling arrangements should be avoided.

Promotional Measures

To take full advantage of the positive role of foreign technology, it is necessary to take certain promotional measures. These include:

1. Assessing technological requirements of various sectors and identifying areas where foreign technology is required.
2. Dissemination of information in foreign countries regarding foreign investment potentials and scope for technical collaboration in the domestic economy, government policy and regulation in respect of foreign capital and technology, institutional assistance and infrastructural and other facilities for industrial development. The Indian Investment Centre, established in 1961 has been playing such a role.
3. Provision of advisory services to Indian entrepreneurs in respect of foreign technology including the techniques and process of technology transfers.

SUMMARY

The natural factors and available technology indicate, normally, the innate potential for development of business/economy of a nation/region. The extent to which this potential is really exploited depends on the economic, social and demographic, and political environments.

Technological developments have been revolutionising the business scene. They facilitate not only the introduction of new products but also tremendous improvements in the operational efficiency and exciting changes in the modus operandi of business. It implies, *inter alia*, that even when good demand exists for an old product, adoption of the state-of-the-art technology for the conduct of the business would be necessary for survival.

The information technology has vastly transformed the marketing and the financial markets scenario and has significantly contributed to the globalisation process.

Technology often provides a competitive advantage. Success in many industries has a lot to do with R&D and innovation. There are many factors which stimulate the innovative drive of a firm. These include the company's own strategy, demanding customers, competition (including threat of substitutes), certain social forces, government policies etc.

There is no guarantee that an innovation will be a commercial success. An innovative product can commercially fail due to various reasons; success presupposes several favourable conditions.

An important strategic issue confronting many firms is whether to be a technology leader or follower – there are a number of prerequisites, advantages and disadvantages associated with both.

A company may also source technology externally, like from R&D organisations, other firms (including foreign firms). While sourcing foreign technology, the firm should ensure that the technology it chooses is the appropriate one and should be able to properly absorb the technology. Japanese industry is known for the choice of appropriate technology and improving on them after the absorption.

Government policy sometimes is a very important technological environment. Restrictions on foreign technology, scale of operation, type of the technology etc. very adversely affected the Indian business in the past. The liberalisation has significantly improved the situation.

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Chapter 7

DEMOGRAPHIC ENVIRONMENT

Structure

Importance of Demographic Environment

Falling Birth Rate and Changing Age Structure

Migration and Ethnic Aspects

Summary

References

IMPORTANCE OF DEMOGRAPHIC ENVIRONMENT

It is conventionally said that Management is Men, Material, Machinery and Money. Even if all the other Ms are excellent, it would not be of use unless the Men is the right one (in terms of quality, potential, motivation and commitment etc.)

Market is people in the sense that the demand depends on the people and their characteristics – the number, income levels, tastes and preferences, beliefs, attitudes and sentiments and a host of other demographic factors. No wonder, *demography* is an important basis of market segmentation.

The importance of demographic factors to business is clear from the facts that "management is men" and "market is people."

Important demographic bases of market segmentation include the following:

- Age structure
- Gender
- Income distribution
- Family size
- Family life cycle (For example: young, single: young, married, no children; young married with children ....)
- Occupation
- Education
- Social class
- Religion
- Race
- Nationality

The demographic environment differs from country to country and from place to place within the same country or region. Further, it may change significantly over time. Peter Drucker, who emphasises the tremendous economic and business implications of demographic changes, suggests that any strategy, that is any commitment of present resources to the future expectations, has to start out with demographics.[1]

Demographic diversity between and within nations is very conspicuous.

Demographic factors such as size of the population, population growth rates, age composition, ethnic composition, density of population, rural-urban distribution, family size, nature of the family, income levels etc. have very significant implications for business.

Population Size

The size of the population is an important determinant of demand for many products. There are countries with less than a lakh of people on the one hand and those with over a thousand million on the other hand.

One of the important objectives of the formation of the European Union (EU) was to bring about a single market that compares, in terms of the number of consumers, to that of USA and Japan.

Nations with large and growing population and rising income are the future markets.

Poor countries with small population are generally not attractive for business. However, even such countries may hold out opportunities for some companies. As these markets may not be of interest for large companies, small firms may find promising *niches* in these markets.

Advanced countries, particularly with large population, are generally attractive markets. The major part of the international trade and foreign investments naturally take place between these nations. Because of the large potential of these markets, competition is generally strong in them.

BOX 7.1 : DEMOGRAPHIC DECLINE vs. DEMOGRAPHIC DIVIDEND

While population in several developed countries are either saturating or declining (as pointed out in the following section), it is still rising fast in the developing countries. According to the United Nations Population Division, the world population will likely increase by 2.5 billion over the 43 years since 2007, passing from rent 6.7 billion to 9.2 billion in 2050. This increase is equivalent to the total size of the world population in 1950, and it will be absorbed mostly by the less developed regions, whose population is projected to rise from 5.4 billion in 2007 to 7.9 billion in 2050. In contrast, the population of the more developed regions is expected to remain largely unchanged at 1.2 billion, and would have declined, were it not for the projected net migration from developing to developed countries, which is expected to average 2.3 million persons annually.

According to the BRIC Report by the global consulting firm Goldman Sachs, India has the potential to emerge as the fastest growing economy, overtaking China, in the near future. One of the important basis of this exciting potential is India`s remarkable demographic advantage that has come to be widely described as the demographic dividend (large size and large proportion of working age population). According to the UN`s projections, the increase in India`s population between 2000 and 2020 is 310 million, about the samesize as the US population today and during this period India will create the equivalent of the combined workingpopulation of France, Germany, Italy and the UK. While India struggles with a burgeoning population of educatedyouth, the rest of the world, especially developed countries, faces a shortage of working-age people, caused largely by lower birth rates and an ageing working population. While the requirement for skilled workers in these markets is increasing in line with economic growth, the availability of skilled people simply isn`t keeping pace. In professions like IT services, medicine, and education, the problems are already beginning to be felt. China is also likely to be affected by manpower shortage.

For the developed world, these shortages present a huge challenge. It may increase wage rates, reducing the competitiveness and slowing down economic growth. Pressure on the existing social security and pension systems will increase as a significantly larger percentage of retired population has to be supported by a smaller percentage of working population.

FALLING BIRTH RATE AND CHANGING AGE STRUCTURE

The falling birth rate, declining population and changing age structure have important implications for business and governments.

True, there has been an explosive growth of the global population, particularly in the developing countries. The universal trend now, however, is fall in birth rates, although the total population is still growing at over one per cent annually. Developing countries are also experiencing significant decline in the population growth rates. In developed countries, the fall in the birth rate is so steep that the population size would shrink drastically.

Because of the declining birth rate, population is already peaking in a number of countries. The collapse of population size has serious implications for business.

The declining birth rate poses a problem for many businesses. Because of the decline in the birth rates and the consequent fall in the size of the baby population, the market for baby products has shrunk. This has prompted some companies, such as Johnson and Johnson, to reposition their products (originally introduced as baby products) and to pay more importance to international business.

The declining birth rate has, however, been a boon to certain industries. *For example,* industries such as hotels, airlines and restaurants have benefited from the fact that young childless couples have more time and income for travel and dining out. Small families have also similar advantages when compared with large families.

It is obvious that business should necessarily ponder over whether the falling birth rate and the shrinkage in the number of young people—and especially of people under eighteen, that is, babies, children and teenagers—is a threat or an opportunity.

According to Drucker, the most important single new certainty about future is the *collapsing birth rate in the developed world*, which he describes as "national suicide" He points out that in Western and Central Europe and in Japan, the birth rate has already fallen well below the rate needed to reproduce the population. That is, below 2.1 live births for women of reproductive age. In some of Italy's richest regions, *for example,* in Bologna, the birth rate by the year 1999 had fallen to 0.8; in Japan to 1.3. In fact, Japan and all of Southern Europe—Portugal, Spain, Southern France, Italy, Greece—are drifting toward collective national suicide by the end of the 21st century. By then Italy's population, for instance—now 60 million—might be down to 20 or 22 million; Japan's population—now 125 million—might be down to 50 or 55 million. But even in Western and Northern Europe the birth rates are down to 1.5 and falling. But in the United States, too, the birth rate is now below 2 and going down steadily. And it is as high as it is only because of the large number of recent immigrants who still, for the first generation, tend to retain the high birth rates of their country of origin *for example,* Mexico.[2]

The collapsing birth rate is redefining the characteristics of the 'child market'.

As Drucker points out, for a business that makes its living making goods for small children, the collapsing birth rate may be an opportunity. It is conceivable that having fewer children means that the child becomes more and more precious and that a larger share of the disposable income is spent on it. This apparently has already happened in China where a majority of families have only one child. Many families, there, despite their poverty, apparently spend more on the single child than they used to spend on three or four children. There are signs in other countries like Germany, Italy and even in the United States of similar developments.[3]

Although birth rates have fallen in developing countries, the population growth rates are still very high. This coupled with a steady increase in income drives fast the growth of the markets of a number of developing economies

When the population is very large, even if the country is generally poor, there could be a sizeable market even for those goods and services which are regarded luxuries in these countries. *For example,* if just five per cent of the Indian population is well to do, the absolute number (more than 50 million) is larger than the total population of many of the high income economies.

High population growth rate also implies an enormous increase in the labour supply. When the Western countries experienced industrial revolution, the population growth was comparatively slow. Labour shortage and rising wages encouraged the growth of labour-intensive methods of production. Capital-intensive technologies, automation, and even rationalisation, are opposed by labour, and many sociologists, politicians and economists in developing countries. Cheap labour and a growing market have encouraged many multinationals to invest in developing countries. Many companies in the developed countries have relocated their production facilities, wholly or partially, in the developing countries to reduce the labour costs.

The problems of developing countries due to the population explosion also indicate the enormous scope for several industries. A very significant share of the Indian population is below the poverty line. Although these people, who do not have sufficient income even to meet the bare minimum basic necessities of life, do not come within the market for a large variety of goods and services, the existence of such a large size of poor population has a lot of other implications. To solve the basic problems, the additional number of children to be educated, the additional number of people to be provided with medical care, water supply etc. during one Five Year Plan in India are more than what most nations have done over centuries. While it is a formidable national challenge, it also indicates enormous business opportunities.

Although India has the largest size of the poor people in the world, the size of India's middle and upper income class is larger than total population of most nations.

TABLE 7.1 : MOST POPULOUS NATIONS AND INDIA

Share (%) of Ten Most Populous Countries in World Population

Country	Share (%)
China	19.4
India	17.5
USA	4.5
Indonesia	3.4
Brazil	2.8
Pakistan	2.7
Bangladesh	2.4
Nigeria	2.3
Russia Federal	2.0
Japan	1.9
Others	41.2

Growth of Population of India

Census Year	Population (Million)
1901	238.40
1911	252.09
1921	251.32
1931	278.98
1941	318.66
1951	361.09
1961	439.23
1971	548.16
1981	683.33
1991	846.42
2001	1028.74
2011	1210.19
2021 (Projection)	1400.00

Source: Marketriser.com

The occupational and spatial mobilities of population too have implications for business. If labour is very mobile between regions and occupations, labour problems are likely to be less than would otherwise be the case.

If the labour is highly heterogeneous in respect of language, religion and caste, ethnicity etc., personnel management is likely to become a more complex task. A highly heterogeneous population with its varied tastes, preferences, beliefs temperaments etc. give rise to differing demand patterns and calls for differing marketing strategies.

The population of several developed nations at the end of this century would be much smaller in size than today.

The falling birth rate and rising longevity will significantly alter the age distribution within the population. The proportion of aged in the total population will go up. *For example,* of those 20-odd million Italians by the year 2080, a very small number will be under fifteen, and a very large number—at least one-third of the population—well above sixty. In Japan, the disproportion between younger people and people above any traditional retirement age will be equally great if not greater. In the United States, the young population is already growing much more slowly than the older population, past traditional retirement. Still, up to the year 2015 or so, the number of young people will still be growing in absolute numbers in the United States. But then it is likely to go down and quite rapidly. The share of old in the total population will increase in the future in almost every nation.[4]

The changes in the age distribution have a lot of implications for business. Several pharmaceutical companies, for instance, are paying a lot attention to the potential requirements of the aged population.

The increasing proportion of the aged would have implications for the Government. It may increase the welfare burden of the governments.

According to Drucker, the collapsing birth rates will have the following implications.[5]

1. For the next twenty or thirty years, demographics will dominate the politics of all developed countries. And they will inevitably be politics *of great turbulence*. Important issues include the retirement age and immigration.
2. For the next twenty or thirty years, no developed country is likely, therefore, to have stable politics or a strong government. Government instability is going to be the norm.
3. "Retirement" may come to mean two different things. It is quite likely that the trend toward "early retirement" will continue. But it will no longer mean that a person stops working. It will come to mean that a person stops working full-time or as an employee for an organisation for the entire year rather than a few months at a time. Employment relations—traditionally among the most rigid and most uniform relationships—are likely to become increasingly heterogeneous and increasingly flexible, at least for older people. This will increasingly be the case as the center of gravity in the older population shifts from manual workers to people who have never worked with their hands, and especially to knowledge workers—a shift that will begin in the United States around the year 2010 when the babies of the "baby boom" which began in 1948 reach traditional retirement age.
4. The final implication is that in all developed countries the productivity of all workers—whether full-time or part-time—and especially of all knowledge workers, will have to increase very rapidly. Otherwise the country—and every organisation in it—will lose position and become steadily poorer.

MIGRATION AND ETHNIC ASPECTS

While the population will be declining in many developed countries, which may also lead to labour shortage, population pressure will be mounting in developing nations many of which are neighbours of the rich nations. As a consequence, to prevent migration pressure, as Drucker observes, is like preventing the law of gravity.[6] The response to immigration will be different between countries. On the one hand is the United States which has been a great nation of immigrants and on the other is Japan, which has never allowed any immigration whatsoever. The immigration will likely be a hot political issue in a number of countries.

The demographic characteristics of a number of countries are changing because of migration.

Already, immigration has brought about very remarkable ethnic changes in USA.[7] A number of localities are concentrated by immigrant communities. Detroit claims to be the Arab capital of America. Miami used to be thought of as a Cuban enclave, but is becoming more Haitian, more Jamaican, more all sorts of things. According to the mayor of Miami, his region is home to 156 nationalities. Silicon Valley is merely the latest American showpiece to be built in large part by immigrants.

In the 1950 census, America was 89 per cent white and 10 per cent black. Other races hardly got a look-in. Now, Latinos account for around 12 per cent of the population. Within the next five years, they will overtake blacks to become the largest minority group. If current trends continue, they will be the majority in Los Angeles County in ten years. In 20 years, they will dominate Texas and California. By 2050, one in four of the 400 million people who will then be living in the United States will be Latino—and if you add in Asians, their joint share will be one in three.

It is estimated that every year roughly a million new people arrive (700,000 legally, 300,000 illegally) in USA. Once settled, the immigrants generally have more children than their neighbours

(an average of around three per woman, compared with 1.8 for non-Hispanic white women). Half of the 50 million new inhabitants expected in America in the next 25 years will be immigrants or the children of immigrants.

Immigration increases the multicultural complexity, throwing up new challenges and opportunities for business.

The good old dictum be *a Roman when in Rome hardly happens*. Although the US was originally called a *melting pot*, immigrants have been found to retain their identity rather than melting. As Kotler observes,[8] now the US is called a *salad bowl* society with ethnic groups maintaining their ethnic differences, neighbourhoods and cultures. Each specific group has certain specific wants and buying habits. Several food, clothing and furniture companies in the US have directed their products to one or more of these groups. For instance, Sears is taking note of the preferences of different ethnic groups. Colgate Palmolive has successfully promoted its toothpaste within the Hispanic community through ads that place less emphasis on health and more emphasis on appearance. Marketers must, however, be careful not to overgeneralise about ethnic groups because within each ethnic group there are consumers who are different from each other.

BOX 7.2 : THE SURGING INDIAN MARKET

India is the second largest market in terms of the number of consumers. According to 2011 census, the estimated Indian population was about 121 crore compared to about 142 crore of China in 2009. By 2045, the Indian population is expected surpass China`s.

Currently, every sixth person in the world is an Indian, and according to demographers who project a doubling of the country`s burgeoning population by about 2040, every fourth human will be an Indian then.

During 2001-2011, the Indian population increased by about 17.6 per cent, compared to nearly 21.5 per cent in the previous decade.

The decade of 2001-2011 registered the steepest fall in the population growth rate of India since Independence.

The National Population Policy foresees the country being able to reach replacement fertility level, at which the number of births is equal to the number of deaths, by 2010. Population experts, however, strongly feel that it is too optimistic an expectation.

During 2001-2011, India has added about 18 crore people. There are only three countries, excluding India (China, USA and Indonesia), in the world with a total population larger than this figure.

The annual addition to the Indian population (about two crore) is larger than the total population of a large number of countries. This is more than double the size of the total population of Sweden or Switzerland.

The population of India is nearly equivalent to the total population of all the developed countries.

SUMMARY

Demographic factors such as size of the population, population growth rates, age composition, ethnic composition, spatial distribution of population, family size, family life cycle, income levels, ethnic composition, religion etc. have very significant implications for business.

The demographic environment differs from country to country and from place to place within the same country or region. Further, it may change significantly over time.

Because of the diversity of the demographic environment, companies are sometimes compelled to adopt different strategies within the 'same market'.

Population growth rates vary widely between nations.

The world population is projected to jump from about 6 billion in 1999 to over 7 billion by 2014. More than half of the next billion will come from South Asia and Sub-Saharan Africa, Europe and Central Asia will add just 1 per cent and the world's high-income countries will add about 3 per cent.

While there has been an explosive growth of the global population, particularly in the developing countries, the universal trend now, however, is fall in birth rates, although the total population is still growing at over one per cent annually. Developing countries are also experiencing significant decline in the population growth rates. In developed countries, the fall in the birth rate is so steep that the population size would shrink drastically.

Because of the declining birth rate, population is already peaking in a number of countries. The declining birth rate and the collapse of population size have serious implications for business.

The increase in population and increase in income make the developing countries very attractive markets of the future. In fact, there are only three countries, excluding India (China, USA and Indonesia), in the world with a total population larger than the population that India added to itself during 1991-2001. The total population of a large number of countries is smaller than the annual addition to the Indian population.

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Part 2

BUSINESS AND SOCIETY

Business is an integral part of the social system. The social system influences business which, in turn, is affected by the business.

Social factors are among the most important factors which affect business. The type of products to be manufactured and marketed, the marketing strategies to be employed, the way the business should be organised and governed, the values and norms it should adhere to etc. are all influenced by the social structure and the culture of a society. Many aspects of the social/cultural environment are not very obvious. Ignorance/neglect of certain dimensions of the societal environment may create tremendous problems.

The first chapter of this *Part* provides a brief description of a number of societal factors important to business. The next chapter deals with the social responsibilities expected of business and social audit of business. This is followed by a short account of a social environment of increasing relevance to business, *viz.,* consumer rights and consumerism. Lastly, this *Part* takes a look at a very important social concern, *viz.,* corporate governance.

Chapter 8

SOCIETAL ENVIRONMENT

Structure

- Business and Society
- Professionalisation
- Business Ethics
- Business and Culture
- Technological Developments and Social Change
- Summary
- References

The social environment of business is, often, very complex and intricate.

The type of products to be manufactured and marketed, the marketing strategies to be employed, the way the business should be organised and governed, the values and norms it should adhere to, are all influenced by the social structure and the culture of a society. The social system, on the other hand, is influenced by the way the business functions. The organisation of the business, the way the business functions, innovations, transmission and diffusion of information and new ideas, etc., may affect society. Business activities greatly influence social attitudes, values, outlooks, customs, etc. However, it is very difficult and, in some case, almost impossible, to change many elements of the social environment in the short run. Hence, a business may have to adapt to these uncontrollable external environments.

BUSINESS AND SOCIETY

CHANGING CONCEPT AND OBJECTIVES OF BUSINESS

Traditionally, the term business commonly referred to commercial activities aimed at making a profit or to organisations formed to make a profit. Indeed, in the past, economic theory made a fundamental assumption that profit maximisation was the basic objective of every firm. The modern outlook, however, is different. For them, profit is only secondary. There are, moreover, many organisations, both private and public, which do not aim at profit from their business. In short, the definition of a business as a commercial activity to make a profit or an organisation formed to make a profit is a narrow one. Yet, to a layman, business still means industry and commerce.

Business is an integral part of the social system and it is influenced by other elements of society which, in turn, is affected by the business.

The old concept of business, confining it to commerce and private profit, has undergone a radical change. Today, business is regarded as a social institution forming an integral part of the social system. As Davis and Blomstorm observe, business is "social institution, performing a social mission and having a broad influence on the way people live and work together."[1] As Calkins remarks: "It is now recognised that the direction of business is important to the public welfare, that businessmen perform a social function."[2]

Thus, "viewed in a broad way, the term business typically refers to the development and processing of economic values in society. Normally, we use the term to apply to the private (non-government) portion of the economy whose primary purpose is to provide goods and services to customers at a price, but the lines of distinction are getting hazy as business and government overlap their functions in organisations such as the Communications, Satellite Corporation and the Tennessee Valley Authority. In addition, business is a term applied to economic and commercial activities of institutions having other purposes, such as the business office of an opera association."[3] Thus, organisations which do not aim of making a profit, like the Delhi Development Authority, charitable hospitals, or other institutions, public relations organisations, government departments, etc., invest capital, price and market their products, services or ideas, manage their human resources, and so on.

The modern concept of business is a very broad one; business is viewed as a subsystem of the total social system.

According to Davis and Blomstorm, "our modern view of society is an ecological one. Ecology is concerned with the mutual relations of human populations or systems with their environment. It is necessary to take this broad view because the influence and involvement of business are extensive. Business cannot isolate itself from the rest of society. Today, the whole society is a business's environment."[4]

Davis and Blomstorm point out that, in taking an ecological view of business in a systems relationship with society, three ideas are significant in addition to the systems idea. The three ideas are values, viability and public visibility.[5]

Values

Business, like other social institutions, develops certain belief systems and values for which they stand, and these beliefs, and values are a source of institutional drive. These values derive from a multitude of sources, such as the mission of business as a social institution, the nation in which a business is located, the type of industry in which it is active and the nature of its employees. These values become guides for employees' decisions in the interface of business. Second, they become strong motivators for people in a business.

Viability

Davis and Blomstorm define viability as the drive to live and grow, to accomplish the potential not yet reached, and to achieve all that a living system is capable of becoming. If a business is to be a viable, vigorous institution in society. It must initiate its share of forces in its own environment, rather than merely adjust to outside forces as a bucket of quicksand does. Every business needs a drive and spirit all its own to make it a positive actor on the social stage rather than a reactor or a reflector. To expect the business to be otherwise is to deny it the opportunities available to other institutions, the authors have pointed out.

Public Visibility

The term public visibility refers to the extent that an organisation's activities are known to persons outside the organisation. Public visibility is different from the idea of a public image. The term public image refers to what people think about an organisation's acts, while public visibility refers to the extent to which its acts are known. The importance of public visibility is that it subjects business activities to public examination, discussion and judgement. If acts are not known, they cannot be judged.

In short, according to modern thinking, business is an integral part of the social system. It is a social organ to help accomplish the social goals.

According to the modern view of business, its activities and attitudes are subject to societal judgement, which may have far-reaching implications. A business enterprise shall make profit only by accomplishing the socially accepted goals and by satisfying society.

PROFESSIONALISATION

The growth of management education and training has contributed to the growing professionalisation which, in turn, has contributed to the growing social orientations of business.

Professionalisation imparts a certain social responsibility and dignity to management. A professional is one who possesses systematic knowledge and skill to perform certain responsible functions with authority and who is bound by certain ethics in the use of his knowledge and skill. According to Lewis Allen, "a professional manager is one who specialises in the work of planning, organising, leading and controlling the efforts of others and does so through a systematic use of classified knowledge, a common vocabulary and principles, and who subscribes to the standards of practice and code of ethics established by a recognised body."[6]

In this connection, Peter Drucker observes: "Management is independent of ownership, rank, or power. It is objective function and ought to be grounded in the responsibility for performance. Professional management is a function, a discipline, a task to be done; and managers are the professionals who practice of this discipline, carry out the functions, and discharge these tasks, it is no longer relevant whether the manager is also an owner; if he is it is incidental to his main function, which is to be a manager."[7]

Drucker further remarks: "The professional has to have autonomy. He cannot be controlled, supervised, or directed by the client. He has to be private in that his knowledge and his judgement have to be entrusted with the decision. But it is the foundation of his autonomy, and indeed its

rationale, that he sees 'himself as affected with the public interest'. A professional, in other words, is private in the sense that he is autonomous and not subject to political or ideological control. But he is public in the sense that the welfare of his client sets limits to his deeds and words."[8]

A professional has enormous responsibilities. He shall not use his knowledge, skill and authority unscrupulously. He shall not knowingly do harm to his customers. He is socially bound by the ethics of his profession.

From what have been stated above, it is clear that professionalisation of business management means that the business should be managed by men:

- who have formally acquired the specialised knowledge and skill for management;
- who have authority and freedom to take the right decision;
- who have no ideological bias in the discharge of the functions; and
- whose decisions and actions are guided by certain ethical consideration.

Though progress has been made in the direction of professionalisation of management in India, there is still a long way to go, particularly in the many enterprises which are owned by one or a few families. Professionalisation does not, of course, mean that the owners shall not be the managers; but it certainly means that the managers should have proper management education and qualifications. In business circles, there has been a growing awareness of the need for professionalising management; and, as a result, many "family concerns" have taken steps for this purpose.

Professionalisation makes business more efficient, dynamic and socially responsible. The growth of management education in the country and the facilities abroad to obtain management education have contributed to professionalisation in the business field.

BOX 8.1 : PROFESSIONALISATION OF MANAGEMENT OF FAMILY OWNED COMPANIES

A trend of professionalisation of management of predominantly family owned/controlled companies has set in India.

The withdrawal of the members of the Aga family, promotors of Thermax, the boiler manufacturer, from active management roles to make way for professional marks the continuation of a welcome trend in Indian industry. Other prominent recent examples of Indian families consciously inducting professional management into the running of their businesses include the late Parvinder Singh of Ranbaxy, the Burman family of Dabur and Vikram Lall of the Eicher group. In both Thermax as well as Dabur, family members in management decided to withdraw after a restructuring exercise carried out on the advice of a leading management consultant; McKinsey in the case of Dabur, the Boston Consulting Group in case of Thermax. In both Dabur as well as Thermax, the continuation of a host of family members in leading positions was seen to be inimical to enhancing shareholder value. It is a measure of how much Indian industry has changed that family owned companies are now willing to countenance established family members stepping down. Better still, they are prepared to look beyond the family to head the company. At Tata Sons, Ratan Tata, has already announced his resolve to step down two years hence. If the job goes to someone other than a family member, it would mark a big transition from family to professional ownership in one of India`s oldest corporate groups. It would also set a precedent that some of the other big names in Indian industry, like Bajaj and Escorts, for instance, would find difficult to ignore. In April 2001, the family owned Murugappa Group appointed a full-time chairman from outside.

This is not to say that family-run concerns are necessarily less well run than those under professional management Some of the most successful companies in the world like Mars, Seagram and Cargill have been family run for generations. What is indisputable is that family members should get into the business only if they have what it takes and are capable of delivering in an increasingly competitive environment The good news is that our home grown business magnates are finally realising this.

Courtesy: *"Aha Aga", editorial, The Economic Times, February 24, 2000.*

BUSINESS ETHICS

The term business ethics refers to the system of moral principles and rules of conduct applied to business.

That there should be business ethics means that the business should be conducted according to certain self-recognised moral standards. Business, being a social organ, shall not conduct itself in a way detrimental to the interests of society and the business sector itself.

Business ethics is a part of the larger societal ethics; it is not exclusive.

A profession is bound by certain ethical principles and rules of conduct which reflect its responsibility, authority and dignity. The professionalisation of business management should, therefore, be reflected in the increasing acceptance of business ethics.

There is, however, no unanimity of opinion on what constitutes business ethics. In this connection, Peter Drucker very appropriately remarks: "There neither is a separate ethics of business, not is one needed." For "men and women do not acquire exemption from ordinary rules of personal behaviour because of their work or job. Nor, however, do they cease to be human beings when appointed vice-president, city manager, or college dean. And there have always been a number of people who cheat, steal, lie, bribe or take bribes. The problem is one of moral values and moral education of the individual, of the family, of the school".[9]

One is inclined to agree with Drucker that every individual and organ in society should abide by certain moral codes, and that there is no separate ethics of business.

However, certain norms and principles of conduct have been commonly advocated as constituting business ethics.

In the 1930s, Rotary International developed its Code of Ethics that is still used extensively. It uses four questions that are called the four way ethical behaviour for any ethical issue a business faces.

There are some common criteria to judge whether a matter is ethical or not.

- Is it the truth?
- Is it fair to all concerned?
- Will it build goodwill and better friendship?
- Will it be beneficial to all concerned?

The most important professional ethics is expressed by the Hippocratic oath of the Greek physician: *Primum non nocere* ("not knowingly do harm"). This dictum implies that a professional should carefully evaluate his decision and ensure that his actions will not produce negative effects. Thus, this code rules out all anti-social business practices.

The code, *primum non nocere*, encompasses most business ethics. We may, however, list the important ethical principles that a business should follow:

1. Do not deceive or cheat customers by selling substandard or defective products, by undermeasurement or by any other means.
2. Do not resort to hoarding, blackmarketing or profiteering.
3. Do not destroy or distort competition.
4. Ensure sincerity and accuracy in advertising, labelling and packaging.
5. Do not tarnish the image of competitors by unfair practices.
6. Make accurate business records available to all authorised persons.
7. Pay taxes and discharge other obligations promptly.

8. Do not form cartel agreements, even informal, to control production, price, etc., to the common detriment.
9. Refrain from secret kickbacks or payoffs to customers, suppliers, administrators, politicians, etc.
10. Ensure payment of fair wages to and fair treatment of employees.

Role of Trade Associations

Trade associations can play an important role to promote business ethics.

Trade associations which are voluntary organisations of businessmen formed to promote their common interests can promote business ethics in three important ways:

Education and Persuasion: Trade associations can promote business ethics by educating the members about the importance of, and the need for, having business ethics, and persuading them to give due regard to ethical principles in the conduct of their business. The members should understand that if every businessman follows business ethics, everyone of them would be benefited and there would be an improvement in the general image of the business community in the eyes of the public.

Code of Ethics: Trade associations can formulate a Code of Conduct for their members. Such a code of conduct should also contain the code of ethics. The code of conduct will not only guide but also regulate the conduct of business by the members.

Moral Sanctions: 'Sanctions' refer to the ways in which moral conduct is rewarded or misconduct is punished. Such incentives and punishments should be expected to promote business ethics. A trade association may even debar a member for a serious violation of the code of conduct. Fear of such punishment might prompt members to refrain from unfair business practices. On the other hand, public recognition and reward for high, moral standards in business might give a positive inducement to them to practice business ethics.

BUSINESS AND CULTURE

Proper understanding of the cultural dimensions is very important for product development, promotion, business negotiations, human resource management, management of the social and political environment etc.

Culture, which is a very intriguing and complex factor is, often, a very critical component of business environment. An important problem is that several dimensions of culture are not easily explicit. A company which sets out to do business in unfamiliar cultural environment may, therefore, encounter several problems if proper homework is not done. Many multinational businessmen agree that "cultural differences are the most significant and troublesome variables encountered by the multinational company. The failure of managers to comprehend fully these disparities has led to most international business blunders."[10]

Meaning of Culture

There are varying definitions of culture: "Culture, in its broadest definition, refers to that part of the total repertoire of human action (and its product) which is socially, as opposed to genetically, transmitted". A very popular definition is that of E.B. Taylor: "Culture of civilisation is that complex whole which includes knowledge, belief, art, morals, law, custom, and other capabilities and habits acquired by man as a member of society". Kluckhohn has defined culture very simply as "the total life way of a people." As Geert Hofstede, a noted Dutch writer and academic has nicely put it, culture is the *software of the mind*—the social programming that runs the way we think, act and perceive ourselves and others. In other words, your brain is simply the hardware that runs the cultural programming. The implication is that culture is not innate. It is learned behaviour and hence can be changed.[11]

On the basis of the various definitions of culture, Francis Merill formulates the concept of culture as follows.[12] Culture:

- is the characteristically human product of social interaction;
- provides socially acceptable patterns for meeting biological and social needs;
- is cumulative, for it is handed down from generation to generation in a given society;
- is meaningful to human beings because of its symbolic quality;
- is learned by each person in the course of his development in a particular society;
- is, therefore, a basic determinant of personality; and
- depends for its existence upon the continued functioning of society but is independent of any individual or group.

Culture is the sum total of accumulated and evolved social norms, perceptions and behaviour.

Culture consists of both *material* culture and *non-material* culture. Material culture involves man-made things (*e.g.,* automobile, television, telephone, etc.) and man-made alternations in the environment. Non-material culture includes such factors as language, ideals, beliefs, values, music, etc.

Elements of Culture

Material culture includes human achievements and non-material culture encompasses human characteristics.

Culture includes at least three elements, namely, knowledge and beliefs, ideals and preferences.

Knowledge and Beliefs: The knowledge and beliefs refer to a people's prevailing notions of reality. They include myths and metaphysical beliefs as well as scientific realities. As Rose remarks, "one of the features of culture in general that is of special sociological interest is the shared quality of a belief system. People who share a given culture tend to take a hostile attitude towards those within their midst who cannot, or will not, accept conventional definitions of fact."[13]

Ideals: Ideals refer to the societal norms which define what is expected, customary, right or proper in a given situation. Norms are enforced by sanctions, *i.e.,* by rewarding the right behaviour and punishing the wrong behaviour.

Folkways and mores are important aspects of every culture. Folkways are norms of proper behaviour (like the proper way to greet a friend) that are informally enforced. But mores are norms of obligatory behaviour considered vital to the welfare of the group.

Preferences: Preferences refer to society's definitions of those things in life which are attractive or unattractive as objects of desire. Preferences may differ between cultures. Interestingly enough, the judgements of the ideal or the proper do not always correspond to our judgements of the pleasant or enjoyable. An example in point is the temptations (not proper but desirable). "All the things I really like to do are immoral, illegal, or fattening," said Alexander Woollcott:[14]

"A culture tends to provide the standards of tastes in specific lines of human activity. Taste in the most liberal sense varies greatly with the food consumption preferences of different cultures. But there is also taste in clothing, housing sexual practices, and in an endless variety of possessions and activities. What is tasteful in one culture may be highly distasteful in another."[15]

Cultural characteristics are very important in the formulation of pragmatic business strategies. The cost of ignoring customs, traditions, taboos, tastes and preferences, etc., can be very high. *For example,* in Italy, a US company that set up a corn-processing plant found that its marketing efforts failed because Italians thought of corn as "pig food". The Nestle company brews a variety of instant coffee to satisfy different national tastes.

Organisation of Culture

The term organisation of culture refers to the social structure and the integration of traits, complexes and patterns that make up the cultural system.

That cultures are organised or integrated "does not mean that every single item of each culture is neatly and precisely integrated with everything else. It means rather that it is normal for the parts to be somewhat organised, and that culture traits receive their significance and meaning out of their relation to the rest of the culture."[16]

The social structure – "the web of organised relationships among individuals and groups that defines their mutual rights and liabilities" – together with traits, complexes and patterns, reflects the organisation of a culture.

The organisation of culture substantially depends on a multitude of institutions which set goals, norms and procedures for group activities.

Stratification, *i.e.,* differentiation based on criteria such as age, sex, caste, occupation, education, income and so on, is an important aspect of the social structure and cultural organisation. Each stratum is assigned or supposed/expected to have a certain rank or position, role, or limitations etc., in the societal set-up. It is important to recognise such roles and ranks for effective negotiation, promotion etc.

The organisation of a culture is determined to a large extent by major social institutions. According to MacIver and Page, institutions are established forms or conditions of procedure characteristic of group activity. The group which performs these standardised actions has been termed by them an association. According to Biesanz and Biesanz, "institutions are clusters of norms organised and established for the pursuit of some need or activity of a social group, supported by the group's knowledge, beliefs and values, as well as by the meaningful aspects of material culture."

The important common institutions of modern cultures are the economic system, the political administrative system, the educational system; religion, family, expressionistic, aesthetic and recreational institutions, etc. Such institutions have been established to meet society's common needs of a biological, sociological, psychological, economic, and political nature – the type and nature of institutions reflect the common goals, aspirations and the ways of achieving them, definition and regulation of roles, positions, interrelationships, etc., of the individuals and sub-groups and groups and the overall organisation of the culture.

Culture traits, complexes and patterns which are integral to the organisation of culture differ between communities.

Culture traits, complexes and patterns also help us to understand the organisation of a culture. A trait is a unit of observation. It may be a unit of normative behaviour, like shaking hands or saying *namaste*; or it may be an articraft, like a culture object such as a wooden bowl. As Lumby observes, "a culture trait is the simplest acquired material or activity pattern known; and these traits are the bricks, so to speak, of which the whole culture of the society is constructed." Most traits are related to others and fit into larger meaningful wholes called trait complexes. *For example,* the various traits involved in greeting and receiving a guest form a trait complex. A complex, thus, is a system of interrelated traits that function together as a unit and a number of complexes, in turn come together to form a culture pattern. A culture pattern "is a specific and enduring system of trait complexes." The organisation of culture may, thus, be looked upon from the point of view a meaningful integration of different traits into interrelated complexes and complexes in turn into patterns. The term culture pattern is sometimes used to designate the overall organisation of the culture; but sometimes it is used to refer to the major segments of the culture, like the religious pattern of a particular ethnic group.

BOX 8.2 : CULTURAL ENVIRONMENT AND TECHNOLOGY

Perhaps it is because of our need for the means of survival that Japanese science tends to concentrate more on the applied than on the theoretical. We have taken many basic ideas and turned them into practical objects, in many cases products not even thought of by the originators of the basic technology. This is inevitable, of course...

We Japanese have always been eager to develop our own technology, absorb aspects of technology from abroad, and blend them to make suitable objects or systems...

The attitude in America is much more easygoing as far as raw materials are concerned than in Japan. America has so much of everything–oil, coal, copper, gold, uranium, timber–that even today Americans do not seem to take conservation seriously. I am reminded of the American expression, "There's plenty more where that came from." We (Japanese) have no such expression. Our people also seem naturally more concerned about precision. It may have something to do with the meticulousness with which we must learn to write the complicated characters of our language. But "for whatever reason, when we tell one of our Japanese employees that the measurement of a certain part must be within a tolerance of plus or minus five, for example, he will automatically strive to get that part as close to zero tolerance as possible. When we started our plant in the United States, we found that workers would follow instructions perfectly. But if we said make it between plus or minus five, we would get it somewhere near plus or minus five all right, but rarely as close to zero as the Japanese workers did. We discussed what to do about this, and in no time had the answer. For the US specifications, we just set the tolerance at plus or minus two, and in that range the American workers consistently gave us what we needed. If we have the need and demand zero tolerance from the American workers, we can get it if we specify it. I do not for a moment discredit the foreign worker. Sometimes you have to use a different approach where people are accustomed to different approaches.

Courtesy: *Akio Morita, Made in Japan, New York, New American Library, 1986*

The culture traits, complexes and patterns differ from community to community. This indicates some of the complexities involved in multicultural business.

Cultural Adaptation

The term cultural adaptation refers to the manner in which a social system or an individual fits into the physical or social environment. The social system may be a small group, such as the family or a larger collectivity, such as an organisation, or even a total society, like a tribal society.

Adaptation is essential for survival. The type of clothing, food and dwelling, suitable for the climatic and weather conditions, are forms of adaptations. Culture adaptation can be viewed in a very wide context. We have adapted to the energy crisis caused by the oil price hikes by modifying our energy policy and intensifying oil exploration, developing, alternative source of energy and restricting oil consumption. Humanity adapts to contagious diseases by immunisation.

The environment of cultural adaptation influences the introduction of new ideas, techniques, products etc.

Adaptation is relevant at the individual level as well. An individual who joins or accepts a new religion has to adapt himself to the beliefs and ways of that religion. A worker who becomes a member of a trade union has to fit into the objectives, rules and ways of the union. A woman who lives with her husband's family would have to fit into that family culture. An Indian who settles in the USA has to adjust to the social and physical environments there. One who joins a new organisation will have to adapt to the new environment.

The message for business is that the firm and its people will have to adapt to the environment of the different markets. As MacIver and Page remark, "every difference of environment means a difference in our habits, our ways of living. On the other hand, our habits, our ways of living, insofar as they differ, create for us a different environment, a different selection within it, and a different accommodation to it. Through a process of constant selection and constant adaptation, the moving equilibrium of life is maintained."[17]

It is often necessary to know the process and nature of the cultural environment for a successful formulation of business strategies. *For example,* while introducing new ideas, techniques, products; while segmenting the market; while formulating the product and promotion mix strategies; one should consider the extent to which different categories of consumers adapt to the new things or environment and the factors favouring and disfavouring adaptations (and also the general attitude of society to the new ideas and environment and their impact on different categories of consumers).

Cultural Shock

Cultural shock is caused by unfamiliar cultural environment.

Environmental changes sometimes produce culture shock – a feeling of confusion, insecurity, and anxiety caused by the strangeness of the new environment. *For example,* if a youngster, born and brought up in a large city; is posted to a bank office in a remote village, he may experience a cultural shock. Similarly, a villager may experience a cultural shock when he takes up a job in a large modern company in a faraway metropolitan city or foreign nation. They have, however, to adapt to the new culture in due course if they want to survive.

Executives and other employees on foreign assignments may experience culture shock in alien environment. Sometimes the organisation itself may suffer shock. Proper homework to understand the culture can help avoid the shock. This also highlights the importance of the selection of people for foreign markets.

Cultural Transmission

A very important character of culture is its transmissive quality. The elements of culture are transmitted among the members of the culture, from one generation to the next, and to the new members admitted into the culture. Some of the aspects of a culture may be transmitted to other cultures also.

Cultural accumulation, facilitated by cultural transmission, enables a society to build upon the achievements of the past.

The transmissive quality of culture makes it cumulative. Every generation inherits a stock of cultural elements, many of which have been accumulated over a long period of time. As time goes on, cultures accumulate more techniques, ideas, products and skills. It is also quite obvious that certain old elements are dropped as new ideas and traits are acquired.

Many cultural behaviours are handed down by one's parents, teachers and other elders. The reference groups play an important role in handing down new traits and ideas. Some cultural behaviours are however, "handed up" to the elders. It is not uncommon to come across elders imitating or adopting some of the new traits of the youngsters who are the trend-setters. Cultural transmission is not only downward and upward; a lot of transmission takes place among contemporaries, too, *e.g.,* styles of dress, recreational fads; reading and learning habits, political, social and economic views. These are often transmitted among contemporaries. Cultural transmission, thus, takes place horizontally as well as vertically.

Cultural transmission takes place by means of symbolic communication. A symbol is any sign, signal or word that conveys a meaning. The great importance of language in cultural transmission is quite clear. Literature, film, T.V. and some other electronic gadgets, social institutions, advertising and marketing techniques, and so on, play very important roles in cultural transmission.

Transmission also facilitates cultural diffusion, *i.e.,* the spread of cultural elements from one place to another. Cultural transmission and diffusion are easy in a culture with high educational levels and a well-organised communication system. An effective communication system and high educational levels facilitate socio-economic change through better cultural transmission and diffusion, for new ideas and innovations are easily and quickly transmitted, diffused, and absorbed in such a culture. In the context of the generally low literacy rates in India, the government has realised the importance of the media, such as film, T.V. and radio in transmitting information

such as better agricultural practices and techniques, market information, the concept and importance of family planning, and so on.

The nature and process of cultural transmission and diffusion in a society is important to business decision-making. *For example,* to formulate a promotional policy for a product, a service or an idea, it is important to identify the relevant elements of transmission, to evaluate the relative effectiveness of alternative communication media, to identify the reference groups and the extent of their influence, to identify the channel of influence on the reference groups, and so on.

The characteristics and pace of cultural transmission and diffusion are important to business strategy formulation.

Cultural Conformity

Individuals in a culture tend either to conform to the cultural norms or to deviate from them. If the culture endures as it is, most people would conform to the norms. As Inkeles observes, "the social order depends on the regular and adequate fulfilment of the role obligations incurred by the incumbents of the major status-positions in a social system. It follows that the most important process in society is that which ensures that people do indeed meet their role obligation."[18]

A student who abides by the rules of his school discipline, does his homeworks promptly and studies properly is conforming to his role obligations. Similarly, an employee who works properly is conforming to his role obligation. And an employee who strikes work for a reasonable cause in response to a strike call by his union is also conforming to his role as member of the union. "When an individual has incorporated within himself the knowledge and appropriate skills necessary to the fulfilment of a role, and when he accepts the value or appropriateness of the action, sociologists speak of his having 'internalised' the role and its psychological underpinnings."[19] Such internalisation helps achieve cultural conformity.

If a society is, by and large, characterised by blind conformity, it would be very difficult to market new revolutionary ideas (including products and techniques) in such a society. Special efforts may be required in such a society to change the attitudes of the people in favour of unconventional ideas. It is also important to understand the extent and nature of the snowballing effects of initial deviations in a society.

Knowledge of the nature and extent of cultural conformity and deviance will be helpful in business decision-making.

Cultural Lag

The cultural lag thesis put forward by William F. Orgburn says that the various parts of modern culture do not change at the same rate, and that since there is a correlation and interdependence of parts, a rapid change in one part of our culture requires readjustments through other changes in various correlated parts of that culture. These readjustments are often difficult, if not impossible, to make because of a variety of factors, ranging from ignorance to active resistance. Technological changes call for adaptive changes in non-material culture, which is inherently conservative. The cultural lag thus places constraints on the scope of social change through technological development. *For example,* in some cultures, social inertia and religious sentiments come in the way of population control, though a variety of techniques are available for birth control.

International business arena is replete with cases of cultural lag. It indicates that different markets may be in different levels of readiness to accept a new product or idea. To successfully market a new idea (including product, service, technique), it is necessary to identify the factors causing the lag and to overcome them by taking appropriate measures. It would be a blunder to introduce a product to a market which is not ready to adopt it.

Important factors that contribute to cultural lag include ignorance, wrong notions, conservatism, sentimental factors., political factors and vested interests.

CULTURAL TRAITS

Cultures have some important traits. An understanding of these cultural dimensions will be helpful in business.

Low-context and High-context Cultures

Whether a culture is high context or low context is very significant in several cases like that of negotiation.

A high-context culture is one that places great value on the intangible aspects of a negotiation or business deal. Individuals from such cultures look beyond the facts and figures and take into consideration such factors as personal relationships, atmosphere and attitudes toward respect, religion and trust.[20]

A low-context culture, on the other hand, assumes a high degree of shared knowledge on the behalf of a transaction partner and thus deals only in such tangible aspects of the deal as facts, figures and performance. The atmosphere and the personal relationship with the business partners means little. In a low-context culture, business can be conducted without ever meeting face-to-face.[21]

Masculine and Feminine Cultures

Societies with so-called masculine values appreciate aggressiveness and assertiveness while respecting the goal of material acquisition. A masculine culture contrasts with a feminine culture which appreciates interpersonal relationships, put quality of life before material acquisition, and applaud concern for individuals and less-fortunates.[22]

Most societies are a mixture of the masculine and feminine traits.

As Mitchell observes, the pace of business tends to be more pedestrian in cultures with a majority of feminine traits. Business hinges more on personal relationships—friends doing business with friends—rather than on pure efficiency and written contracts. Business people from feminine cultures are often more reserved and less time-driven than those from masculine cultures where achievements more important than building a long-term relationship. In masculine cultures, success is the function of the individual and society is made up of leaders and followers.[23]

Needless to say, understanding the cultural trait is essential for formulation of appropriate strategies and for their effective execution.

Monochronic and Polychronic Societies

Monochronic is a term that describes how a culture views time. In a monochronic society, time is used for ordering one's life, for setting priorities and for doing tasks in a sequential order—one thing at a time. Most of the societies of the developed world are monochronic. It contrasts with a polychronic society which uses time to accomplish diverse goals simultaneously and to interact with as many individuals as possible – even at the same time. Polychronism is a characteristic of emerging socities.[24]

Universalism vs. Particularism

This is one of the five cultural dimensions identified by Fons Trompenaars, a Dutch researcher. The other four follows this.[25]

Universalism is the belief that an idea or practice can be applied as it is universally in contrast to particularism which holds that the environment dictates how ideas should be applied.

In cultures with high universalism, the focus is more on rules than on relationships, business contracts are adhered to very closely, and people believe that "a deal is a deal." In cultures with high particularism, the focus is on relationships and trust than on formal rules. In a particularist culture, legal contracts often are modified, and as people get to know each other better, they often change the ways in which deals are executed.

Trompenaars recommends that when individuals from particularist cultures do business in a universalist culture, they should be prepared for rational, professional arguments and a "let's get down to business" attitude.

Conversely, when individuals from universalist cultures do business in a particularist environment, they should be prepared for personal meandering or irrelevancies that seem to go nowhere and should not regard personal, get-to-know-you attitudes as mere small talk.

Universalism and particularism have some semblance of the low context and high context cultures.

Individualism vs. Communitarianism

In individualism, people regard themselves as individuals, while in communitarianism they regard themselves as part of a group. Countries like the United States, Czechoslovakia, and the former Soviet Union have high individualism.

Mexico and Argentina which were earlier found to be collectivistic or communitarianistic by another researcher, Hofstede, are characterised by individualism according to Trompenaars. Interestingly, former communist countries of Czechoslovakia and the Soviet Union now appear to be quite individualistic, which of course is contrary to assumptions and conventional wisdom about the former communist bloc. These may be indications of cultural change over time. The joining of NAFTA and its increasing global orientation might have brought about a cultural change in respect of Mexico. Similarly, such a change could have happened in the former communist countries consequent to the political and economic changes. One also cannot rule out the methodological factors in respect of these findings.

Trompenaars recommends that when people from cultures with high individualism deal with those from communitarianism cultures, they should have patience for the time taken to consent and to consult, and they should aim to build lasting relationships. When people from cultures with high communitarianism deal with those from individualist cultures, they should be prepared to make quick decisions and commit their organisation to these decisions. Also, communitarianistics dealing with individualists should realise that the reason they are dealing with only one negotiator (as opposed to a group) is that this person is respected by his or her organisation and has its authority and esteem.

Understanding differences in cultural traits will be helpful in business negotiations.

Neutral vs. Emotional

A neutral culture is one in which emotions are held in check whereas an emotional culture is one in which emotions are openly and naturally expressed.

Japan and the United Kingdom are regarded high neutral cultures. People in these countries try not to show their feelings; they act stoically and maintain their composure. People in emotional cultures often smile a great deal, talk loudly when they are excited, and greet each other with a great deal of enthusiasm. Mexico, the Netherlands, and Switzerland are examples of high emotional cultures.

Trompenaars recommends that when individuals from emotional cultures do business in neutral cultures, they should put as much as they can on paper and submit it to the other side. They should realise that lack of emotion does not mean disinterest or boredom, but rather that people from neutral cultures do not like to show their hand. Conversely, when those from neutral cultures do business in emotional cultures, they should not be put off stride when the other side creates scenes or grows animated and boisterous, and they should try to respond warmly to the emotional affections of the other group.

Specific vs. Diffuse

A specific culture is one in which individuals have a large public space they readily let others enter and share and a small private space they guard closely and share with only close friends and associates. A diffuse culture is one in which both public and private space are similar in size and individuals guard their public space carefully, because entry into public space affords entry into private space as well. Austria, the United Kingdom, the United States, and Switzerland all are specific cultures, while Venezuela, China, and Spain are diffuse cultures.

In specific cultures, people often are invited into a person's open, public space; individuals in these cultures often are open and extroverted; and there is a strong separation of work and private life. In diffuse cultures, people are not quickly invited into a person's open, public space, because once they are in, there is easy entry into the private space as well. Individuals in these cultures often appear to be indirect and introverted, and work and private life often are closely linked.

People of different cultural traits show different behavioural characteristics.

Trompenaars recommends that when those from specific cultures do business in diffuse cultures, they should respect a person's title, age, and background connections, and they should not get impatient when people are being indirect or circuitous. Conversely, when individuals from diffuse cultures do business in specific cultures, they should try to get to the point and be efficient, learn to structure meetings with the judicious use of agendas, and not use their titles or acknowledge achievements or skills that are irrelevant to the issues being discussed.

Achievement vs. Ascription

An achievement culture is one in which people are accorded status based on how well they perform their functions. An ascription culture is one in which status is attributed based on who or what a person is. Achievement cultures give high status to high achievers whereas ascription cultures accord status based on age, gender, or social connections.

Trompenaars recommends that when individuals from achievement cultures do business in ascription cultures, they should make sure that their group has older, senior, and formal position-holders who can impress the other side, and they should respect the status and influence of their counterparts in the other group. Conversely, when individuals from ascription cultures do business in achievement cultures, they should make sure that their group has sufficient data, technical advisers, and knowledgeable people to convince the other that they are proficient, and they should respect the knowledge and information of their counterparts on the other team.

RELIGION

Different peoples have their own religious convictions, beliefs, sentiments, customs, rituals, festivals etc. The cost of ignoring certain religious aspects could be very high, sometimes even fatal, in business.

Religious beliefs, customs, sentiments etc. have important implications for business.

When an American fast food chain was planning to enter India, one political party stated that it would oppose the marketing of beef product in the country by the multinational. In a country where cow is regarded sacred, although there were some protests against slaughter of cow, beef is consumed by a sizable population and the number of the beef consumers in India is larger than the total population of many countries. It may, therefore, look ironic that a foreign firm should encounter this kind of a situation. Pork is banned in Muslim countries. During the holy *Ramzan* period, restaurants and the like owned by Muslims remain closed during day time. Muslims would consume the meat of only those animals/birds slaughtered following the prescribed religious rituals. Many Christians do not consume non-vegetarian during the *lent* (50 days preceding Easter), during the 24 days preceding Christmas and on all Fridays. During these periods, Christians do not conduct marriages and other celebrations like baptism. Hence, the weeks following

Christmas and Easter are seasons of such celebrations. However, it is interesting to note that although according to the Bible, Christians are expected to fast on Sundays (the Sabbath day) and devote the whole day to God, and not to indulge in any worldly activities, most of them rather eat merrily and celebrate this *holy* day. A Buddhist monk from Thailand, studying in an Indian University, who was found to be a regular non-vegetarian, was asked how the disciple of the Lord who preached *ahimsa* could be a meat eater. His answer was that as a Buddhist he was expected not to kill for meat, but if meat was available in the market he could buy and consume.

Religion may also influence the attitude towards work and wealth. "In the United States, it is common to hear people talk about the Protestant work ethic, which holds that people should work hard, be industrious, and save their money. This work ethic helped to develop capitalism in the United States because of the importance it assigned to saving and to reinvestment of capital. However, Americans are not the only people who work hard. In Asian countries where Confucianism is strong, this attitude is known as the Confucian work ethic. In Japan, it is called the Shinto work ethic."[26] An Indian economist has described the growth rate the Indian economy achieved in the earlier Five Year Plans as the Hindu growth rate.

Religion may also play a role in deciding the weekly holiday, other holidays and working hours. In several countries, religious festival times are great business times. People buy new clothes, exchange gifts, sped a lot on food etc. Companies doing heavy promotions, including discounts and other incentive schemes, have become very common in India.

Many religious groups consider certain days of the week or certain periods auspices for launching new ventures. On the other hand, certain days and periods are regarded bad. Interestingly certain days considered as auspices by some community are considered bad days by some others. Many people, particularly Hindus, do not commence any auspicious thing start out for any important matter during *rahu kala*; important matters have to be done or commenced at *shubha muhurtha*.

Many years ago, a foreign bank in Chennai introduced a promotion scheme to attract new customers. The scheme ran for a month. Although there were many enthusiastic enquiries about the details, when the period of the scheme approached the end, the bank management was disappointed that the number of new accounts opened was nowhere near satisfactory. It was then that the management realised that they chose the wrong period for the promotion. The scheme was, therefore, extended for some more time.

The increasing influence of religion and cast on politics tend to increase the importance of religion to business.

The Islamic holy book *Koran* prohibits payment acceptance of interest. (Interest is considered *riba* or usury.) Islamic banks do not pay regular predetermined interest to depositors nor do they charge predetermined interest rates to borrowers. Rather the banks take a share of the profits (or loss) which are again shared with depositors. What makes profit sharing, unlike interest, permissible in Islam is that only the profit sharing ratio, not the rate of return itself, is predetermined. Islamic banks now handle more assets of huge value worldwide and asset growth at Islamic banking institutions has been growing fast. Even some large Western banks now have Islamic branches. Muslims in other countries, however, do banking in the normal system prevailing there.[27]

Many business decisions in India and in several other countries are based on astrological advices. These include the decisions regarding the timing of the launch, location of the enterprise, name of the firm, brand name, business portfolio and so on. The only forecasting technique some people depend upon is astrological.

The customs of marriage, naming ceremony of the child, festivals etc. vary significantly between religions. These have implications for many types of business like textiles, jewellery, catering, consumer durables etc.

The influence of religion on politics is on the increase in many parts of the world. And politics often plays an important role in shaping economic policies and business regulation and promotion. In a number of countries, religion and government are inseparably united.

ETHNODOMINATION

In many countries, one or other industry or trade is dominated by certain ethnic groups. This is particularly true of trade. Ethnodomination in distribution is defined as "a situation where an ethnic group occupies a majority position in a channel of distribution with respect to the ownership and control of physical and financial resources, or through the manipulation of social environment. The control is manipulated through the familiar coercive and collusive practices such as price setting (in both product and factor markets), exclusive dealing arrangements and discrimination among customers or suppliers.[28]

It is pointed out that a common model is an ethnic group, often a "stranger or sojourner minority, selecting or happening into a trade opportunity in a particular commodity. Members of the ethnic group then master the intricacies of supply and demand in world market for that commodity while learning the mechanics of foreign trade in the host country. Then, through time, they become established and widely recognised as a reliable buyer or seller of the commodity. From this solid base, dominance is then established". In many cases of ethnodomination, it would be beneficial for the international marketer to co-opt rather than compete with the dominant ethnic group."[29]

In many countries, certain types of business are dominated by some ethnic groups.

There are a number of cases of ethnodomination in India. *For example,* the automobile spare parts business is dominated by the Sikhs. There is domination of some communities in the wholesale trade in several products. In several parts of the country, there is dominance of some or other community in banking and money lending like the Chettiars in Tamil Nadu and Vysyas in Karnataka and other places.

Regional patterns of entrepreneurship, which also have some ethnic aspects can also be observed. For example, Soth Canara district in Karnataka boasts several commercial banks and NBFIs like Syndicate Bank, Canara Bank, Vijaya Bank, Corporation Bank, ICDS etc. Similarly, Trichur in Kerala is home to some banks (The South Indian Bank, Catholic Syrian Bank, Lord Krishna Bank) and NBFIs. This region is very active in stock business too. Most Kerala-based large banks are promoted predominantly by Christians. When there was a move to take over The Catholic Syrian Bank by an NRI, there was opposition from a section of the community (while some of the major shareholders from the same community favoured the takeover move). The takeover of the Tamil Nadu Mercantile Bank antoganised the Nadar community and there was even political pressure to wrest the control back to the community. Most Indian banks and NBFIs have an ethnic background.

Many ethnic businesses have scope for international niche marketing.

Many ethnic businesses can go international. *For example, Punjab*i restaurants, *Udupi* restaurants, *Chinese* restaurants etc. are popular in several foreign countries. Several exporters target ethnic population abroad as in the case of Indian curry powders, pickles etc.)

LANGUAGE

Differences in the language is a very important problem area in business. Switzerland, for example, is a country with three fairly distinct cultures, divided between the French, Italian and German-speaking Swiss and the regional differences are profound. In South America, there are more than 40 languages. The African continent has the largest number of languages spoken. Zaire alone has more than 200 languages. Kenya has about 40 ethnic groups, each with its own language and culture. Some 750 languages, each distinct and mutually unintelligible are spoken in Papua New Guinea.

India has numerous languages and their dialects, besides the 18 officially recognised languages. Of the 1652 mother tongues listed by the Census of India, 33 are spoken by people numbering a lakh or more.

Even some of the same words of a language have different meanings or connotations in different places. The meaning of some of the English words and idioms differ between UK and USA. *For example,* in Britain, the statement "the project went a bomb" would mean that it was a great success; but in USA "the project was a bomb" means it was a massive failure. In the Spanish speaking Latin America, the language vocabulary varies widely. *For example,* while *Tambo* means a roadside inn in several countries like Colombia, a dairy farm in some countries like Argentina, in Chile it stands for brothel. The differences between the American and British spellings are well known. Parker Pen Company has also suffered similar problems of multiple meanings in Latin America where it hoped to use *bola* to describe its ballpoint pen. While in some country, it conveys the intended meaning, ball pen, in different countries it means "lie" or "fabrication", "revolution", and in yet another it represents an obscenity.

The estimates of the number of languages in the world range from 4,000 to 10,000. Most countries are multi-linguistic and many of them have a large number of ethnic groups and languages.

Problems caused by languages include, *inter alia*, those related to brand names and other names, and marketing communication. *For example*, Ford's third world truck brand named *Fiera* meant "ugly old woman" in Spanish. Ford again met with a roadblock in respect of its top of the line product *Cliente* in Mexico where cliente is a slang for a street walker. *Cue* seems to be a good brand name for toothpaste, but in French-speaking countries cue is a crude slang expression for derriers. Chervrolet's brand name *Nova* in Spanish means "it doesn't go". The name proposed for a new facial cream that was to be introduced in India was *Joni* which in Indian languages stands for the most innate part of female body. Reebok unveiled a new woman's sneaker named *Incubus*, not knowing that in medieval folklore Incubus was a demon who ravished women in their sleep. Reebok was forced to discontinue the brand.

Differences is verbal and non-verbal languages increases complexities of doing business.

The Arabic language is read from right to left and many Arabians sequence things from right to left. A multinational blundered in the Middle East when in the advertisement of its detergent it pictured soiled clothes on the left, the box of detergent in the middle and clean clothes on the right.

In the area of translation of advertisements etc., there are two important problems. The appropriate word is not there in some languages. *For example,* in many countries, the word aftertaste does not exist, necessitating the use of several words or one or more sentences to convey the meaning. The second problem is that literal translations many a time do not convey the right meaning; sometimes they convey quite different meanings. In Japanese, General Motors' "Body by Fisher" translates as "corpse by Fisher". In Japanese, again, 3M's slogan "sticks like crazy" translates as "sticks foolishly". In some languages, Pepsi-Cola's slogan "come alive" translates as "come out of the grave."

Non-verbal communications create equally, perhaps even more, difficult problems. Body language has different interpretations in different cultures. The same symbols and gestures may mean different things in different countries and sometimes in different regions of the same country. A symbol or gesture that represents an appreciation in one society may mean quite a different thing in another. *For example,* the thumbs up sign, with the thumb held straight up and four fingers kept folded represents approval in countries like USA, UK and Russia; it is highly offensive in Iran and regarded rude in Australia. The OK sign with the thumb and index finger forming a circle and the other three fingers held straight up means every thing is great in USA and Germany and things are just good, not excellent, in Mexico. In most of Europe and Argentina, it means an absolute zero or worthless. It is regarded a vulgar gesture in countries such as Spain, Russia, Brazil and Uruguay. In Japan, it symbolises money, mostly coins. In Tunisia, it conveys a threat of bodily harm. A backward victory symbol is an insulting gesture in Europe. Shaking head left to right while conveys *no* in the United States and most of the world, it means *yes* in some countries like

Bulgaria, Saudi Arabia and Malaysia. A pat on the shoulder is offensive in Thailand while it connotes encouragement/sympathy in several countries.[30]

CULTURE AND ORGANISATIONAL BEHAVIOUR

The cultural impact on international management is reflected by several basic beliefs and behaviours. Given below are some specific examples where the culture of a society can directly affect management approaches and organisational behaviour, highlighted by Hodgetts and Luthans.[31]

Different cultures have different characteristics which have implications for organisational behaviour.

- ***Centralised vs. Decentralised Decision-making:*** In some societies, all important organisational decisions are made by top managers. In others, these decisions are diffused throughout the enterprise, and middle and lower-level managers actively participate in, and make, key decisions.
- ***Safety vs. Risk:*** In some societies, organisational decision-makers are risk-aversive and have great difficulty with conditions of uncertainty. In others, risk-taking is encouraged, and decision-making under uncertainty is common.
- ***Individual vs. Group Reward:*** In some countries, personnel who do outstanding work are given individual rewards in the form of bonuses and commissions. In others, cultural norms require group rewards, and individual rewards are frowned on.
- ***Informal vs. Formal Procedure:*** In some societies, much is accomplished through informal means. In others, formal procedures are set forth and followed rigidly.
- ***High vs. Low Organisational Loyalty:*** In some societies, people identify very strongly with their organisation or employer. In others, people identify with their occupational group, such as engineer or mechanic.
- ***Cooperation vs. Competition:*** Some societies encourage cooperation between their people. Others encourage competition between their people.
- ***Short-term vs. Long-term Horizon:*** Some nations focus most heavily on short-term horizons, such as short-range goals of profit and efficiency. Others are more interested in long-range goals, such as market share and technological development.
- ***Stability vs. Innovation:*** The culture of some countries encourages stability and resistance to change. The culture of others puts high value on innovation and change.

These cultural differences influence the way that international management should be conducted.

Many companies modify their products and/or promotion strategies to suit the tastes and preferences or other characteristics of the population of the different countries.

OTHER SOCIAL/CULTURAL FACTORS

As indicated in the preceding sections, social or cultural environment encompassing the religious aspects; language; customs, traditions and beliefs; tastes and preferences; social stratification; social institutions; buying and consumption habits etc. are all very important factors for business. One of the most important reasons for the failure of a number of companies in foreign markets is their failure to understand the cultural environment of these markets and to suitably formulate their business strategies. This section takes a look at certain social factors relevant to business, some of which would have overlapping with those described in the preceding sections.

Consumer Preferences, Habits and Beliefs

What is liked by people of one culture may not be liked by those of some other culture. Significant differences in the tastes and preferences may exist even within the same country, particularly when the country is very vast, populous and multicultural, like India. *For example,*

while *Nescafe* has about a three-fourth share of the Mumbai market, its share is very small in Bangalore and insignificant in Chennai. *Bru* which takes the large chunk of the Madras and Bangalore markets has a very low market share in Bombay. It may be relevant to recall here that while *Nescafe* advertisement projects an international/cosmopolitan image of the product, the *Bru* advertisement has as its backdrop the South Indian, particularly Tamil Nadu culture.

For a business to be successful, its strategy should be the one that is appropriate in the socio-cultural environment. The marketing mix will have to be so designed as best to suit the environmental characteristics of the market.

Even when people of different cultures use the same basic product, the mode of consumption, conditions of use, purpose of use or the perceptions of the product attributes may vary so much so that the product attributes, method of presentation, positioning, or method of promoting the product may have to be varied to suit the characteristics of different markets.

Bicycles, *for example,* are mostly a basic means of transportation in many developing countries whereas in several developed countries they are used largely for exercising and sporting. Honda found that in North America, where motorcycles are used primarily for leisure and sports, consumers look for high horsepower output and speed. Low cost and ease of maintenance are scoring points in South East Asia where motorcycles are a basic means of transportation. The low-speed torque is preferred to either high speed or ease of maintenance by the shepherds of Australia who use it to drive sheep. Even when a product serves the same purpose, the relative importance of various product attributes may differ between markets. Goodyear, *for example,* stresses tyre safety in Britain, durability and mileage in United States and agile performance in Germany.

Eating habits, consumer preferences and the resultant demand patterns vary greatly from one market to another. *For example,* certain seafood species which are in great demand in some markets may be non-existent in certain markets. Even when the same species is widely used in different markets, product forms and product attributes demanded may vary significantly. Further, within a market, there may be different segments on the basis of demand patterns, for the same species. Again, consumer preferences may change over time.

Although shrimp is in great demand in a number of markets, product requirements vary considerably among markets and from one segment to another. Headless shrimps are sold primarily in Europe but there is no market for this in certain countries like Spain. In Spain, consumers prefer whole shrimps with head and shell on for use as appetizers, as ingredients in a dish or as the main course. In most cases, the Spanish consumers peel the shrimp while eating it. In France, there is similar, though less marked, preference for whole unpeeled shrimps. In the US, on the other hand, whole head on shrimps are virtually never served, and greater proportion of the demand is for breaded shrimp. In Japan, shrimps are eaten in different ways, headless shrimp accounting for the bulk of demand. A small but high priced market for whole shrimp including live ones also exists.

There is considerable difference between the product attributes the Americans and Japanese (two major importers of seafood) value. In the US market, correct weight and bacteriological factors are more important than eye appeal, colour, uniformity of size and arrangement of the shrimp which are very important in Japan. This aspect of the behaviour of the Japanese consumers is true of other water species and food items in general. *For example,* brighter the colour of the tuna meat, the higher the tuna is priced. Japanese began to eat red coloured sea bream for celebrations as red was considered a colour of good luck. Accordingly, sea bream with a faded red colour is low in product value and is used only for slices. The Japanese also place great importance on how the fish looks on the dinner table so that fish with scars on the skin or missing fins has a low product value. Further, there are size preferences for many species. In the case of tuna, the Japanese buyers prefer those weighing at least 50 kg. Served on merry occasions, sea bream should not be too big or too small, optimally around 300 gms.

The buying behaviour in respect of a product and its consumption pattern may vary between cultures.

It is pointed out that there is a difference in the attitude towards packaging between the American and Japanese. Much better quality of packaging is needed in Japan. The US consumer sees the pack as a means of getting the product home, and does not want to pay extra for packaging, at least for staple items. But the Japanese consumer wants the presentation to be quality one both before and after the package is opened. There are a number of other differences in consumer behaviour in respect of seafood between different markets. (For details, see Francis Cherunilam, *Fisheries: Global Perspective and Indian Development*, Himalaya Publishing House, Bombay 1993.)

Nature of use, occasion of use etc. of products may vary between markets. Cola drinks are taken with snacks in North America, just as coffee or tea in India, but they are promoted as thirst quencher in India and several other countries. In USA, orange juice may be promoted as a breakfast drink but the promotion strategy will have to be different in countries where fruit juice is not taken with breakfast. People in several countries use talc powder after bathing, but Japanese feel that it would make them dirty again. Any time is coffee time for many people in India; coffee may be taken early in the morning (bed-coffee), with breakfast, with tiffin or snacks, in the evening and any other time. It is considered a common man's refreshing beverage, and is also commonly served to guests. In most European and Middle Eastern culture, coffee is served after dessert and, in the case of Europe, after the cheese course which concludes the meal. In Japan, however, coffee is considered a luxurious drink. There is indeed wide variations in the consumption rates (in Sweden, annual per capita consumption of coffee is 18 pounds compared to half a gram in Japan and habits and related factors in respect of coffee.

The values and beliefs associated with colour vary significantly between different cultures. Blue, considered feminine and warm in Holland, is regarded as masculine and cold in Sweden. Green is a favourite colour in the Muslim world; but in Malaysia, it is associated with illness. White indicates death and mourning in China and Korea; but in some countries, it expresses happiness and is the colour of the bridal dress. Red is a popular colour in the communist countries, but many African countries have a national distaste for red colour. Just before launching an elaborate outdoor ad campaign in one foreign markets, Singer discovered that it would be doing a big blunder because the background colour it used (blue) represented death in that country. In Thailand, Helene Curtis switched to black shampoo because Thai women felt that it made their hair look glossier. Just as colours, various flowers or the colour of the flowers used have different connotations (including sorrow and joy) in different countries.

In some cases, the success of marketing depends, to a very large extent, on the success in changing social attitudes or value systems.

There are similar differences regarding value associations with numbers. Certain numbers are regarded lucky while some others are considered bad or unlucky. **13** is considered a bad/unlucky number in several cultures. It is not uncommon in several countries, including America, that hospitals, lodges etc. skip 13 while numbering rooms. Social inertia and associated factors come in the way of the promotion of certain products, services or ideas. We come across such social stigmas in the marketing of family planning ideas, use of biogas for cooking etc.

Etiquettes

There are great differences in the manners of greeting people and physical distance to be kept between people. While embracing, hugging or kissing is common in some cultures, they are quite embarrassing, and even highly objectionable in many societies.

Even laughter is interpreted differently around the world. While most countries consider it an expression, joy, some cultures discourage it. In many West African countries, laughter indicates embarrassment, discomfort, or surprise. Smiles of people who are not very familiar do not generate smiles in return everywhere; sometimes it may cause suspicion.

Handshake while greeting and bidding good-bye are common in many societies, but it is not common in many others. Some peoples dislike it or object to it. Shaking hands with people of opposite sex should be avoided in some culture. Even in societies where handshake is quite common, the manner of doing it may differ. Some cases presented by Chaney and Martin[32] are reproduced here.

Properly responding to a guest's invitation/treat is very important. Knowing well the right response in different occasions is the crux of the problem. It is observed that "even the rejection of a cup of coffee can cause major problems. While a very profitable opportunity was being negotiated, one US executive innocently made the mistake of refusing a Saudi Arabian's friendly offer to join him for a cup of coffee. Such a rejection is considered an affront in Saudi Arabia. Naturally, the Saudi became much less sociable, and the negotiation process was much less successful than it might have been."[33]

The ways of meeting and greeting people, expression of appreciation or disapproval, methods of showing respect, ways of conducting meetings and functions, table manners etc. vary quite widely between cultures. What is regarded as the right behaviour in one culture may be offending in some others.

Gift giving has its own place in most cultures. It is indeed customary on many occasions. There are many aspects of gift giving that must be meticulously understood such as what is an appropriate gift, to whom should it be given, when should it be given and how should it be given. Failure to take meticulous care of these factors can sometimes produce negative effects. "Sometimes gifts are expected and the failure to supply them is seen as insulting. Other times, however, the mere offer of such a token is considered offensive. ...In many parts of Latin America, cutlery or handkerchiefs should not be given because these gifts imply a cutting off of a relationship or the likelihood of a tearful event. And giving a clock to someone in China is not a good idea, either. The Chinese word for clock sounds similar to their word for funeral. In fact, even the way in which a gift is presented is important. In most parts of Asia, gifts should be given privately to avoid embarrassing the Asians, but in the Middle East they need to be offered publicly in order to reduce the possible impression that bribery is being attempted."[34]

Some Social Trends

There are also a number of other social and demographic factors, such as the age and sex composition of population, family size, habitat, attitude towards employment, occupational pattern etc. which influence the business.

The number and proportion of the women in the workforce have been rising in most of the countries. However, the percentage of women working outside the household vary significantly between nations. This ratio is generally high in the advanced countries in comparison with the developing countries. Birth control has been a contributory factor in raising the proportion of women employees.

Several social and demographic trends are very important factors that business should take serious note of.

That the wife as well as the husband are working means less time and energy available for cooking at home. It is estimated that, in the US, of the three meals a day, one-and-a-half are eaten away from the home and of the remainder, half are ready prepared. It also means that the family operates differently. It was estimated that $40 billion in family funds was spent by teenagers, mostly for groceries and other household items.[35] This has lot of implications for the marketers. In the developing countries, particularly, the situation would be different from that in the US.

The rise in the number of double income households increases the demand for a number of products like household appliances, electronic gadgets, packaged food products etc.

There are also several other demographic trends which have implications for business strategy formulation. While some of these trends are confined to certain countries only, the strength of other trends vary greatly between nations. *For example,* the number of unmarried couples living together has risen in the two decades ended 1990 from about half a million to 2.5 million in the US.[36] Such a thing is quite unheard of in several countries like India.

Similarly, the high divorce rate has created over a million single parent families in the US. Most of the divorced remarry, leading to the emergence of a large number of blended families. This is not the situation in several countries where people attach more sanctity to marriage so that the marriage lasts lifelong. In countries where the culture is that a marriage relationship is to last lifelong, a company may advertise that its durable product will be a lifelong companion like one's life partner, but to use such a promotional theme in a culture where divorce rate is high and even unmarried partnerships which normally last for only short periods is common, will be a blunder.

One in four US homes now consists of a person living alone compared to about one in thirty ten years ago. The Census Bureau estimates that this group was expected to continue to expand growing to 33.7 million households by 2000. Experts say these loners are more prone to impulse buying because there is no other household member to disagree with or question the purchase.[37]

In short, the social environment of different markets differ vastly. Even within a nation, cultural diversity may be very significant. It is essential to understand these differences to formulate successful business strategies.

TECHNOLOGICAL DEVELOPMENTS AND SOCIAL CHANGE

Social change is brought about by a number of factors—technological, cultural, demographic, biological, economic, environmental, psychological, political, etc.

According to Han Gerth and Wright Mills, social change refers "to whatever may happen in the course of time to the roles, the institutions or the orders comprising the social structure: their emergence, growth and decline". To Morris Ginsberg, social change means a change in the social structure, *e.g.,* the size of a society, the composition or balance of its part or the type of its organisation. As Biesanz and Biesanz observe: "social change includes significant alterations in social structure, in cultural definitions, and in the products of socio-cultural action. Social structure may change in size, in the degree of formality and informality, in the types of social relationships, and in the system of statuses and roles. Cultural change is reflected in changing knowledge, beliefs, values and norms. Material products will change as a result of advances in science and technology". In short, social change may cause one or more of the following: changes in the size of society: changes in social institutions: changes in occupational patterns; changes in positions, status and roles, changes in values, beliefs and attitudes, changes in social interactions; changes in social mobility; and so on.

Technology is one of the important determinants of social change. "The rapid changes in our society are obviously related to, and somehow dependent upon, the development of new techniques, new inventions, new modes of production, new standards of living."[38] Indeed, technology has profoundly altered social attitudes and modes of like "attitudes, beliefs, traditions, which once were though to be the very expression of essential human nature, have crumbled before its advance."[39]

The industrial age has profoundly changed the social life and status of women. "Industrialisation destroyed the domestic systems of productions, brought women from the home to the factory and the office differentiated their tasks and distinguished their earnings. Here is the new environment, and the new social life of women is the response."[40] The introductions of new techniques for the processing and preservation of food and the appliances to perform kitchen and other domestic work facilitated the emancipation of women from the kitchens.

The impact of developments in the field of transport and communications on society is very profound. The automobile and telephone made suburbanisation possible in the USA and other countries. Films, television and radio have become very helpful in the transmission and diffusion

of information and in the education of the common man. These media play an important role in bringing about social change. Television or radio enables a person to address, at one time, millions and millions who are geographically widely spread. Free radio and television make possible the rapid rise of new political and social movements. No wonder that, in a number of countries, these media are monopolised or controlled by the state, which use them for propaganda purposes. These media have brought about significant changes in the sphere of family and individual recreation. Such technologies have considerably reduced the social distance between the urban and rural areas.

Modern industrialisation, a product of technological development, has upset the social structure. It has administered a severe blow to the caste system. Social mobility has become very conspicuous. Society has become more materialistic. Industrialisation has also given rise to class conflicts.

The industrial, agrarian and transport revolutions have brought about physical environment to some extent and to harness the natural resources better. Air conditioners have made life more comfortable. Huge dams are built to control floods, generate power and to irrigate land. Experiments to produce artificial rains have shown positive signs of success.

Technological developments have a number of adverse effects on society. Some of the technology-induced developments have caused serious ecological problems – pollution, for example. The film is said to be having some immoral effects on society. There is a criticism that many Indian movies encourage crime, rape, alcoholism and violence. Technology is regarded as one of the factors responsible for the concentration of economic power in a few hands. Some sociologists are of the opinion that capitalism is merely a by-product of mechanisation. Developments in the field of nuclear science, though they offer great scope for advancement, pose a serious threat to the very survival of the human race. "But to condemn technology altogether is forget that it also saves lives, makes desert bloom, and lets us hear music in our living rooms."

Technological developments have made material progress rapid and widespread, though unequal. And the social attitude in general has become more materialistic.

The preceding pages have given a glimpse of a number of important elements and aspects of the social system that have implications for a business, and have indicated several inter-relationships between business and society. Indeed, business and society are very intricately intertwined, acting and reacting upon each other.

SUMMARY

Business is an integral part of the society and they influence each other.

It is now widely recognised that business has certain social objectives, besides the economic objectives.

The cultural environment of a nation/market may profoundly influence business in different ways and dimensions. The attitude of workers, labour-management relations, government-business relations, entrepreneurial nature and attitude, political philosophies and systems, legal environment, business ethics, governance, government policies etc. could have a social influence on them. Management may undergo a social transformation. *For example,* a number of family owned business groups in India have ushered in professional management. The need for good corporate governance is getting more and more recognition.

In short, the type of products to be manufactured and marketed, the marketing strategies to be employed, the way the business should be organised and governed, the values and norms it should adhere to, are all influenced by the social structure and the culture of a society.

The tastes and preferences, purpose of consumption, method of consumption, occasion of consumption, quantity of consumption, values associated with consumption, etc. of a product may show wide variations between cultures.

It is difficult and, in some cases, almost impossible, to change many elements of the social environment in the short run. Hence, a business may have to adapt to these uncontrollable external environments.

Cultures have some important traits. An understanding of these cultural dimensions will be necessary for successful management. The culture of a society can directly affect management approaches and organisational behaviour.

Even most national markets are multicultural. The number of ethnic groups and languages in use in many countries is mind boggling. Such a wide cultural diversity poses a tremendous challenge to management. Cultural difference is one of the most difficult problems in international business.

Because of the cultural differences, a promotion strategy that is very effective in one market may utterly fail in another, or may even result in social or legal reprisals. Etiquettes differ from culture to culture. The ways of meeting and greeting people, expression of appreciation or disapproval, methods of showing respect, ways of conducting meetings and functions, table manners etc. vary quite widely between cultures. What is regarded as the right behaviour in one culture may be offending in some others. Familiarity with cultural idiosyncrasies is necessary for success.

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Chapter 9

SOCIAL RESPONSIBILITY OF BUSINESS

Structure

Classical and Contemporary Views

Social Orientations of Business

Factors Affecting Social Orientation

Responsibilities to Different Sections

The Indian Situation

Arguments for and against Social Involvement

Social Audit

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Companies Act 2013 and CSR

Summary

References

Social responsibility of business refers to what the business does, over and above the statutory requirement, for the benefit of the society. The word *responsibility* connotes that the business has some moral obligations to the society.

Corporate social responsibility (CSR)/corporate citizenship refers to the moral responsibility of the business to the society by the virtue of being a part of the society and resourceful to serve the society,

The term *corporate citizenship* is also commonly used to refer to the moral obligations of business to the society. This implies that, just as individuals, corporates are also integral part of the society and that their behaviour shall be guided by certain social norms.

BOX 9.1 : SOCIAL EXPECTATIONS

In the development of corporate ethics, we have reached a stage where the question of the social responsibility of business to the community can no longer be scoffed at or taken lightly. In the environment of modern economic development, the corporate sector no longer functions in isolation. If the plea of the companies that they are performing a social purpose in the development of the country is to be accepted, it can only be judged by the test of social responsiveness shown to the needs of the community by the companies. The company must behave and function as a responsible member of society; like any other individual. It cannot shun moral values, nor can it ignore actual compulsions. The real need is for some focus of accountability on the part of the management which is not limited to shareholders alone. In modern times, the objective of business has to be the proper utilisation of resources for the benefit of others. A profit is still a necessary part of the total picture, but it is not the primary purpose. This implies that the claims of various interests will have to be balanced, not on the narrow ground of what is best for the shareholders alone but from the point of view of what is best for the community at large. The company must accept its obligation to be socially responsible and to work for the larger benefit of the community.

Courtesy: *Government of India, Report of the High-powered Expert Committee on Companies and MRTPA Acts (Sachar Committee), 1978.*

The operations of business enterprises affect a wide spectrum. The resources they make use of are not limited to those of the proprietors and the impact of their operations is felt also by many a people who are in no way connected with the enterprises. The shareholders, the suppliers of resources, the consumers, the local community and society at large are affected by the way an enterprise functions. Hence, a business enterprise has to be socially very responsive so that a social balance may be struck between the opposing interests of these groups. Goyder argues: "Industry in the twentieth century can no longer be regarded as a private arrangement for enriching shareholders. It has become a joint enterprise in which workers, management, consumers, the locality, Government and trade union officials all play a part. If the system which we know by the name private enterprise is to continue, some way must be found to embrace many interests which go to make up industry in a common purpose."[1] Later, in 1978, while delivering the C.C. Desai Memorial Lecture, he reiterated his plea that if the corporation has to function effectively, it has to be accountable to the public at large; and he sought to equate the suggestion of a responsible company with the trusteeship concept advocated by Gandhiji, the aim of which was to ensure that private property was used for the common good. The declaration issued by the international seminar on the social responsibility of business held in India in 1965 also correlated the Gandhian concept of trusteeship with the social responsibility of business as "responsibility to customers, workers, shareholders and the community."[2]

There has been a growing acceptance of the plea that business should be socially responsible in the sense that the business enterprise, which makes use of the resources of society and depends on society for its functioning, should discharge its duties and responsibilities in enhancing the welfare of the society of which it is an integral part.

H.S. Singhania classifies the nature of the social responsibility of business into two categories.

- The manner in which a business carries out its own business activity.
- The welfare activity that it takes upon itself as an additional function.

The first involves the acceptance of the fact that business is not merely a profit-making occupation but a social function which involves certain duties, and requires that appropriate ethics are followed. *For example,* a business must obey all the laws, even when they are

disagreeable; it should produce the maximum goods of good quality, ensure smooth supplies at competitive prices, pay taxes, shun malpractices, pay a fair wage to employees and a reasonable dividend to shareholders. It is also the duty of a business to undertake new investment and promote the dispersal of economic activity through ancillarisation and the setting up of industries in backward areas so as to spread enterprise and take employment to the doorsteps of labour. In addition to its commercial activity, business also plays a role in promoting social welfare activity, even directly.[3]

Also see *Appendix 2* at the end of the book.

CLASSICAL AND CONTEMPORARY VIEWS

The contemporary view of social responsibility of business is substantially broader and benevolent than the classical one.

According to the classical view, business has only economic objectives and no other responsibility beyond that. Milton Friedman, a Nobel economist and a proponent of this view, argues that "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud.... Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible. This is a fundamentally subversive doctrine."[4]

While the classical view of business overlooked the social responsibility of business, according to the contemporary view, CSR is integral to the business.

The contemporary view of business is an *ecological* one according to which business is an integral part of the society to serve a social purposes. Proponents of this view like Davis and Blomstorm hold that business is a social institution, performing a social mission and having a broad influence on the way people live and work together (See the section *Business and Society* in the previous chapter for details.)

The points listed under the sub-title *Arguments for Social Involvement of Business* given elsewhere in this chapter reflect the basic tenets of the contemporary view. Figure 9.1 and the explanation of social responsibility of business given in this chapter are based on the contemporary view of its scope.

According to Steiner and Steiner, a reasonable approach to social responsibility is as follows.[5]

1. Each business must take into account the situation in which it finds itself in meeting stakeholder expectations.
2. Business is an economic entity and cannot jeopardise its profitability meeting social needs.
3. Business should recognise that in the long run, the general social good benefits everyone.
4. The social responsibility expected of a business is directly related to its social power to influence outcomes.
5. Social responsibility is related to the size of the company and to the industry it is in.
6. A business should tackle only those social problems in which it has competence.
7. Business must assume its share of the social burden and be willing to absorb reasonable social costs.

BOX 9.2 : BUSINESS LEADERS ON CORPORATE SOCIAL RESPONSIBILITY

Here are the observations of some business leaders speaking at a summit on, corporate social responsibility (CSR).

According to N R Narayana Murthy, chairman and chief executive officer of Infosys Technologies, corporate`s foremost social responsibility is to create maximum shareholder value working under the circumstances where it is fair to all its stake holders-workers, consumers, the community, government and the environment. He points out that by living in harmony with the community and environment around us and not cheating our customers and workers, we might not gain anything in the short-run, but in the long term it means greater profits and shareholder value.

In the opinion of Aman Mehta, CBO, HSBC, Hong Kong, however, it is not so straight forward. He says that CSR as a concept is different to different people and in different countries. Fundamentally, CSR is balancing the conflicting interest put on the corporations from different stockholders with the objectives a commercial organisation in such a way that there is minimum loss to anybody.

Bertrand Collomb, chairman and chief executive officer, Lafarge, France, observes that a company can`t be successful in the long-run without a happy community around and a motivated and happy workforce which would translate into greater labour productivity, lower wastage in manufacturing process and product rejection rate resulting in greater profits. According to him, international companies can exhibit a greater social responsibility by bringing in efficient manufacturing and business practices to the developing countries and training and educating local people in new skills and knowledge.

Courtesy: *The Economic Times, 5 December, 2001.*

SOCIAL ORIENTATIONS OF BUSINESS

The extent of social orientations of companies vary very widely. Further, the social orientation or the extent of social involvement of a company may change over time.

SOCIAL RESPONSIBILITY MODELS

There are some models which endeavour to describe the evolution and extent of social orientation of companies. Notables ones include Carroll's model, Halal's model and Ackerman's model.

Archie B. Carroll, who defines corporate social responsibility as the entire range of obligations business has to society, has proposed a *three-dimensional conceptual model of corporate performance*. According to Carroll, a firm has the following four categories of obligations of corporate performance.[6]

- Economic
- Legal
- Ethical
- Discretionary

Economic and legal responsibilities are fundamental responsibilities and ethical and discretionary responsibilities are contingent responsibilities.

The firm being an economic entity, its primary responsibility is economic, *i.e.*, efficient operations to satisfy economic needs of the society and generation of surplus for rewarding the investors and further development.

Legal responsibilities are also fundamental in nature because a company is bound to obey the law of the land.

Ethical responsibilities are certain norms which the society expects the business to observe though they are not mandated by law. *For example,* a company shall not resort to bribing or unethical practices, unfair competitive practices etc.

Discretionary responsibilities refer to the voluntary contribution of the business to the social cause, like involvement in community development or other social programmes.

Carroll points out that these four categories are not mutually exclusive, and the boundaries between them are difficult, if not impossible, to define. Further, these terms are not value-free and they may be interpreted differently by different people.

Carroll later presented the different categories of responsibilities as a *pyramid of corporate social responsibility*.[7] Economic responsibilities are at the base of the pyramid, succeeded by legal responsibilities, ethical responsibilities and, finally, philanthropic responsibilities.

According to Carroll's pyramid, legal responsibilities come only at the second stage. This is not a right view. A company must inevitably obey the laws, even if it is unable to discharge some of the economic objectives, as long as it exists. Figure 9.1 presents the right perspective.

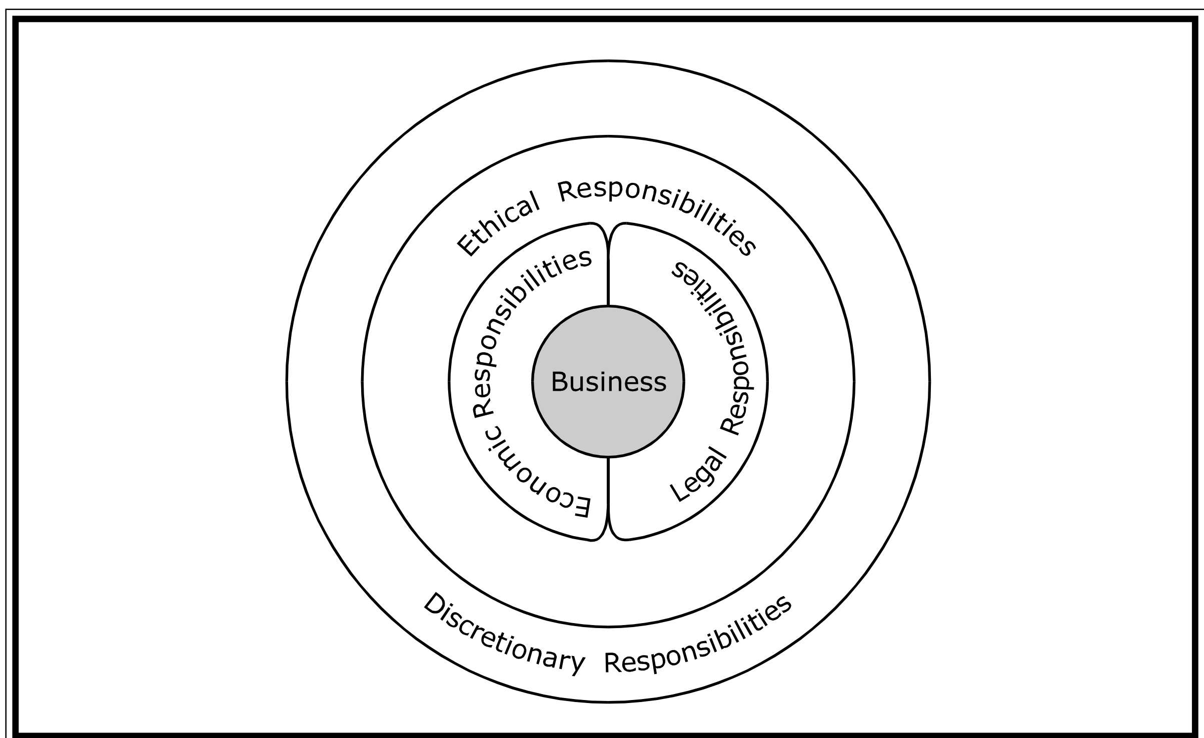

Fig. 9.1 : Responsibilities of Business

William E. Halal's *return-on-resources model of corporate performance*[8] recognises the fact that no corporate social posture will be value-free, and this makes corporate social responsiveness a tremendously difficult task. He pointed out that a firm can only attempt to unite the diverse interests of various social groups to form a workable coalition engaged in creating value for distribution among members of the coalition. Beyond a certain level of economic activity, the social issues at stake may become conflicting. *For example,* large spending for social cause may affect the profitability of the firm which could have implications for the stakeholders and the future of the firm. This calls for trade-offs which involve both economic and ethical decisions that will not necessarily satisfy the needs of every stakeholder.

A firm shall endeavour to achieve a proper trade-off between the interests of the internal stakeholders and the social responsibility.

According to Ackerman's model, there are three phases in the development of the social responsiveness of a company.

The first phase is one when the top management recognises the existence of a social problem which deserves the company's attention and acknowledges the company's policy towards it by making an oral or written statement.

The second phase is characterised by the company appointing staff specialists or external consultants to study the problem and suggest ways of dealing with it.

The third phase involves the implementation of the social responsibility programmes.

EXTENT OF SOCIAL ORIENTATION AND INVOLVEMENT

On the basis of the extent of social orientation and involvement of companies, this author would classify them into the following categories.

The extent of social orientation and discharge of CSR varies widely between corporates.

Anti-social: Not only that these companies have no social orientation but also they are unfair and unscrupulous in the conduct of the business. Rather than respecting laws and norms in their letter and spirit, attempts may be made to take advantage of the loopholes/interpretational flexibility or to circumvent the rules and regulations by malpractices. Promoters and top managerial personnel of several organisations have been found to engage in insider trading, price rigging and the like. These businesses may even contribute a part of their ill-gotten money for social purpose to mask their real face or because of some compulsion to which they yield for fear of some reaction or for getting some favours or goodwill.

Indifferent: These are companies which have no social orientation beyond discharging the legal as well as the economic responsibilities. The attitude is that going by the rules and regulations is good enough; there is the government and other organisations to work for the social cause and it is not the business of the business.

Peripheral: These companies are slightly a shade better than the indifferent category. They have little bit of social orientation, often for the name sake.

Socially Oriented: Companies in this category have a high level of social orientation but their real involvement is constrained by limitations of resource.

Committed and Very Active: These companies are characterised by high level of social orientation and real involvement in the societal welfare programmes. What distinguishes these companies from those in the preceding category is mostly their ability to commit significant amount of resources to make the social orientation meaningful.

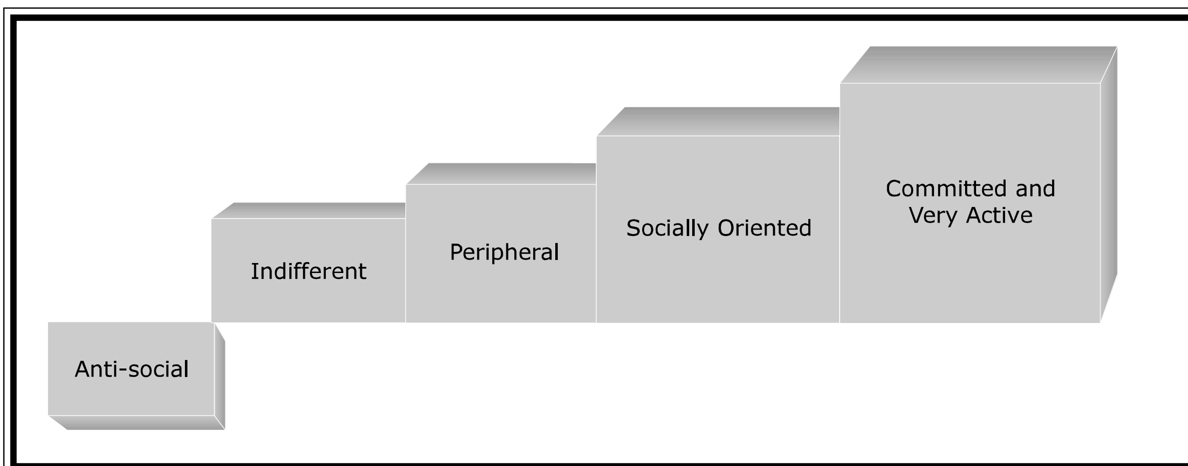

Fig. 9.2 : ***Social Orientations and Involvement of Business***

Social orientation of corporates is shaped by a host of factors, both internal and external.

FACTORS AFFECTING SOCIAL ORIENTATION

Important factors which influence the social orientation of companies include the following.

Promoters and Top Management: The values and vision of promoters and top management is one of the very important factors which influence the corporate social responsibility, as pointed out in Box 9.3.

BOX 9.3 : EVOLUTION OF SOCIAL RESPONSIBILITY AT TISCO

Since its inception, the Tata Iron and Steel Company (Tisco) has been a shining example of social responsibility. The Committee appointed to conduct the Social Audit of Tisco has observed in its Report: "At a time when Max Weber, the great German Sociologist, was advocating his theory of transforming a traditional society into a modern one through industrialisation and modern management, little did he know that in the jungles of Bihar an Indian visionary had already planned the establishment of the first Steel City (not a mere factory) in Asia. Before he passed away, Jamsedji Tata had in a letter to his son Dorab instructed him: "Be sure to lay out wide streets planted with shady trees, every other one of a quick growing variety. Be sure there is plenty of space for lawns and gardens. Reserve large areas for football, hockey and parks. Earmark areas for Hindu temples, Mohammedan mosques and Christian churches." No wonder Jamshedpur emerged as a beautiful and well developed city.

1970 witnessed a landmark development when the Articles of association of the company was amended to incorporate the social and moral responsibilities of the company to consumers, employees, share holders, society and the local people. A decade later the Board of Directors of Tisco appointed a Social Audit Committee to go in to the question of whether and to what extend the company had fulfilled its social obligations laid down in the Articles. This resulted in the first social audit ever undertaken by any company, public or private, in India, at a time it was not popular anywhere in the world. The Report of the Committee was a glowing tribute to Tisco's endeavours in the discharge of its social obligations to the various segments of the society.

In 2000, Tisco won the National Corporate Governance Award, instituted by the Union Finance Ministry and sponsored by the Unit Trust of India (UTI). See Box 11.3 (Chapter 11) for details.

Board of Directors: As it is the Board of Directors which decides the major policies and resource allocation of company, the attitude of the members of the Board is an important influencer of the social orientation. Box 9.3 gives some indication of this.

Stakeholders and Internal Power Relationship: The attitude of various stakeholders like shareholders, creditors, employees etc. and the internal power relationship also affect the social orientation of a company. As suggested by the Halal's model described in the previous section of this chapter, a firm can only attempt to unite the diverse interests of various social groups to form a workable coalition engaged in creating value for distribution among members of the coalition. Beyond a certain level of economic activity, the social issues at stake may become conflicting.

Societal Factors: The social orientation of company is also influenced by certain characteristics of the society and general attitude and expectation of the society regarding the social responsibility of business. *For example,* a resourceful firm located in a poor community may be expected to contribute to the development of education and health facilities etc. of the locality whereas such involvement may not be required of a firm in a well developed community. The orientations or approaches may vary in accordance with the environment. The behaviour or social orientation expected of business may vary between different societies.

Industry and Trade Associations: Industry and trade associations also influence the behaviour of the firms by establishing professional and ethical codes and norms, education and collective decisions.

Government and Laws: Laws are society's codification of right and wrong. Business shall play the rules of the game. Anti-trust legislations, legislations to curb corruption, unfair practices etc. vary between nations. What is right or not anti-law in one country may not be so in some other country. Further, what is legally controlled in some countries have no legal control in some other countries.

The resources, values and vision of the organisation and several environmental factors affect the CSR.

Besides legislation, there are other methods of government influence like guidelines, persuasion, incentives (like tax exemptions) and pressurising.

The social orientation would also depend on the government's view of social responsibility and the power and earnestness of government/agencies (like SEBI, for example) in dealing with defaulting companies.

Political Influences: Political influences include pressure exerted by special interest groups in society and media to control business practices. These include a variety of non-government organisations (NGOs) like consumer interest groups, environmentalists etc. They use a variety of methods like lobbying to persuade government and public agencies to adopt regulatory measures, conducting public awareness campaigns, and even direct confrontation with the business in some cases.

Competitors: Social orientation of company is also influenced by competitive forces. Two types of competitive behaviour are often noted. When one or some companies become socially involved, others may be encouraged or provoked to do some thing. Sometimes, there may be competition between companies to outperform others. The other way by which the society benefits by competitive behaviour is the actions of suing competitors for unfair practices or publicly exposing the misbehaviour of competitors.

Resources: Social involvement of companies is also affected by the financial position and other resources of the company. It may be noted that the Tisco has been constrained to cap, *albeit* at fairly high level, its social responsibility expenditure.

Ethical Influences: Another factor influencing the social orientation is the ethical decision-making and self-regulation of business conduct. Some companies have well laid down codes and norms of ethical behaviour. See the previous chapter for more information.

Five ethical standards that are in vague are summarised by Gene Laczniak as follows:[9]

1. ***The Golden Rule:*** Act in the way you would expect others to act towards you.
2. ***The Utilitarian Principle:*** Act in a way that results in the greatest good for the greatest number.
3. ***Kant's Categorical Imperative:*** Act in such a way that the action you take could be a universal law or rule of behaviour under the circumstances.
4. ***The Professional Ethic:*** Take actions that a disinterested panel of professional colleagues would view as proper.
5. ***The T.V. Test:*** Ask, "Would I feel comfortable explaining to a national T.V. audience why I took this action?"

RESPONSIBILITIES TO DIFFERENT SECTIONS

There is no unanimity of opinion as to what constitutes social responsibility of business. The important generally accepted responsibilities of the business to different sections of the society are described below.

RESPONSIBILITY TO SHAREHOLDERS

The responsibility of a company to its shareholders, who are the owners, is indeed a primary one. The fact that the shareholders have taken a great risk in making investment in the business should be adequately recognised.

Shareholders are interested not only in the wealth creation but also in the social performance and image of the company.

To protect the interests of the shareholders and employees, "the primary business of a business is to stay in business". To safeguard the capital of the shareholders and to provide a reasonable dividend, the company has to strengthen and consolidate its position. Hence, it should develop and improve its business and build up its financial independence.

Needless to say, to provide dividend, the company should earn sufficient profit. Adequate reserves should be built up so that it will be able to declare a reasonable dividend during a lean period as well.

If a company fails to cope with changes in a changing and dynamic world, its position will be shaken, and the shareholders' interests will be affected. By innovation and growth, the company should consolidate and improve its position and help strengthen the share prices.

The shareholders are interested not only in the protection of their investment and the return on it but also in the image of the company. It shall, therefore, be the endeavour of the company to ensure that its public image is such that the shareholders can feel proud of their company.

It may be mentioned here that the shareholders also have certain responsibilities which they have to discharge to protect their own interests. They shall not only offer wholehearted support and cooperation in the positive efforts of the company but shall also guide and control properly its policies and activities. At the same time, they shall appreciate the responsibility of the business to other sections of society – to the workers, consumers and the community.

RESPONSIBILITY TO EMPLOYEES

The success of an organisation depends to a very large extent on the morale of the employees and their wholehearted cooperation. Employee morale depends to a large extent on the discharge of the company's responsibilities to them and the employer-employee relationship. The responsibility of the organisation to the workers include:

1. The payment of fair wages;
2. The provision of the best possible working conditions;
3. The establishment of fair work standards and norms;
4. The provision of labour welfare facilities to the extent possible and desirable;
5. Arrangements for proper training and education of the workers;
6. Reasonable chances and proper system for accomplishment and promotion;
7. Proper recognition, appreciation and encouragement of special skills and capabilities of the workers;

8. The installation of an efficient grievance handling system;
9. An opportunity for participating in managerial decisions to the extent desirable.

The Committee that conducted the social audit of Tata Iron and Steel Company (TISCO) observes that "not only should the company carry out its various obligations to the employees as well as the larger community as a matter of principle, but this has also led to a higher degree of efficiency in TISCO works and an unparalleled performance in industrial peace and considerable team spirit and discipline which have all resulted in high productivity and utilisation of capacity". Thus, by discharging its responsibilities to the employees, the business advances its own interests.

Employee morale and productivity can be influenced by the attitude of the company towards its employees.

It may, however, be pointed out that the expenditure on labour welfare, etc., should have relevance to the financial position of the company and the economic conditions of the nation. This aspect has to be particularly taken note of by public sector enterprises. Such expenditure shall not exceed the socially and economically warranted limits and shall not cause undue burden on the consumers or the general public. It shall not result in the formation of islands of affluence or comfort in the midst of poverty and suffering at the expense of society.

RESPONSIBILITY TO CONSUMERS

According to Peter Drucker, "there is only one valid definition of business purpose; *to create a customer*." Drucker observes: "The customer is the foundation of a business and keeps it in existence. He alone gives employment. To supply the wants and needs of a consumer, society entrusts wealth-producing resources to the business enterprise".

It has been widely recognised that customer satisfaction shall be the key to satisfying the organisational goals. Important responsibilities of the business to the customers are:

1. To improve the efficiency of the functioning of the business so as to: *(a)* increase productivity and reduce prices, *(b)* improve quality, and *(c)* smoothen the distribution system to make goods easily available.
2. To do research and development, to improve quality and to introduce better and new products.
3. To take appropriate steps to remove the imperfections in the distribution system, including blackmarketing or profiteering by middlemen or anti-social elements.
4. To supply goods at reasonable prices even when there is a seller's market.
5. To provide the required after-sales services.
6. To ensure that the product supplied has no adverse effect on the consumer.
7. To provide sufficient information about the products, including their adverse effects, risks, and care to be taken while using the products.
8. To avoid misleading the customers by improper advertisements or otherwise.
9. To provide an opportunity for being heard and to redress genuine grievances.
10. To understand customer needs and to take necessary measures to satisfy these needs

Companies need to imbibe the societal marketing concept in their strategies.

Despite the popularity of the *Marketing Concept* and societal marketing concept and the growing awareness of consumer rights, consumers all over the world are, by and large, dissatisfied. *Consumerism,* which is an organised endeavour of the consumers to *protect their rights,* is a manifestation of this fact. In shortage economies like India, many businessmen pay scant attention to their responsibilities to consumers. To protect consumer rights and to make the business discharge its responsibilities to them, the consumers should give up their indifferent attitude and build up a strong consumer movement.

RESPONSIBILITY TO THE COMMUNITY

A business has a lot of responsibility to the community around its location and to the society at large. These responsibilities include:

A company has special responsibilities to the community around its location.

1. Taking appropriate steps to prevent environmental pollution and to preserve the ecological balance.
2. Rehabilitating the population displaced by the operation of the business, if any.
3. Assisting in the overall development of the locality.
4. Taking steps to conserve scarce resources and developing alternatives, wherever possible.
5. Improving the efficiency of the business operation.
6. Contributing to research and development.
7. Development of backward areas.
8. Promotion of ancillarisation and small-scale industries.
9. Making possible contribution to furthering social causes like the promotion of education and population control.
10. Contributing to the national effort to build up a better society.

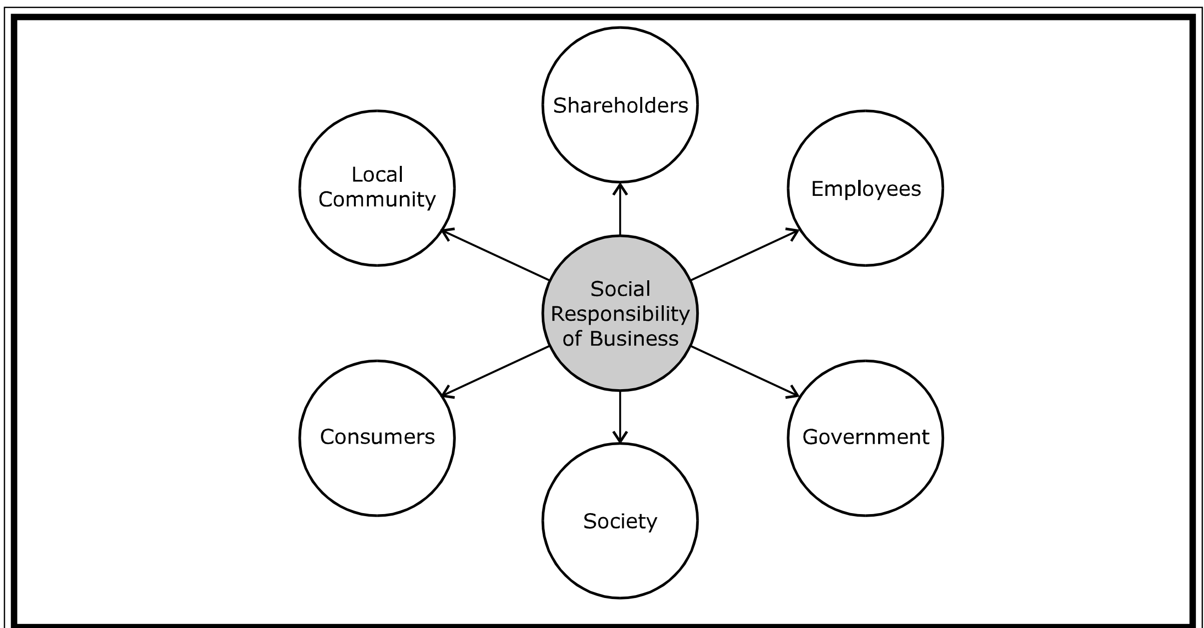

Fig. 9.3 : Claimants of Social Responsibility of Business

THE INDIAN SITUATION

There is a growing acceptance of CSR in India.

The Indian business sector presents a mixed picture as far as social responsibility is concerned. J.R.D. Tata, who was instrumental in conducting the first social audit in India and perhaps in the world, was of the opinion that while on the side of production, of growth, of efficiency, Indian industry, on the whole, did remarkably well, usually against odds and inspite of crippling infrastructural shortages unknown in advanced countries, on the distributional side, however, its record was often poor and, in some respects, dismal, judged by the size of the black-market, the volume of black money and the general corruption that pervaded our economic life.[10] True,

many a time, the imperfections on the distribution side – mostly hoarding and blackmarketing – mercilessly gouge the unfortunate consumer. "Although it is the trader rather than the manufacturer who is mainly responsible for such diversion of goods and for the resulting heavy burden imposed on the consumer, the fact remains that, to that extent, corporate management of even large Indian industries has, perhaps unavoidably, failed in the important obligation of ensuring that their goods reach the consumer at fair prices".[11] It is high time the producer realised that his responsibility does not end with producing goods and services; he should ensure that whatever is produced reached the ultimate consumer in time and at reasonable prices.

It is gratifying to note that a number of leading companies in India have shown recognition of the social responsibility of the corporate sector. The business community has been instrumental in setting up hundreds of institutions of public service like schools, colleges, management institutes, dispensaries, hospitals, technological institutes, research institutes (medical, scientific and technological), libraries, dharamshalas, cultural institutions, institutes for the dumb, deaf and blind, museums and places of religions worship. Some of the leading enterprises have extended welfare measures like health and medical facilities to people of the surrounding villages. Many businessmen have risen up to the occasion to help the victims of droughts, floods, earthquakes and other natural calamities.

One of the important *externalities* of industrialisation is the serious ecological damage it has inflicted. The problem of environmental pollution caused by industries is very serious in a number of places in our country. Though some enterprises have taken pollution abatement measures, many – both in the private and public sectors – continue to be major offenders against the environment. In fact, some of the public sector enterprises are notorious for their irresponsibility in this matter.

As J.R.D. Tata has rightly pointed out,[12] high standards of behaviour and the discharge of social obligations should be expected of or demanded from, not only business and industry but from all economic groups in the country whose actions have an impact on the public weal. This applies in particular to trade unions which, both in India and abroad, have, in recent years, acquired and often misused enormous economic powers, exceeded only by the Government's own. The millions of man-days of production lost in India every year owing to labour unrest and the violent form which such unrest has taken in many cases, clearly indicate the need for a new approach to trade unionism and a recognition of its social obligations.

The participation of labour in management has been suggested as a remedy for many a causes of industrial unrest. While it is a welcome suggestion, it should be ensured that the "collaboration" between labour and capital does not become instrumental in exploiting society.

In some cases, in fact, the record of the public sector is more dismal than that of the private. As far as the pollution of the environment is concerned, the public sector is as guilty as the private.

The CSR is usually advocated for the private sector, presumably on the assumption that the public sector is socially quite responsible. But the fact remains that the public sector in India has yet to prove that it is more responsive to society than the private sector.

Many public sector enterprises in India have undoubtedly failed to discharge their primary responsibilities – increase in the productivity and production, efficiency in the provision of the services, etc. This is reflected in the mounting losses of many public enterprises. Some may argue that the public sector is not, and should not be, profit-motivated. But gone are the days of such philosophy. It has been clearly laid down that the public sector should generate surplus to finance our future development programmes. The huge losses incurred by the Indian public sector are not the result of any charity; they are the inevitable outcome of inefficiency, irresponsibility and mismanagement at various levels. The failure of the public sector in discharging its primary duties has made the plight of the common man worse than it would have been, for it resulted in shortages, higher prices and more taxes. There is also a very wide gap between the sweet expectations from the public distribution system designed to save the common man from the

clutches of the "unscrupulous private sector" and the bitter experiences of the way the public distribution system functions. The least said about the efficiency of the service of the public sector transport undertakings the better. In our country, a social audit is indeed, perhaps, more for the public sector than the private sector.

The emerging business environment in India which is thoroughly shaking up the public sector management should make them socially more responsible.

The Sachar Committee suggested that companies in the public sector, which were very much a part of the total corporate sector and accounted for about 70 per cent of the total investment in the corporate sector, must reckon with the social cost and social benefits arising out of any given investment. As a matter of fact, social cost-benefit analysis is accepted as one of the prime considerations for making any investment in the public sector. It is natural, therefore, to expect from the private corporate sector that, in the matter of investment, it will also show a similar consideration of social cost and social benefit. The accountability of the public sector to the people through parliament must find its parallel in the private sector in the form of social accountability, at least to the extent of informing the public about the extent and manner in which it has or has not been able to discharge its social obligations in the course of its own economic operations. It is in this sense that the social responsibility of business, as far as the private sector is concerned, is another name for social accountability and is, in our view, a mere extension of the principle of public disclosure to which the corporations must be subject. It has also been repeatedly emphasised that the report on social responsibility of the company should not be in a vague or general manner, but should have an element of particularisation and certainty.[13]

ARGUMENTS FOR AND AGAINST SOCIAL INVOLVEMENT

While there is a lot of appreciation of the idea of social responsibility of the business, there are also people who argue that social involvement of business has certain negative aspects.

The important arguments for and against the social involvement of business are given below.

Arguments for Social Involvement Business

1. Business which survives using the resources of the society has a responsibility to the society.
2. Business which is an integral part of the social system has to care for the varied needs of the society.
3. Business which is resourceful has a special responsibility to the society.
4. Social involvement of business would foster a harmonious and healthy relationship between the society and business to the mutual benefit of both.
5. Social responsibilities like recycling of waste may have favourable financial effects.
6. Social involvement may discourage additional government regulation and intervention.
7. Social involvement may create a better public image for the company which may help it in attracting customers, efficient personnel and investors.

Arguments against Social Involvement of Business

CSR shall not result in burdening the consumer or dominating the community.

1. Business should confine to its own business. There are government and social organisations to carry out social activities.
2. Involvement in social activities could adversely affect the economic health of a business enterprise. It may be noted that the expenditures on social welfare has been imposing severe burden on TISCO.

3. If the cost of the social involvement of the business is ultimately passed on to the consumers, there is no point in exalting the social involvement of business. Sometimes there could even be a net loss to the society because of the high cost of the corporate sector undertaking such activities.

4. Many companies involve themselves in social activities because of the tax exemptions on the income spent on special social purposes.

5. If the social involvement of a business enterprise causes an increase in the price of its products, it could affect its competitiveness both in the domestic and international markets.

6. Social involvement of business could lead to an increase in the dominance or influence of business over the society.

SOCIAL AUDIT

MEANING

One important issue related to social responsibility of business is how to evaluate the social performance.

Social audit is a tool for evaluating how satisfactorily a company has discharged its social responsibilities. Social audit enables the public as well as the company to evaluate the social performance of the company.

Bauer and Fenn Jr. define social audit as "a commitment to systematic assessment of and activities on some meaningful, definable domain of the company's activities that have social impact." According to Ahmed Belkaoui, "social audit much like the financial audit – is an identification and examination of the activities of the firm in order to assess, evaluate, measure and report their impact on the immediate social environment." In other words, social audit involves:

1. Identification of the firm's activities having potential social impact;

2. Assessment and evaluation of the social costs and social benefits of such activities;

3. Measurement of the social costs and benefits; and

4. Reporting, that is presenting in a proper format and manner, the social performance of the firm.

Dr. Clark C. Abt, in his book *Audit for Management,* suggests that a Social Audit should, as far as possible, be approximated to an ordinary commercial audit; that this should be based on a social balance sheet with a "credit" side and "debit" side. He calls them "inputs" and "outputs" or "costs" and "benefits" so far as the social balance sheet is concerned. After suggesting that every "input" and "output" must be measured in monetary terms, he points out that the basic purpose of a business corporation is to maximise the financial return, earned on its financial investment plus the amount of social return on its social investment. To make rational investment decisions in social areas, it is necessary to know the social costs and if we are to assess them by the same measures as of financial investment, this must be expressed in dollar terms. He further asserts that, sooner or later, the social balance sheet must become a mandatory part of the normal commercial balance sheet of the company.

Social audit provides a valuable introspection and increases public visibility of the company.

Objectives and Benefits of Social Audit

1. The basic objective of social audit is to evaluate the social dimensions of the performance of the company.
2. Another principal objective which follows the objective mentioned above is to take measures to improve the social performance of the company on the basis of the feedback provided by the social audit.
3. Social audit increases the *public visibility* of the organisation.
4. If the social audit reveals a socially commendable performance of the company, it will help boost the public image of the company.

METHODS OF SOCIAL AUDIT

There is no single universally agreed upon method of social auditing.

Some of the important methods of social audit developed by different people or organisations are given below.

(i) Social Process Audit: The aim of the social process audit, also known as *Programme Management Audit*, is to develop an internal management information system that will allow management to create and administer the social programmes in a better way. This involves the determination of the objectives of the social programmes and a social cost-benefit analysis of the programmes with a view to determining whether these objectives have been met.

(ii) Financial Statement Format Audit: Under the financial statement format audit, the social information is presented in the conventional financial statement format, *i.e.,* balance sheet and/ or income statement.

(iii) Macro-Micro Social Indicator Audit: The macro-micro social indicator audit attempts to evaluate the micro indicators (*i.e.,* the company's performance) against a set of macro indicators such as national policies.

(iv) Constituency Group Audit: Under this audit, the preference and attitudes of various constituencies (like employees, creditors, suppliers and customers) are identified and measured and the firm's performance is evaluated against the criteria developed for each group.

(v) Partial Social Audit: Partial social audit evaluates any particular aspects of social performance like energy conservation or ecological preservation.

(vi) Comprehensive Audit: Comprehensive audit attempts to evaluate the total performance of the organisation including social performance.

(vii) Corporate Rating Approach: In contradistinction to the audits mentioned above, this is an external evaluation of the company's performance by public groups like consumer organisations, social welfare organisations or media.

Given below is the format of social reporting used by the Cement Corporation of India.

OBSTACLES TO SOCIAL AUDIT

There are conceptual and practical problems in conducting social audit.

Social audit encounters a number of problems. The important obstacles are:

1. Being a relatively new concept, social audit is yet to gain wide appreciation and acceptance.
2. Being a relatively new concept, a clear and generally well accepted methodology for conducting the social audits is not available.

3. There is no agreement as to the items to be included for social audit.
4. It is very difficult, and in several cases even impossible, to quantify the social costs and benefits of different activities or items.
5. There may be resistance within the company to social audit because of the time, effort, and difficulty involved in the task.
6. There may also be resistance because of the fear of a dismal or unsatisfactory picture that may be presented by the social audit.

As the Committee set up by the Tata Iron and Steel Company Limited (TISCO) to conduct the Social Audit of the TISCO points out, though social audits have been undertaken in a number of countries, principally in the USA (to which the practice owes its origin), Japan, the UK and one or two other Western countries, the subject has not yet attained the status of a science. There is no agreement, much less unanimity, among its most ardent proponents, particularly as to its basic principles or its true objectives. It is only a child of the last decade, during which there has been a growing concern about the environment and the problems of pollution, consumer protection, workers' safety and equal employment opportunities. Melvin Anshen, Professor of Public Policy and Business Responsibility at the Graduate School of Business, Columbia University, and an eminent authority on the subject, remarks that "the social audit has been described as an idea whose time has come but which isn't ready to be taken off the drawing board and put to work".

SOCIAL AUDIT IN INDIA

Although the idea of social audit originated in the United States about half a century ago, it is only recently that it received serious attention of corporations even in the advance countries.

TISCO (Tata Steel) was one of the first companies in the world to conduct social audit.

The first comprehensive social audit in India was conducted by the TISCO in 1980. It was conducted by the Social Audit Committee appointed by the Board of Directors of the company "to examine and report whether, and the extent to which, the company has fulfilled the objectives contained in Clause 3A of its Articles of Association regarding its social and moral responsibilities to the consumers, employees, shareholders, society and the local community." The report of the Committee was a glowing tribute to the endeavours of the company in the discharge of its social and moral obligations to the various segments of the society.

Some companies like the Cement Corporation of India have been making some social reporting in their annual reports.

The High-powered Expert Committee on Companies and MRTP Acts (Sachar Committee) observes that the acceptance of the concept of social responsibility must be reflected in the information and disclosures that the company makes available for the benefit of its various constituents – shareholders, creditors, workers and the community – and has suggested that a provision may be made in the Companies Act that every company shall give a social report which will indicate and quantify, in as precise and clear terms as possible, the various activities relating to social responsibility which have been carried out by the company in the previous year. The Committee has further suggested that it is possible that a company may be required to alter its Memorandum with respect to the objects of the company so as to carry out its activities as an obligation to the concept of social responsibility.[14] It should be pointed out here that the TISCO had, in 1970, voluntarily incorporated in its Articles of Association its social and moral responsibilities to the consumers, employees, shareholders, society and the local people.

The concept of social audit has not yet taken off in India.

CEMENT CORPORATION OF INDIA LTD.
SOCIAL ACCOUNTS

I. Social Benefits and Costs to Staff

A. Social Benefits to Staff

1. Medical and hospital facilities
2. Educational facilities
3. Canteen facilities
4. Recreation, entertainment and cultural activities
5. Housing and township facilities
6. Water supply, concessional electricity and transport
7. Training and career development
8. Provident Fund, Gratuity, Bonus and Insurance benefits
9. Holiday, leave encashment and leave travel benefits
10. Other benefits.

Total Benefits to Staff

B. Social Costs to staff

1. Lay-off and involuntary termination
2. Extra hours put in by officers voluntarily

Total Cost to Staff

Social Income to Staff (A – B)

II. Social Benefits and Costs to Community

A. Social Benefits to Community

1. Local taxes paid to Panchayat/Municipality
2. Environmental improvements
3. Generation of job potential
4. Generation of business

Total Social Benefits to Community

B. Social Costs to Community

1. Increase in cost of living in the vicinity on account of the cement plants

III. Social Benefits and Costs to General Public

A. Social Benefits to General Public

1. Taxes, duties, etc. paid to State Government
2. Taxes, duties etc. paid to Central Government

Total Benefits to General Public

B. Social Costs to General Public

1. State services consumed – Electricity
2. Central services consumed – Telephone, Telegraph, Postal Services and Banking

Total Social Costs to General Public

Net Social Benefits to General Public III (A – B)

Net Social Income to Staff, Community and

General Public (I + II + III)

RECENT DEVELOPMENTS IN INDIA

National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business, announced by the Government of India and the Companies Act, 2013, now make CSR compelling in India.

It may be mentioned here that several Indian companies have been publishing social audit report, CSR report, sustainability report etc. Some companies have been very quick to respond to the *National Voluntary Guidelines*. For example, the Annual Report of ITC for 2011-12 includes reporting as per the format prescribed by the *Guidelines*.

Although the Companies Act, 2013, mandates companies to spend 2 per cent of their net profit on CSR, there are companies which spend a much higher proportion on CSR. Tata Steel, for example, has been spending 5 to 7 per cent of the profit after tax for this purpose.

GOVERNMENT GUIDELINES

The Ministry of Corporate Affairs had released Voluntary Guidelines on CSR in 2009 as the first step towards mainstreaming the concept of Business Responsibilities. Keeping in view the feedback from stakeholders, it was decided to revise the same with a more comprehensive set of guidelines that encompasses social, environmental and economical responsibilities of business. Accordingly, on 8th Ju1y, 2011, Government of India announced, the **National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business.**

Nature and Significance of the Guidelines

These Guidelines are not prescriptive in nature, but are based on practices and precepts that take into account the realities of Indian business and society as well as global trends and best practices adapted to the Indian context. It urges businesses to embrace the "triple bottom-line" approach whereby its financial performance can be harmonised with the expectations of society, the environment and the many stakeholders it interfaces with in a sustainable manner.

The Guidelines have been articulated in the form of Nine Principles with the Core Elements to actualise each of the principles. The Guidelines are designed to be used by all businesses irrespective of size (including MSMEs), sector or location and therefore touch on the fundamental aspects – the 'spirit' – of an enterprise.

It is expected that all businesses in India, including multinational companies that operate in the country, would consciously work towards following the Guidelines. The Guidelines also provide a framework for responsible business action for Indian MNCs planning to invest or

already operating in other parts of the world. Businesses are encouraged to move beyond the recommended minimum provisions articulated in the document.

Government expects that the adoption of these National Voluntary Guidelines will improve the ability of businesses to enhance their competitive strengths improve their reputations, increase their ability to attract and retain talent and manage their relations with investors and society at large.

Principles

The Guidelines have been articulated in the form of Nine Principles with the Core Elements to actualise each of the principles. A reading of each Principle with its attendant Core Elements, should provide a very clear basis for putting that Principle into practice.

Principle 1: Businesses should conduct and govern themselves with Ethics, Transparency and Accountability.

Principle 2: Businesses should provide goods and services that are safe and contribute to sustainability throughout their life cycle.

Principle 3: Businesses should promote the well-being of all employees.

Principle 4: Businesses should respect the interests of, and be responsive towards all stakeholders, especially those who are disadvantaged, vulnerable and marginalised.

Principle 5: Businesses should respect and promote human rights.

Principle 6: Business should respect, protect, and make efforts to restore the environment.

Principle 7: Businesses, when engaged in influencing public and regulatory policy, should do so in a responsible manner.

Principle 8: Businesses should support inclusive growth and equitable development.

Principle 9: Businesses should engage with and provide value to their customers and consumers in a responsible manner.

Actions Required

The Principles and Core elements laid down in the Guidelines are required to be integrated in the business policies, strategies and business processes emanating from the core business purpose of an enterprise. According to the Guidelines, this requires specifically that the following actions are taken:

Leadership The Chairman/CEO/Owner-Manager should play a proactive role in convincing the board/Top Management and staff within the business that adopting these principles is crucial for success. The board and senior management need to ensure that the principles are fully understood across the organisation and comprehensively executed.

Integration These principles and core elements must be embedded in the business policies and strategies emanating from the core business purpose of the organisation. *For this to happen, these must align with each business's internal values and/or must provide clear business benefits.*

Engagement Building strong relationships and engaging with stakeholders on a consistent, continuous basis is crucial.

Reporting Implementation process includes disclosure by companies of their impact on society and environment to their stakeholders.

Reporting Framework For each of these principles, companies need to provide their declaration/report on their compliance and level of compliance by providing numbers, data and any specific cases relevant to each of the principles. The format of a Business Responsibility Report is given in the Table below.

TABLE 9.1 : THE FORMAT OF A BUSINESS RESPONSIBILITY REPORT	
Part A Basic Company Information	• Business details • Economic and financial details • Management properties and commitment • Risks, goals and targets that the management deems fit to disclose
Part B Compliance towards the Nine Principles	• Details of compliance across the nine different principles • Explanation to be given if the company is not compliant to any of the principles and when it plans to comply to them
Part A Business Responsibility Information	• Report on any material/significant negative consequences of the operations of the business entity • Brief on goals and targets in the area of social, environmental and economic responsibilities for the next reporting period

COMPANIES ACT 2013 AND CSR

With the Companies Act, 2013, which replaced the 56-year-old Companies Act 1956, India became the first country to make spending towards corporate social responsibility mandatory.

According to Clause 135 of the Act, every company having net worth of ₹ 500 crore or more, or turnover of ₹ 1,000 crore or more or a net profit of ₹ 5 crore or more during any financial year shall constitute a Corporate Social Responsibility Committee (CSRC) consisting of three or more directors, out of which at least one director shall be an independent director.

The CSRC shall formulate and recommend to the Board, a Corporate Social Responsibility Policy (CSRP) which shall indicate the activities to be undertaken by the company as specified in Schedule VII of the Act. The Committee shall recommend the amount of expenditure to be incurred on these activities. The Committee shall also monitor the CSR Policy of the company from time to time.

The Board shall disclose in its report the contents of the CSR Policy as approved by the Board considering the recommendations made by the CSR Committee, and shall also place it on the company's website, if any.

According to Schedule VII, the activities which may be undertaken under the CSR Policy relate to:

I. eradicating extreme hunger and poverty;

II. promotion of education;

III. promoting gender equality and empowering women;

IV. reducing child mortality and improving maternal health;

V. combating human immunodeficiency virus, acquired immune deficiency syndrome, malaria and other diseases;

VI. ensuring environmental sustainability;

VII. employment enhancing vocational skills;

VIII. social business projects;

IX. contribution to the Prime Minister's National Relief Fund or any other fund set up by the Central Government or the State Governments for socio-economic development and relief and funds for the welfare of the Scheduled Castes, the Scheduled Tribes, other backward classes, minorities and women; and

X. such other matters as may be prescribed.

It shall be ensured that the company spends, in every financial year, at least two per cent of the average net profits of the company during the three immediately preceding financial years, in pursuance of its CSR Policy. The company shall give preference to the local area and areas around it where it operates, for spending the amount earmarked for Corporate Social Responsibility activities.

In the statements laid before a company in general meeting, there shall be attached a report by its Board of Directors the details about the policy developed and implemented by the company on CSR initiatives taken during the year. If the company fails to spend the specified amount, the Board shall specify the reasons for it.

It is estimated that about 12,000 companies will come under the ambit of the CSR regulation of the Companies Act. The total spending by these companies under CSR was estimated at about ₹ 5,000 crores (as against earlier estimates ranging from ₹ 10,000 to ₹ 20,000).

SUMMARY

The rationale of the concept of social responsibility is that industry "can no longer be regarded as a private arrangement for enriching shareholders. It has become a joint enterprise in which workers, management, consumers, the locality, Government and trade union officials all play a part. If the system which we know by the name private enterprise is to continue, some way must be found to embrace many interests which go to make up industry in a common purpose."

It is argued that a company has a number of social responsibilities to the employees, shareholders, consumers and the community.

Social responsibility of business is advocated on the ground that the resources it makes use of are not limited to those of the proprietors and the impact of their operations is felt also by many a people who are in no way connected with the enterprises. The shareholders, the suppliers of resources, the consumers, the local community and the society at large are affected by the way an enterprise functions. Hence, a business enterprise has to be socially very responsive so that a social balance may be struck between the opposing interests of these groups. Further, companies which have huge resources at their disposal have a moral responsibility to care for the society. Besides, discharge of social responsibilities will be in the company's own interest, because it will help build up good rapport with the society and Government and improve employee morale and industrial relations.

However, there are also arguments against the social involvement of business. It will affect the financial health of companies, it may lead to attempt to dominate the community's affairs, the costs of social involvement may be passed on to the consumers by price increase, for many companies it is a tax-saving gimmick, so goes the arguments.

A social audit enables the public as well as the company to evaluate the social performance of the company. The "social audit – much like the financial audit – is an identification and examination of the activities of the firm in order to assess, evaluate, measure and report their impact on the immediate social environment."

There is no single universally agreed upon method of social auditing. Some of the important methods of social audit developed by different people or organisations include social process audit, financial statement format audit, macro-micro social indicator audit, constituency group audit, partial social audit, comprehensive audit, and corporate rating approach.

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Chapter 10

CONSUMER RIGHTS, CONSUMERISM AND BUSINESS

Structure

UN Guidelines for Consumer Protection

Consumer Protection and Consumerism in India

Consumer Protection Act, 1986

Summary

References

An important socio-political environment confronting the business is the growth of consumerism and the legislative measures to protect the consumers. Consumer movement had its conspicuous beginning and development in the United States. There has been a growth of consumer awareness in most countries leading to growth of consumerism and growing demand for consumer protection.

Awareness of consumer rights and demand for consumer protection are growing all around the world.

Though consumerism is not well developed in India, there are several consumer organisations in India like the Consumer Guidance Society of India (CGSI), Mumbai, and the Consumer Education and Research Centre (CERC), Ahmedabad, which are doing commendable work. Some of these organisations are very active in conducting product testing and exposing substandard quality and adulteration. The demand for regulatory measures or effective implementation of available measures for consumer protection have been substantiated by the results of such tests. ISI certification of food colours, demanded by the CGSI is now mandatory. Consumer organisations also play an important role in redressing consumer grievances.

Since 1993, the Consumer Education and Research Society (CERS), sponsored by the CERC, has been performing a very bold and commendable task of comparative testing of consumer goods at their in-house laboratory, and since 1998 its publication *INSIGHT – The Consumer Magazine* has been carrying our test results far and near. The media have been publishing the test findings. These test results enable the consumers to evaluate and compare product of different companies. The manufacturers can, therefore, no longer be complacent.

Consumer movement is growing, *albeit* slowly, in India. It may gather momentum from the growing consumer awareness and the growing feeling that the consumer is ruthlessly exploited and taken for a ride. Many products fail to satisfy the quality requirements and many sellers do not favourably respond to the genuine grievances of consumers.

Product tests reveal that numerous products fail to satisfy quality/safety standards.

Many products tests conducted by some consumer organisations have brought to light alarming facts regarding product quality and safety and, they have, therefore, been very vehemently demanding governmental action ensuring quality standards. Consumers have been increasingly taking resort to redressal measures. In short, the business can no more take the consumer for granted.

This does not, however, mean that consumerism is necessarily a problem for the business. Consumerism is, in fact, regarded as an opportunity by consumer-oriented businessmen, as described later in this chapter.

CONSUMER RIGHTS

Consumers in the advanced countries, obviously, are much more conscious of their rights than in countries like India. In 1962, President John F. Kennedy, and in 1965 President Johnson emphasised the consumer rights and gave an impetus to consumerism in the USA and other countries.

The essence of consumer rights is protection of genuine interests of consumers.

Important consumer rights include:

1. Right against exploitation by unfair trade practices.
2. Right to protection of health and safety from the goods and services the consumers buy or are offered free.
3. Right to be informed of the quality and performance standards, ingredients of the product, operational requirements, freshness of the product, possible adverse side-effects and other relevant facts concerning the product or service.
4. Right to be heard if there is any grievance or suggestions.

5. Right to get the genuine grievances redressed.
6. Right to choose the best from a variety of offers.
7. Right to a physical environment that will protect and enhance the quality of life.

The Consumer Protection Act, 1986, has listed the consumer rights it seeks to protect in India. Details of the Act are given at the end of the Chapter.

BOX 10.1 : RESPONSIBILITIES OF CONSUMERS

Rights do not exist independently. Like a coin which has obverse and reverse, consumer rights have the other side, consumer responsibilities. They are:

1. *The consumer should not make vague or general complaints, but have a specific complaint, with supporting information and proof such as a bill.*
2. *The consumer should try to understand the viewpoint of the seller before making a complaint.*
3. *In some situations, consumers have to cooperate with the sellers. For instance, in observing a queue, or in a situation of coin shortage using the coupons issued by the bus transport system.*
4. *Consumers, in asserting their rights, should not inconvenience or hurt other sections of the public. For instance, Rasta Roko, Satyagraha, Dhama, Bandh etc., are ways of expressing one`s anger and generating enthusiasm for a cause among general public, but they result in disrupting normal life for others. This is not justified.*
5. *The consumers should, as a rule, complain against a system and not attack individuals who are incumbents of posts. In most cases, the system or practices call for a change, not individuals. If "A" is removed or transferred from a post, "B" will occupy it, and may be equally helpless in the particular situation to serve consumers!*

Courtesy: *M.R. Pai, Guidelines to Consumers – Rights & Responsibilities, 1987*
(Sponsored in public interest by the Rotary Club of Bombay)

EXPLOITATION OF CONSUMERS

Exploitation of consumers by unfair trade practices, poor quality and spurious products and overpricing is very widespread.

Consumers are, however, by and large, practically denied most of these rights. They are exploited by a large number of restrictive and unfair trade practices. A situation has developed in which the public have become victims of false claims for products blatantly advertised. Behavioural science is extensively applied to marketing to ruthlessly, exploit the consumers by stimulating the weak points and soft corners of their mind. Misleading, false or deceptive advertisements are quite common. Many a time, the advertisements deliberately give only half-truths so as to give a different impression than is the actual fact. Thus, advertisements may be misleading because things that should be said have not been said, or, because advertisements are composed or purposefully presented in such a way as to mislead. The situation is such that misrepresentations about the quality of a product or the potency of a drug or medicine can be projected without much risk.

As the High-powered Expert Committee on Companies and MRTP Acts, popularly known as the Sachar Committee, points out, fictitious bargains are another common form of deception. Many devices are used to lure buyers into believing that they are getting something for nothing or at a nominal value for their money. Prices may be advertised as generally reduced and cut when in reality the goods may be sold at sellers' regular prices.

Thus, apart from the monopolistic and restrictive trade practices that have the effect of restricting competition and increasing the market imperfections to the common detriment, consumer exploitation through unfair trade practices that mislead or dupe the customers has become widespread. And it is this situation that has largely led to the growth of consumerism.

CONSUMERISM

Exploitation of consumer and neglect of consumer rights lead to consumerism - a social movement to protect consumer rights.

Philip Kotler defines Consumerism as "a social movement seeking to augment the rights and powers of the buyers in relation to sellers".[1] Boyd and Allen state that "although often abused as a term, consumerism may be best defined as the dedication of those activities of both public and private organisations which are designed to protect individuals from practices that impinge upon their rights as consumers."[2]

In his speech delivered at the 44th Annual General Meeting of *Hindustan Lever Ltd.* in 1977, the Chairman, Mr. T. Thomas, rightly pointed out: "While the producer has the power or the right to design the product, distribute, advertise and price it, the consumer has only the power of not buying it. One may argue that the producer runs the greater risk in spite of having several rights because the veto power remains with the consumer. However, the consumer often feels that while he has the power of veto, he is not always fully equipped to exercise that power in his best interests. This situation may be the effect of lack of information, too much indigestible information or even misinformation from one or several competing producers. This problem facing the consumer has led to 'consumerism'. It is worthwhile to note that consumerism, like several other social movements, *e.g.,* independence movement, Civil Rights movement, etc., has been the result of a social conflict and cannot, therefore, be wished away. It will be with us till the conflict facing the consumer is resolved".

Consumerism, interpreted as a collective endeavour of the consumers to protect their interests, is a manifestation of the failure of the business, including that of the public sector, and the government to guarantee and ensure the legitimate rights of the consumers.

CONSUMER PROTECTION

Business firms, government and consumers have their roles in consumer protection.

For effective consumer protection, a practical response on the part of three parties, the business, the government and the consumers, is essential.

Firstly, the business, comprising the producers and all the elements of the distribution channels, has to pay due regard to consumer rights. The producer has an inescapable responsibility to ensure efficiency in production and the quality of output. He should also resist the temptation to charge exorbitant prices in a seller's market. Many a time, the imperfections on the supply side, like hoarding and blackmarketing, mercilessly gouge the consumer. Hence, a socially responsible producer should see to it that whatever is produced reaches the ultimate consumer in time and at reasonable prices.

As T. Thomas observes, "Restraint is best exercised voluntarily than through legislation which will otherwise become inevitable. Advertising agencies and marketing management have a very important role to play in this respect. By overplaying the claims, they will be cutting the very branch on which they are perched."[3]

Secondly, the Government has to come to the rescue of the helpless consumer to prevent him from being mislead, duped, cheated and exploited. It should also take special care of the vulnerable sections.

The UN Guidelines for Consumer Protection points out that "the governmental role in consumer protection is vital and finds expression through policy-making, legislation and the development of institutional capacity for its enforcement. To provide a legal basis for enforcing basic consumer rights, every country needs to have an irreducible minimum of consumer protection legislation, covering physical safety, promotion and protection of consumers' economic interests, standards for the safety and quality of goods and services, distribution facilities, redress, and education and information programmes. Governments also require the necessary machinery to enforce such legislation." The Guidelines encourage Governments to develop, strengthen or

maintain a strong consumer protection policy. In doing so, each Government must set its own priorities for the protection of consumers in accordance with its economic and social circumstances and the needs of its population.

The UN Guidelines also calls upon the Government to establish distribution facilities for essential consumer goods and services. It is suggested that Governments should, where appropriate, consider: *(a)* Adopting or maintaining policies to ensure the efficient distribution of goods and services to consumers; where appropriate, specific policies should be considered to ensure the distribution of essential goods and services where this distribution is endangered, as could be the case particularly in rural areas. Such policies could include assistance for the creation of adequate storage and retail facilities in rural centres, incentives for consumer self-help and better control of the conditions under which essential goods and services are provided in rural areas; and *(b)* encouraging the establishment of consumer cooperatives and related trading activities, as well as information about them especially in rural areas.

UN Guidelines for Consumer Protection envisages a multidimensional role for government in consumer protection.

Further, according to the Guidelines, Governments should establish or maintain legal and/ or administrative measures to enable consumers or, as appropriate, relevant organisations to obtain redress through formal or informal procedures that are expeditious, fair, inexpensive and accessible. Such procedures should take particular account of the needs of low-income consumers. Governments should also encourage all enterprises to resolve consumer disputes in a fair, expeditious and informal manner, and to establish voluntary mechanisms, including advisory services and informal complaints procedures, which can provide assistance to consumers. Information on available redress and other dispute-resolving procedures should be made available to consumers.

The motive of private gain tempts business to maximise income by socially undesirable trade practices; and this calls for government intervention. Statutory action to protect the interests of consumers has become quite common. In the United Kingdom, for instance, the Trade Description Act, 1968, prohibits the use of misleading descriptions of goods or services or misleading representation of price reductions. In a number of countries, pro-consumer legislation contains provisions that enable an affected party to seek remedy for compensation for the loss or damage suffered by it at the hands of a person who has indulged in prohibited practices. This is true of the Sherman Act and the Clayton Act of the USA, the Federal Act of Switzerland, the Act against Restraint of Competition of Spain, the Act concerning Prohibition of Private Monopoly and Maintenance of Fair Trade of Japan, the Trade Practices Act of Australia, the Combines Investigation Act of Canada, etc.

In some countries, statutory bodies are empowered to require the advertiser to substantiate the claims made in the advertisements. For instance, the Federal Trade Commission (FTC) of the United States can seek *affirmative disclosures*. That is, if information in an advertisement is considered insufficient by the FTC, the Commission may require a company to disclose in its advertising some of the deficiencies or limitations of its product or service so that the consumer can judge its negative, as well as, positive attributes. The FTC can also require the advertisers to submit on demand by the Commission data to back up advertising claims for a product's safety, performance, quality or price comparability. The intent of this *substantiation* is to help consumers make more reasoned choices by having information made available to them. Members of many industry groups, including automobiles, appliances, soaps and detergents, television sets, dentistries, hearing aids, and all over-the-counter drugs have been ordered to provide the Commission with documentation in support of their designated advertising claims. *Corrective advertising* requirements have increasingly been a part of many FTC consent orders. Corrective advertising doctrines are based upon the idea that inaccurate information has already been communicated by advertisers, and that corrective advertising is needed to eliminate the lingering effects of such information.[4]

Thirdly, consumers should accept consumerism as a means of asserting and enjoying their rights. Consumerism should succeed in making the business and the government more responsive to the rights of the consumers.

Consumerism is a social force to: (i) make the business more honest, efficient, responsive and responsible, and (ii) pressurise the government to adopt the necessary measures to protect consumer interests by guaranteeing their legitimate rights.

Peter Drucker has remarked that "consumerism is the shame of the total marketing concept,"[5] implying that the concept is not widely implemented. Consumerism reflects not only the failure of the business to widely implement the marketing concept but also the need to give the business policies a social orientation so as to enhance long-run social welfare. As Philip Kotler observes, "consumerism is a clarion call for a *revised marketing concept.*"[6] Hence, the original marketing concept has to be broadened to include the societal marketing concept.

"The societal marketing concept calls for customer orientation backed by integrated marketing aimed at generating customer satisfaction and long-run consumer welfare, as the key to attaining long-run profitable volume".[7]

As Kotler points out, "the addition of long-run consumer welfare asks the businessman to include social and ecological considerations in his product and market planning. He is asked to do it not only to meet his social responsibilities but also because failure to do this may hurt his long-run interests as producer."[8] Thus, the message of consumerism is not a setback for marketing but rather points to the next stage in the evolution of enlightened marketing. Just as the sales concept said that sales were all important, and the original marketing concept said that consumer satisfaction was also important, the societal marketing concept has emerged to say that long-run consumer welfare is also important."[9] Hence, he feels that consumerism will be enduring, beneficial, pro-marketing and ultimately profitable. "Consumerism mobilises the energies of consumers, businessmen and government leaders to seek solutions to several complex problems in a technologically advanced society. One of these is the difference between serving consumer desires efficiently and serving their long-run interests. To marketers, it says that products and marketing practices must be found which combine short-run and long-run values for the consumer. It says that a societal marketing is an advance over the original marketing concept and a basis for earning increased consumer goodwill and profits. The enlightened marketer attempts to satisfy the consumer *and* hence his total well-being on the theory that what is good in the long-run for consumer is good for business."[10]

Non-governmental Organisations: NGOs or voluntary organisations have a very important role in consumer protection.

Successful consumer movements almost everywhere owe a lot to the efforts of consumer advocates (NGOs).

It may be noted that one of the stated objectives of the UN Guidelines for Consumer Protection is to facilitate the development of independent consumer groups which should have the freedom to present their views in decision-making processes affecting them. The Guidelines state that consumer organisations should be encouraged to monitor adverse practices, such as the adulteration of foods, false or misleading claims in marketing and service frauds. Business and consumer groups should also be encouraged by Governments to formulate codes of marketing and other business practices to ensure adequate consumer protection. Consumer groups have a role to play as well in undertaking education and information programmes, particularly for low-income populations. Promoting the growth of a strong consumer movement and increasing protection for people in their role as consumers are central aims of Consumers International's work. To this end, it assists newly formed consumer groups in developing countries. Consumers International's independence is guaranteed by strict membership rules – organisations that join must be non-profit-making and non-commercial and must operate exclusively in the consumer's interest.

Utility of Consumerism

Well-organised and dynamic consumerism may be expected to produce the following results:

1. Producers and sellers will not take the consumer for granted. When consumers are strong enough to protect their rights, the business will be compelled to shun unfair trade practices.

Strong consumerism makes the business responsive and government more responsible.

2. Consumerism will provide feedback for the business. It will enable the producers to understand consumer grievances, needs and wants. This will assist in the more effective implementation of the marketing concept or the societal marketing concept, depending upon the nature of consumerism.
3. Producers will be able to enlist the support of consumers to minimise the imperfections on the distribution front. Several times, the supply position is made worse by hoarding and blackmarketing by traders. Further, many sellers have a tendency to charge a price which is higher than the actual by giving one or other reason. There is no reason why the consumer and producer should not cooperate to get rid of the unscrupulous traders.

   (The above points indicate that consumerism is an opportunity for honest and dynamic firms. In fact, quite a few leading businessmen view it so.)
4. Consumerism will make the government more responsive to consumer interests, prompt it to take necessary statutory measures, and make the required institutional arrangements to safeguard consumer rights.

UN GUIDELINES FOR CONSUMER PROTECTION

The UN Guidelines for Consumer Protection have laid down a number of principles and responsibilities for governments and enterprises with a view to protecting consumer rights and enhancing their welfare.

After many years of hard lobbying by the International Organisation of Consumer Unions (later renamed as Consumers International), on 9 April 1985, the United Nations adopted the Guidelines for Consumer Protection by the General Assembly which provide for enhanced protection of consumers by enunciating various steps and measures around seven themes: (1) Physical Safety, (2) Economic Interests, (3) Standards, (4) Essential Goods and Services, (5) Redress, (6) Education and Information, and (7) Health. The Guidelines also provide for international cooperation in the area of consumer protection. These Guidelines were reviewed from time to time by the UN and resolutions adopted to take the issues forward.

Objective: Taking into account the interests and needs of consumers in all countries, particularly those in developing countries; recognising that consumers often face imbalances in economic terms, educational levels, and bargaining power; and bearing in mind that consumers should have the right of access to non-hazardous products, as well as the importance of promoting just, equitable and sustainable economic and social development, these guidelines for consumer protection have the following objectives:

1. To assist countries in achieving or maintaining adequate protection for their population as consumers.
2. To facilitate production and distribution patterns responsive to the needs and desires of consumers.
3. To encourage high levels of ethical conduct for those engaged in the production and distribution of goods and services to consumers.
4. To assist countries in curbing abusive business practices by all enterprises at the national and international levels which adversely affect consumers.

5. To facilitate the development of independent consumer groups.
6. To further international cooperation in the field of consumer protection.
7. To encourage the development of market conditions which provide consumers with greater choice at lower prices.

General Principles: Governments should develop, strengthen or maintain a strong consumer protection policy, taking into account the guidelines set out below. In so doing, each Government must set its own priorities for the protection of consumers in accordance with the economic and social circumstances of the country, and the needs of its population, and bearing in mind the costs and benefits of proposed measures.

The legitimate needs which the guidelines are intended to meet are the following:

1. The protection of consumers from hazards to their health and safety.
2. The promotion and protection of the economic interests of consumers.
3. Access of consumers to adequate information to enable them to make informed choices according to individual wishes and needs.
4. Consumer education.
5. Availability of effective consumer redress.
6. Freedom to form consumer and other relevant groups or organisations and the opportunity of such organisations to present their views in decision-making processes affecting them.

Governments should provide or maintain adequate infrastructure to develop, implement and monitor consumer protection policies. Special care should be taken to ensure that measures for consumer protection are implemented for the benefit of all sectors of the population, particularly the rural population.

The UN Guidelines for Consumer Protection declare that all enterprises should obey the relevant laws and regulations of the countries in which they do business. They should also conform to the appropriate provisions of international standards for consumer protection to which the competent authorities of the country in question have agreed.

Guidelines: The following guidelines should apply both to home-produced goods and services and to imports.

In applying any procedures or regulations for consumer protection, due regard should be given to ensuring that they do not become barriers to international trade and that they are consistent with international trade obligations.

Physical Safety: Governments should adopt or encourage the adoption of appropriate measures including legal systems, safety regulations, national or international standards, voluntary standards and the maintenance of safety records to ensure that products are safe for either intended or normally foreseeable use.

Promotion and Protection of Consumers' Economic Interests: Government policies should seek to enable consumers to obtain optimum benefit from their economic resources. They should also seek to achieve the goals of satisfactory production and performance standards, adequate distribution methods, fair business practices, informative marketing and effective protection against practices which could adversely affect the economic interests of consumers and the exercise of choice in the marketplace.

Consumers should also be protected from such contractual abuses as one-sided standard contracts, exclusion of essential rights in contracts, and unconscionable conditions of credit by sellers.

Standards for the Safety and Quality of Consumer Goods and Services: Governments should, as appropriate, formulate or promote the elaboration and implementation of standards,

voluntary and other, at the national and international levels for the safety and quality of goods and services and give them appropriate publicity. National standards and regulations for product safety and quality should be reviewed from time to time, in order to ensure that they conform, where possible, to confirm generally accepted international standards. Where a standard lower than the generally accepted international standard is being applied because of local economic conditions, every effort should be made to raise that standard as soon as possible.

Governments should encourage and ensure the availability of facilities to test and certify the safety, quality and performance of essential consumer goods and services.

Distribution Facilities for Essential Consumer Goods and Services: Governments should, where appropriate, consider: *(a)* Adopting or maintaining policies to ensure the efficient distribution of goods and services to consumers; where appropriate, specific policies should be considered to ensure the distribution of essential goods and services where this distribution is endangered, as could be the case particularly in rural areas. Such policies could include assistance for the creation of adequate storage and retail facilities in rural centres, incentives for consumer self-help and better control of the conditions under which essential goods and services are provided in rural areas. *(b)* Encouraging the establishment of consumer cooperatives and related trading activities as well as information about them especially in rural areas.

Measures Enabling Consumers to Obtain Redress: Governments should establish or maintain legal and/or administrative measures to enable consumers or, as appropriate, relevant organisations to obtain redress through formal or informal procedures that are expeditious, fair, inexpensive and accessible. Such procedures should take particular account of the needs of low-income consumers.

Governments should encourage all enterprises to resolve consumer disputes in a fair, expeditious and informal manner, and to establish voluntary mechanisms, including advisory services and informal complaints procedures, which can provide assistance to consumers. Information on available redress and other dispute-resolving procedures should be made available for consumers.

Education and Information Programmes: Governments should develop or encourage the development of general consumer education and information programmes, bearing in mind the cultural traditions of the people concerned. The aim of such programmes should be to enable people to act as discriminating consumers, capable of making an informed choice of goods and services, and conscious of their rights and responsibilities. In developing such programmes, special attention should be given to the needs of disadvantaged consumers, in both rural and urban areas, including low-income consumers and those with low or non-existent literacy levels.

Consumer education should, where appropriate, become an integral part of the basic curriculum of the education system, preferably as a component of existing subjects.

Consumer education and information programmes should cover such important aspects of consumer protection as the following: *(a)* Health, nutrition, prevention of food-borne diseases and food adulteration; *(b)* Product hazards; *(c)* Product labelling; *(d)* Relevant legislation, how to obtain redress, and agencies and organisations for consumer protection; *(e)* Information on weights and measures, prices, quality, credit conditions and availability of basic necessities; and *(f)* As appropriate, pollution and environment.

Governments should encourage consumer organisations and other interested groups, including the media, to undertake education and information programmes, particularly for the benefit of low-income consumer groups in rural and urban areas.

Business should, where appropriate, undertake or participate in factual and relevant consumer education and information programmes.

CONSUMER PROTECTION AND CONSUMERISM IN INDIA

PLIGHT OF THE INDIAN CONSUMER

An examination of the important problems facing the Indian consumer would make clear the need for more effective government intervention and consumer movement to safeguard consumer rights.

The following factors make the plight of the Indian consumer miserable.

1. Short supply of many goods and services, especially of essential items, is a very serious problem afflicting the Indian consumer. The demand-supply imbalance has produced all the associated evils of profiteering, hoarding and blackmarketing, corruption, nepotism, irresponsiveness and arrogance towards consumers. Although the situation has improved as a result of the increase in competition due to liberalisation, it is still far from satisfactory.
2. The Indian consumer has also been the victim of lack of *effective* or *workable competition*. "Competition among sellers, even though imperfect, may be regarded as effective or workable if it offers buyers real alternatives sufficient to enable them, by shifting their purchases from one seller to another, substantially to influence quality, service, and price. Competition, to be effective, need not involve the standardisation of commodities; it does, however, require the ready substitution of one product for another; it may manifest itself in differences in quality and service as well as in price. Effective competition depends also upon the general availability of essential information; buyers cannot influence the behaviour of sellers unless alternatives are known. It requires the presence in the market of several sellers, each of them possessing the capacity to survive and grow, and the preservation of conditions which keep alive the threat of potential competition from others.... The test of effectiveness and workability in competition among sellers is thus to be found in the availability of buyers of genuine alternatives in policy among their sources of supply."[11]

   (The above two points should not be confused as one and the same. Short supply refers to quantitative insufficiency whereas lack of effective competition refers to dearth of enough alternatives.)

Lack of education and information, generally the poor economic condition and poor enforcement of laws, make Indian consumers very vulnerable to exploitation.

3. Many products with which consumers in advanced countries are quite familiar are still new to a very large segment of the Indian consumers. The unfamiliarity of the consumers with product features makes the sale of substandard, inferior or even defective products easier in India than in advanced countries.
4. Due to low literacy levels and unsatisfactory information flows, the Indian consumers, by and large, are not conscious of all their rights. This encourages irresponsible and unscrupulous business attitudes and tactics.
5. It has been said that the legal process in India is comparatively time-consuming and cumbersome. This discourages the consumers from seeking the redressal of their grievance by means of the judicial process.
6. Consumerism in India is not well organised and developed.
7. Though the public sector had been developed and expanded to serve the public interest by providing effective competition to the private sector, increasing production, improving distribution, etc., it failed to produce benefits that were commensurate with the investment. It is an irony that though consumer welfare is an avowed objective of the public sector, in certain areas the poor performance of the public sector monopolies has made the

plight of the consumer more miserable. Some of them have even been charged with unfair trade practices.

8. Though there are a number of laws to safeguard the interests of consumers, they are not effectively implemented and enforced to achieve the objectives.

The above factors call for effective State intervention and consumerism to ensure the rights of consumers.

BOX 10.2 : COUNTERFEITS AND PASS-OFFS

An important problem which consumers all around the world encounter is that of fake products.

There are two types of spurious or fake products. Counterfeit products are fakes that use the same name, design, colour scheme, trademark and even the same name and address of the manufacturer as that of the original. Pass-off products are fakes that use similar sounding names with deceptively similar colour schemes and packaging – Ariel could be Real or Head & Shoulders could be Hair & Sholwer.

Faking is a bane of Government. Government loses out on revenue that would have been generated on excise, octroi, sales and income taxes that would have been paid on these sales. Besides, the fakers violate many laws, including working conditions and running an enterprise without a licence. Those involved in the international trade of fakes often engage in smuggling, money laundering and violation of intellectual property laws of other countries. Counterfeiting erodes India`s credibility among foreign investors leaving a negative impact on the economy.

Indian consumers, largely uneducated, are easy targets of spurious products – products that follow no quality parameters or guidelines. Food products that are ingested can do a lot of harm. Fake biscuits, chocolates or sweets consumed by children may result in serious health disorders.

To guard against faking, vigilance of the companies, government agencies and consumers is essential.

As the CERS suggests, the role of the consumers include the following.

- *Deal with reputed shops.*
- *Check the brand name, logo and name of the manufacture carefully for any discrepancies.*
- *Be wary of unusually low-priced products.*
- *Return fakes. Do not use under any circumstances.*
- *Retain the bill, product carton or photograph of a fake.*
- *Write to the concerned company.*
- *Inform consumer groups.*
- *Log on to the website www.fake-busters.com and report the matter.*

There are a number of laws under which legal action can be taken against manufacturers or sellers of counterfeit and pass-off products. These are: (1) Trademarks Act, 1999, (2) Prevention of Food Adulteration Act, 1954, (3) Drugs and Cosmetics Act, 1940, (4) Consumer Protection Act, 1986, (5) Bureau of Indian Standards Act, 1986, (6) Indian Penal Code, 1860, (7) Monopolies and Restrictive Trade Practices Act, 1969, (8) Standard of Weights & Measures Act, 1976, (9) Drug & Magic Remedies (Objectionable Advertisements) Act, 1954. A recent proposal by the government to amend the Copyright Act and to empower the customs and excise officers to investigate cases involving counterfeit product is a step in the right direction.

***Courtesy:** INSIGHT – The Consumer Magazine, Nov.-Dec., 2000.*

GOVERNMENT MEASURES

In India, the Government has taken a number of measures to protect consumer interests. The various Government measures may be classified into: *(i)* statutory regulation of private business, and *(ii)* development of the public sector.

There are a number of laws which are applicable to different areas of consumer protection.

Statutory Regulation: Government of India has armed itself with a number of statutory weapons to control the production, supply, distribution, price and quality of a large number of goods and services. It is empowered to regulate the terms and conditions of sale, the nature of trade and commerce, etc. There is a feeling that, "unlike in the West, the Government in India has a large number of controls on industry and is, therefore, in a position to respond more swiftly and effectively than Western Governments. In some ways, our bureaucracy has perfected the art of assuming the guardianship of all interests of the consumers and the vulnerable sections."[12]

Important legislations in this respect include the Competition Act, Industries (Development and Regulation) Act, Essential Commodities Act, Prevention of Food Adulteration Act, Prevention of Blackmarketing and Maintenance of Supplies of Essential Commodities Act, Trade Marks and Merchandise Marks Act, Sale of Goods Act, Indian Patents and Designs Act, Agricultural Products Grading and Marketing Act, Indian Standard Institute's Certification Act, Standard Weights and Measures Act, Imports and Exports Control Act, Packaged Commodities Order, Price and Stock Display Order, Consumer Protection Act etc.

There are, thus, a good number of laws to protect consumer interests. But a common complaint is that these laws are not effectively implemented.

The Competition Act 2002, which replaced the MRTP Act,[13] contains provisions to deal with monopolistic, restrictive and unfair trade practices that are prejudicial to public interest.

Growth of Public Sector: There had been a significant growth and expansion of the public sector in India. One of the most important objectives of the public sector was the enhancement of consumer welfare by increasing production, improving efficiency in production and supply, making available goods and services at fair prices, curbing private monopolies and reducing market imperfections, improving the distribution system, and so on. The public sector, in fact, is expected to implement the societal marketing concept.

There is, however, a general feeling that the public sector in India has still a long way to go to realise these objectives.

The irony, further, is that certain laws like the MRTP Act were not applicable to the public sector. As the Sachar Committee has observed, "There is no justification for exempting Government and Government-controlled/owned undertakings from the provisions relating to control and prohibition of monopolistic and restrictive trade practices and the....provisions relating to unfair trade practices..... The beneficiary of monopoly legislation is the consumer and it is only fair and reasonable that undertakings owned or controlled by the Government should be subject to the same type of rigour and discipline as the private sector undertakings where the interests of consumers are involved."[14]

The Government has developed the public distribution system to reduce the hardships of consumers, especially of the vulnerable sections, by making essential consumer goods available more equitably and at fair prices. There is, however, a common complaint that some of the items, especially the foodgrains supplied by the system, are of inferior quality.

Consumerism

Consumerism is still in its infancy in India. There have been occasional mass consumer demonstrations against market imperfections, mainly shortages and exorbitant prices. But several of these demonstrations have been organised with vested political interests and consumer involvement and dedication have been limited. Of course, a number of consumer organisations have been formed in different parts of the country. But with the exception of a very few, they are yet to demonstrate their practical utility. Further, whatever little organised consumer movement there is in India is almost confined to urban areas, leaving the large majority of the Indian consumers high and dry.

Consumer organisations can play a very important role in consumer protection.

A well developed consumerism is essential for the protection of consumer rights. Consumerism has the following important roles to play:

1. ***Consumer Education:*** The consumer is given information about various consumer goods and services. This relates to prices, what the consumer can expect, standard trade practices, etc. Consumers are also made aware of their rights and responsibilities and the ways of getting the grievances redressed.
2. ***Product Rating:*** In order to guide the consumer in his choice of products, some of the agencies (*for example*, CERS, Ahmedabad) carry out tests and reports the results of such tests.
3. ***Liaison with Government and with Producers:*** Another important role of consumer organisations is to maintain liaison with producers on the one hand and Government authorities on the other. As Government has a key role in protecting consumer rights, the consumer organisations have an important role to see that government plays its role.

OPPORTUNITY FOR INDUSTRY

A well-organised consumerism is needed to make the Government responsive and effective and the business responsible and obliging. To sincere and dynamic business enterprises, consumerism does not pose a threat but offer an opportunity.

T. Thomas (former Chairman, Hindustan Lever) observes that consumerism in India has not developed as a social reaction against overselling by industry, as happened in the West. On the contrary, it has been more a reaction to the evil effects of shortages and inflation. Therefore, the industry in India has a unique opportunity to respond to consumerism in a positive manner as outlined below.[15]

1. First of all, marketing must be recognised and practised as something more than sales and distribution. It has to be considered as the company's relationship with the consumer. In the wider context, it can be extended to become a part of the organisation's total responsibility to society. When we talk of the social responsibility of industry, one of its prime social responsibilities is to the consumer through the adoption of sound marketing methods.
2. Yet we cannot be complacent even with good marketing because it is not possible that many manufacturers, including large ones, will always ask all the questions that are relevant to the consumer, particularly with regard to product safety, comparative cost effectiveness, etc. Consumer movements tend to focus on such questions and may well be seen as an extension of the marketing role. Therefore, industry should cooperate with consumer movements in terms of information on, and education in, the products. Conversely, such information may also educate the consumer in the issues facing the producers, *viz.,* cost of capital, norms of profitability, impact of Government policies, etc.
3. Industry will have to invest increasingly in testing the safety of the products in use. It is far better to organise for this than to wait for nasty accidents which will make it all mandatory and exaggerated.
4. Dealing with consumer complaints satisfactorily is yet another responsibility of the industry. Promptness, courtesy and generosity are expected by the consumer with a genuine complaint. Apart from the loss and irritation caused to the consumer, persistent complaints, even if small in number, are often a good indicator of a necessary improvement.
5. Another important role of the industry is in relation to claims made on behalf of the products through advertising. Restraint is best exercised voluntarily than through legislation which will otherwise become inevitable. Advertising agencies and marketing managements have a very important role to play in this respect. By overplaying the claims, they will cut the very branch on which they are perched.

6. Lastly, if industry has to continue to cope with consumerism, it has to invest in R&D because consumer expectations and needs are constantly rising and the constraints on meeting them are changing. To cope with this effectively, industry has to find solution through R&D. It is when consumer needs exceed the industry's ability to meet them that consumerism lends to become menacing. With adequate anticipation by industry, such a situation need not arise.

The above facts indicate that cooperative efforts on the part of consumers, business and the Government are very necessary to protect the rights of the consumers.

CONSUMER PROTECTION ACT, 1986

An important landmark in consumer protection endeavours in India is the Consumer Protection Act, 1986, which provides for a system for the protection of consumer rights and the redressal of consumer disputes.

This Act extends to the whole of India except the State of Jammu and Kashmir, and save as otherwise expressly provided by the Central Government by notification, it applies to all goods and services.

The objective of the Act is to provide for the better protection of the interests of consumers and for that purpose to make provision for the establishment of consumer councils and authorities for the settlement of consumer disputes and for matters connected therewith.

CONSUMER PROTECTION COUNCILS

The Consumer Protection Act, provides for an institutional framework for dealing with consumer complaints.

The Act provides for the establishment of a Central Consumer Protection Council by the Central Government and a State Consumer Protection Council in each State by the respective State Governments.

The Central Council shall consist of the Minister in charge of Consumer Affairs in the Central Government who shall be its Chairman and such number of other official or non-official members representing such interests as may be prescribed. The Council shall meet as and when necessary but at least one meeting of the Council shall be held every year.

The State Council shall consist of such members as may be specified by the State Government by notification from time to time.

Objects of Councils: The objects of the Central Council are to promote and protect the rights of the consumers such as:

(a) the right to be protected against marketing of goods and services which are hazardous to life and property;

(b) the right to be informed about the quality, quantity, potency, purity, standard and price of goods and services so as to protect the consumer against unfair trade practices;

(c) the right to be assured, wherever possible, access to a variety of goods at competitive prices;

(d) the right to be heard and assured that consumers' interests will receive due consideration at appropriate forums;

(e) the right to seek redressal against unfair trade practices or unscrupulous exploitation of consumers; and

(f) the right to consumer education.

The objects of every State Council are to protect within the State the rights of the consumers listed above.

CONSUMER DISPUTES REDRESSAL AGENCIES

There are two levels of consumer disputes redressal agencies in the State and one agency at the national level. In other words, the Act provides for the establishment of the following consumer disputes redressal agencies:

The Consumer Protection Act provides for a three-tier consumer disputes redressal system encompassing the district, state and national levels.

(i) A *District Forum* in each district of every State. If the State Government deems it fit, more than one District Forum may be established in a district.

(ii) A *State Commission* in each State.

(iii) A *National Commission.*

The National Commission was established by the Central Government in August 1988. The responsibility for the establishment of the other two agencies, with the prior approval of the Central Government, rests with the respective State Government.

The District Forum shall consist of: *(a)* a person who is, or has been, or is qualified to be a District Judge nominated by the State Government who shall be its President, *(b)* a person of eminence in the field of education, trade or commerce, and *(c)* a lady social worker.

Each State Commission shall consist of a person who is or has been a judge of a High Court, appointed by the State Government (who shall be its President) and two other members who shall be persons of ability, integrity and standing and have adequate knowledge or experience of or have shown capacity in dealing with problems relating to economics, law, commerce, accountancy, industry, public affairs or administration, one of whom shall be a woman.

The National Commission shall consist of a person who is or who has been a judge of the Supreme Court, appointed by the Central Government (who shall be its President) and two other members who shall be persons of ability, integrity and standing and have adequate knowledge or experience of or have shown capacity in dealing with problems relating to economics, law, commerce, accountancy, industry, public affairs or administration, one of whom shall be a woman.

A complaint where the value of the goods or services and the compensation, if any, is less than rupees five lakhs is to be dealt with the District Forum; where such value exceeds rupees five lakhs but does not exceed rupees twenty lakhs it is to be dealt with the State Commission and cases involving more than rupees twenty lakhs fall within the jurisdiction of the National Commission.

It is the value of the goods and services involved in the dispute that determines the redressal agency to deal with the dispute.

The State Commission will also entertain appeals against the orders of any District Forum within the State. Appeals against the orders of the State Commission can be made to the National Commission. Appeals against the orders of the National Commission can be made to the Supreme Court.

The State Commission is empowered to call for the records and pass appropriate orders in any consumer dispute which is pending before or has been decided by any District Forum within the State, where it appears to the State Commission that such District Forum has exercised a jurisdiction not vested in it by law, or has failed to exercise a jurisdiction so vested or has acted in exercise of its jurisdiction illegally or with material irregularity. The National Commission has similar jurisdiction over the State Commissions.

Consumer Complaints

A complaint, in relation to any goods sold or delivered or any service provided, may be filed with the redressal agency by:

(a) the consumer to whom such goods are sold or delivered or such service provided;

(b) any recognised consumer association, whether the aggrieved consumer is a member of such association or not;

(c) one or more consumers, where there are numerous consumers having the same interest; or

(d) the Central or State Government.

A consumer, consumer association, Central Government or a State Government can file a complaint with a redressal agency.

Remedial Action

If the consumer disputes redressal agency is satisfied that any of the allegations contained in the complaint is true, it shall issue an order to the opposite party directing him to take one or more of the following things, namely:

(i) to remove the defect pointed out by the appropriate laboratory from the goods in question;

(ii) to replace the goods with new goods of similar description which shall be free from all defects;

(iii) to return to the complainant the price, or, as the case may be, the charges paid by the complainant;

(iv) to pay such amount as may be awarded by it as compensation to the consumer for any loss or injury suffered by the consumer due to the negligence of the opposite party;

(v) to remove the defects or deficiencies in the services in question;

(vi) to discontinue the unfair/restrictive trade practice or not to repeat them;

(vii) not to offer the hazardous goods for sale;

(viii) to withdraw the hazardous goods from being offered for sale;

(ix) to provide for adequate costs to parties.

Penalties

If a trader or person against whom a complaint is made or the complainant fails or omits to comply with any order made by a redressal agency, he shall be punishable with imprisonment for any term not exceeding three years or with fine not exceeding ten thousand rupees or with both.

Conclusion

The Consumer Protection Act, 1986, which was modified by the Amendment Act of 1993, is a very important means to protect the consumer rights.

The Act has been hailed for the time frame set for the disposal of the cases. In fact, the Act envisages a simple, inexpensive and speedy redressal of consumer grievances related to defective goods, deficient services and unfair and restrictive trade practices. But several problems mentioned above come in the way of expeditious disposal of the cases.

The posts of president and/or other members of the fora remaining vacant are not uncommon. Many redressal agencies are not adequately staffed. They also suffer from financial problems.

Further, taking recourse to the law is affected by the lack of consumer awareness and education.

The effective functioning of the consumer redressal agencies and, consequently, the achievement of objectives of the Act, are hindered by several implementational problems and inadequate consumer actions.

One redeeming feature of the Consumer Protection Act is that it applies not only to the private sector but also to the public sector and government agencies. As against this, it may be noted that, the undertakings in the public and cooperative sectors and those undertakings the management of which has been taken over by the Government are exempted even from the provisions dealing with *unfair trade practices* under the MRTP Act.

SUMMARY

Consumers, all around the world, are victims of poor quality, unsafety, undermeasurement, adulteration and false promises. Indian consumers suffer and lose thousands of crores of rupees every year due to adulteration and quantity deceptions. Further, genuine companies, consumers and governments suffer huge losses due to fake products.

A reaction to these problems has been the growth of consumerism, which may be defined as a collective endeavour of the consumers to protect their interests, is a manifestation of the failure of the business, including that of the public sector, and the government to guarantee and ensure the legitimate rights of the consumers.

International organisations like the United Nations and Consumers International have a keen interest in fostering consumer protection measures throughout the world. The UN at the persuasion of the Consumers International has issued a set of guidelines for consumer protection measures.

Fig. 10.1 presents the important factors of consumer protection.

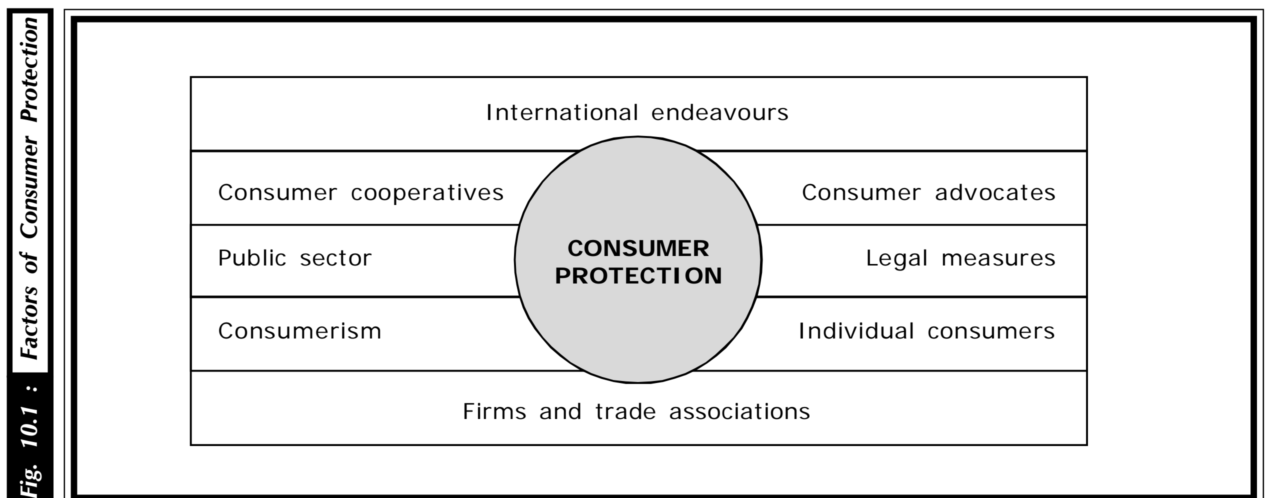

Fig. 10.1 : Factors of Consumer Protection

The most important legal measure to protect the consumer rights is the Consumer Protection Act, 1986. This Act provides for the establishment of a Central Consumer Protection Council by the Central Government and a State Consumer Protection Council in each State by the respective State Governments.

The objects of these Councils are to promote and protect the rights of the consumers such as: *(a)* the right to be protected against marketing of hazardous goods and services; *(b)* the right to be informed about the relevant factors about the goods and services so as to protect the consumer against unfair trade practices; *(c)* the right to reasonable choice; *(d)* the right to be heard; *(e)* the right to seek redressal of legitimate complaints; and *(f)* the right to consumer education.

Figure 10.2 depicts the consumer disputes redressal agencies under this Act.

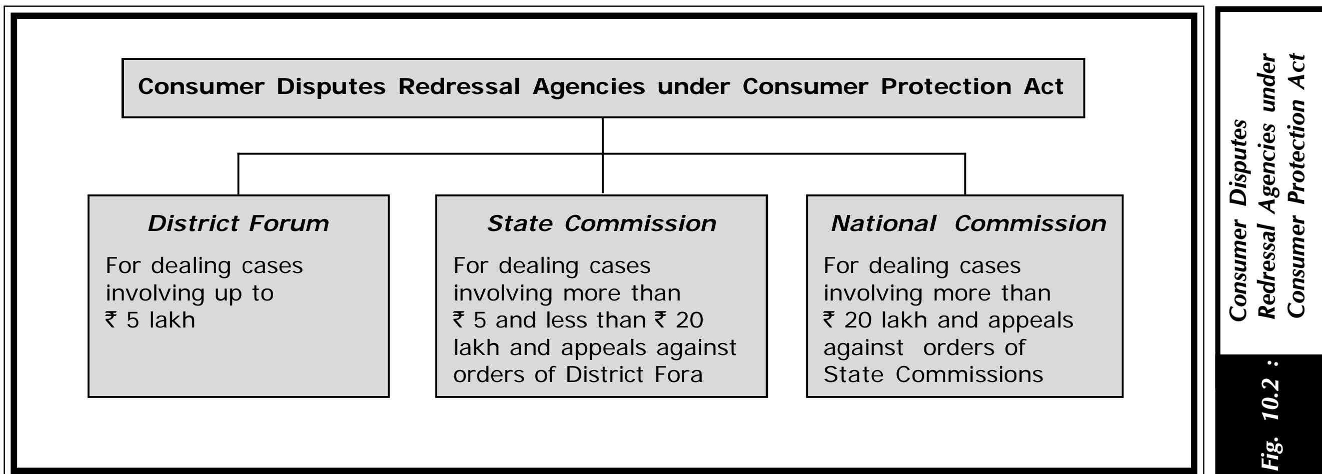

Fig. 10.2 : Consumer Disputes Redressal Agencies under Consumer Protection Act

If the consumer disputes redressal agency is satisfied that any of the allegations contained in a complaint made to it is true, it shall issue an order to the opposite party directing him to take one or more of the following things, namely: *(i)* to remove the defect from the goods in question; *(ii)* to replace the goods with new goods; *(iii)* to return to the complainant the price, or charges paid by him; *(iv)* to pay compensation to the consumer for any loss or injury suffered; *(v)* to remove the defects or deficiencies in the services in question; *(vi)* to discontinue the unfair/ restrictive trade practice or not to repeat them; *(vii)* not to offer the hazardous goods for sale; *(viii)* to withdraw the hazardous goods from being offered for sale and *(ix)* to provide for adequate costs to parties.

Failure to comply with any order made by a redressal agency shall be punishable with imprisonment or fine or both.

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Chapter 11

CORPORATE GOVERNANCE

Structure

- Meaning
- Reasons for the Growing Demand for Corporate Governance
- Importance of Corporate Governance
- Prerequisites
- Regulatory and Voluntary Actions
- Recommendations of Birla Committee
- Legal Environment of Corporate Governance in India
- Summary
- References

The objective of corporate governance is socially responsible, accountable and transparent management of the corporate, protecting and promoting the interests of the stakeholders.

The concept of corporate governance, which emerged as a response to corporate failures and widespread dissatisfaction with the way many corporates function, has become one of wide and deep discussions around the globe recently. Although it did not receive much attention until the dawn of the 1990s, it has became very popular with in a short period.

MEANING

Although the idea of corporate governance has received wide attention, there is considerable variations in the conceptual definition, even resulting in inconsistencies in the usage of the term.

BOX 11.1 : THE AIM AND PURPOSE OF CORPORATE GOVERNANCE

Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations, and society. The incentive to corporations and to those who own and manage them to adopt internationally accepted governance standards is that these standards will help them to achieve their corporate aims and to attract investment. The incentive for their adoption by states is that these standards will strengthen the economy and discourage fraud and mismanagement.

The foundation of any structure of corporate governance is disclosure. Openness is the basis of public confidence in the corporate system, and funds will flow to the centers of economic activity that inspire trust.

Sir Adrian Cadbury in the Foreword to M.R. Iskander and N. Chamlou, Corporate Governance: A Framework for Implementation.

In its narrowest sense, the term may describe the formal system of accountability of senior management to the shareholders. At its most expansive, the term is stretched to include the entire network of formal and informal relations involving the corporate sector and their consequences for the society in general. Corporate governance, however, as generally understood, includes the structure, process, cultures and systems that engender the successful operation of the organisations.[1]

"*Governance is the process whereby people in power make decisions that create, destroy or maintain social systems, structures and processes*. Corporate governance is, therefore, the process whereby people in power direct, monitor and lead corporations, and thereby either create, modify or destroy the structures and systems under which they operate. Corporate governors are both potential agents for change and also guardians of existing ways of working. As such, they are therefore a significant part of the fabric of our society."[2]

"The concept of corporate governance primarily hinges on complete transparency, integrity and accountability of the management... There is also an increasingly greater focus on investor protection and public interest."[3]

It is pointed out that "the concept of corporate governance is to some extent similar to the quality practices adopted under the ISO standard. The key question is to ensure how effectively organisations are managed. This would also include defining of the powers of Directors, particularly non-executive ones, making available information on the Company's current state of affairs to all the Directors, and systems control to ensure the authenticity, timeliness and effectiveness of the information."[4] According to the Kumar Mangalam Birla Committee, the fundamental objective of corporate governance is the "enhancement of long-term shareholder value while, at the same time, protecting the interests of other stakeholders."

BOX 11.2 : PUBLIC AND PRIVATE PERSPECTIVES OF CORPORATE GOVERNANCE

Just what constitutes corporate governance is still a topic of debate. From a corporation`s perspective, the emerging consensus is that corporate governance is about maximising value subject to meeting the corporation`s financial and other legal and contractual obligations. This inclusive definition stresses the need for boards of directors to balance the interests of shareholders with those of other stakeholders–employees, customers, suppliers, investors, communities–in order to achieve long-term sustained value for the corporation. From a public policy perspective, corporate governance is about nurturing enterprises while ensuring accountability in the exercise of power and patronage by firms. The role of public policy is to provide firms with the incentives and discipline to minimise the divergence between private and social returns and to protect the interests of stakeholders.

These two definitions–from public and private perspectives–provide a framework for corporate governance that reflects an interplay between internal incentives (which define the relationships among the keyplayers in the corporation) and external forces (notably policy; legal, regulatory; and market) that together govern the behaviour and performance of the firm.

M.R. Iskander and N. Chamlou, Corporate Governance: A Framework for Implementation.

Now, there is a growing recognition of the difference between corporate governance and corporate management and the need to align corporate management with corporate governance.

Corporate governance is concerned with the values, vision and visibility. It is about the value orientation of the organisation, ethical norms for its performance, the direction of development and social accomplishment of the organisation and the visibility of its performance and practices. "In short, the concept of good corporate governance connotes that ethics is as important as economics, fair play as crucial as financial success, morals as vital as market share."

Corporate management is concerned with the efficiency of the resource use, value addition and wealth creation within the broad parameters of the corporate philosophy established by corporate governance.

It is very relevant to note in this context that the Eicher Group has a two-tier board. At the top is the Corporate Board, consisting of veterans, which examines issues related to ethics, mission, vision and long-term direction. Below this is the Management Board of which the business heads are a part of, which oversees operations.

REASONS FOR THE GROWING DEMAND FOR CORPORATE GOVERNANCE

The need for greater transparency in corporate management and protection of interests of stakeholders led to growing demand for corporate governance.

Inadequacies and failures of an existing system often bring to the fore the need for norms and codes to remedy them. This is true of corporate governance too. In the UK, deficiencies in the Accounting Standards became more evident after many companies, in their eagerness to increase earnings and accelerate growth, exploited the weaknesses in the accounting standards to show inflated profits and understate liabilities. While companies grew phenomenally, accounting standards went haywire. The tendency to combine the roles of chairman and chief executive in one person and Board structures that were not conducive tended to make matters very undesirable. The resultant failure of several companies raised serious concerns regarding corporate governance and this eventually led to the appointment of the Sir Adrian Cadbury Committee on Corporate Governance by the London Stock Exchange and the Financial Reporting Council in Britain in 1991. Several other notable reports and codes on the subject were also published internationally, like the Report of the Greenbury Committee, the Combined Code of the London Stock Exchange, the OECD Code on Corporate Governance and The Blue Ribbon Committee on Corporate Governance in the US. In India, the CII has published a Code of Corporate Governance.

As Iskander and Chamlou observe, corporate governance becomes necessary because "the interests of those who have effective control over a firm can differ from the interests of those who

supply the firm with external finance. The problem, commonly referred to as a principal-agent problem, grows out of the separation of ownership and control and of corporate outsiders and insiders."[5]

The need for a system of corporate governance has been described by SEBI by pointing out the background of the appointment of the Kumar Mangalam Birla Committee on Corporate Governance.

There was an increasing concern about standards of financial reporting and accountability, especially after losses suffered by investors and lenders which could have been avoided, with better and more transparent reporting practices. Investors suffered on account of unscrupulous management of the companies, which have raised capital from the market at high valuations and have performed much worse than the past reported figures, leave alone the future projections at the time of raising money. Another example of bad governance had been the allotment of promoter's shares, on preferential basis at preferential prices, disproportionate to market valuation of shares, leading to further dilution of wealth of minority shareholders. This practice has, however, since been contained.

There were also many companies, which are not paying adequate attention to the basic procedures for shareholders' service; *for example,* many of these companies do not pay adequate attention to redress investors' grievances such as delay in transfer of shares, delay in despatch of share certificates and dividend warrants and non-receipt of dividend warrants; companies also do not pay sufficient attention to timely dissemination of information to investors as also to the quality of such information. While enough laws existed to take care of many of these investor grievances, the implementation and inadequacy of penal provisions left a lot to be desired.

Corporate governance is considered an important instrument of investor protection, and it is, therefore, a priority on SEBI's agenda.

To further improve the level of corporate governance, need was felt for a comprehensive approach at this stage of development of the capital market, to accelerate the adoption of globally acceptable practices of corporate governance. This would ensure that the Indian investors are in no way less informed and protected as compared to their counterparts in the best-developed capital markets and economies of the world.

Securities market regulators in almost all developed and emerging markets have for sometime been concerned about the importance of the subject and of the need to raise the standards of corporate governance. The financial crisis in the Asian markets in the recent past have highlighted the need for improved level of corporate governance and the lack of it in certain countries have been mentioned as one of the causes of the crisis. Indeed, corporate governance has been a widely discussed topic at the recent meetings of the International Organisation of Securities Commissions (IOSCO). Besides in an environment in which emerging markets increasingly compete for global capital, it is evident that global capital will flow to markets which are better regulated and observe higher standards of transparency, efficiency and integrity. Raising standards of corporate governance is, therefore, also extremely relevant in this context.

Confronted with the above problems and enlightened by the developments in the sphere of corporate governance in other countries, there has been an all-round eagerness in corporate India to adopt good corporate governance. Two sets of factors have contributed to this trend. There is a necessitating set of factors and a facilitating set of factors. One important necessitating factor is the mandatory requirement resulting from the recommendations of the Birla Committee on Corporate Governance set up by the SEBI. Another necessitating factor has something to do with the liberalisation. The foreign investors, collaborators and buyers have been demanding more transparency in respect of the functioning of the Indian corporates. Thirdly, the Indian investors have become more keen on good corporate governance. An important facilitating factor is that there is a growing awareness and enthusiasm in the corporate India to embrace good corporate governance. Many captains of industry, corporate leaders and top executives are keen to usher

in good corporate governance. In fact, a few years prior to the formation of the Birla Committee, the path for good corporate governance was paved by the Draft Code on Desirable Corporate Governance drawn up by the Confederation of Indian Industries (CII).

IMPORTANCE OF CORPORATE GOVERNANCE

The preface to the Birla Committee Report has highlighted the significance and need for good corporate governance. The salient points are reproduced here. It is almost a truism that the adequacy and the quality of corporate governance shape the growth and the future of any capital market and economy. Progressive firms in India have voluntarily put in place systems of good corporate governance. Internationally also, while this topic has been accepted for a long time, the financial crisis in emerging markets has led to renewed discussions and inevitably focused them on the lack of corporate as well as governmental oversight. The same applies to recent high-profile financial reporting failures even among firms in the developed economies. Focus on corporate governance and related issues is an inevitable outcome of a process, which leads firms to increasingly shift to financial markets as the pre-eminent source for capital. In the process, more and more people are recognising that corporate governance is indispensable to effective market discipline. This growing consensus is both an enlightened and a realistic view. In an age where capital flows worldwide, just as quickly as information, a company that does not promote a culture of strong, independent oversight, risks its very stability and future health. As a result, the link between a company's management, directors and its financial reporting system has never been more crucial. As the boards provide stewardship of companies, they play a significant role in their efficient functioning.

The concept of corporate governance is no longer confined to the halls of academia and is increasingly finding acceptance for its relevance and underlying importance in the industry and capital markets.

Studies of firms in India and abroad have shown that markets and investors take notice of well-managed companies, respond positively to them, and reward such companies, with higher valuations. A common feature of such companies is that they have systems in place, which allow sufficient freedom to the boards and management to take decisions towards the progress of their companies and to innovate, while remaining within a framework of effective accountability. In other words, they have a system of good corporate governance.

Strong corporate governance is, thus, indispensable to resilient and vibrant capital markets and is an important instrument of investor protection. It is the blood that fills the veins of transparent corporate disclosure and high-quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure. Without financial reporting premised on sound, honest numbers, capital markets will collapse upon themselves.

Another important aspect of corporate governance relates to issues of insider trading. It is important that insiders do not use their position of knowledge and access to inside information about the company, *and* take unfair advantage of the resulting information asymmetry. To prevent this from happening, corporates are expected to disseminate the material price-sensitive information in a timely and proper manner and also ensure that till such information is made public, insiders abstain from transacting in the securities of the company. The principle should be 'disclose or desist'. This, therefore, calls for companies to devise an internal procedure for adequate and timely disclosures, reporting requirements, confidentiality norms, code of conduct and specific rules for the conduct of its directors and employees and other insiders. However, the need for such procedures, reporting requirements and rules also goes beyond corporates to other entities in the financial markets such as Stock Exchanges, Intermediaries, Financial Institutions, Mutual Funds and concerned professionals who may have access to inside information.

Good corporate governance, besides protecting the interests of shareholders and all other stakeholders, contributes to the efficiency of a business enterprise, to the creation of wealth and to the country's economy.

According to Charkham, good corporate governance is considered vital from medium- and long-term perspectives to enable firms to compete internationally in sustained way and make

them flourish and grow so as to provide employment, wealth and satisfaction, not only to improve standard of living materially but also to enhance social cohesion.[6]

PREREQUISITES

A review of the literature on corporate governance, including the Reports of Various Committees, suggests that there are some prerequisites for good corporate governance. They are:

- A proper system consisting of clearly defined and adequate structure of roles, authority and responsibility.
- Vision, principles and norms which indicate development path, normative considerations, and guidelines and norms for performance.
- A proper system for guiding, monitoring, reporting and control.

REGULATORY AND VOLUNTARY ACTIONS

The Organisation for Economic Cooperation and Development (OECD) formed the Business Sector Advisory Group in 1996 and a task force to distill a set of core principles of good corporate governance. The advisory group's report (OECD, 1998) emphasised that good corporate governance can best be achieved through a combination of *regulatory* and *voluntary private actions*.

On the regulatory side, it noted that government interventions are most effective when consistently and expeditiously enforced. They should focus on:[7]

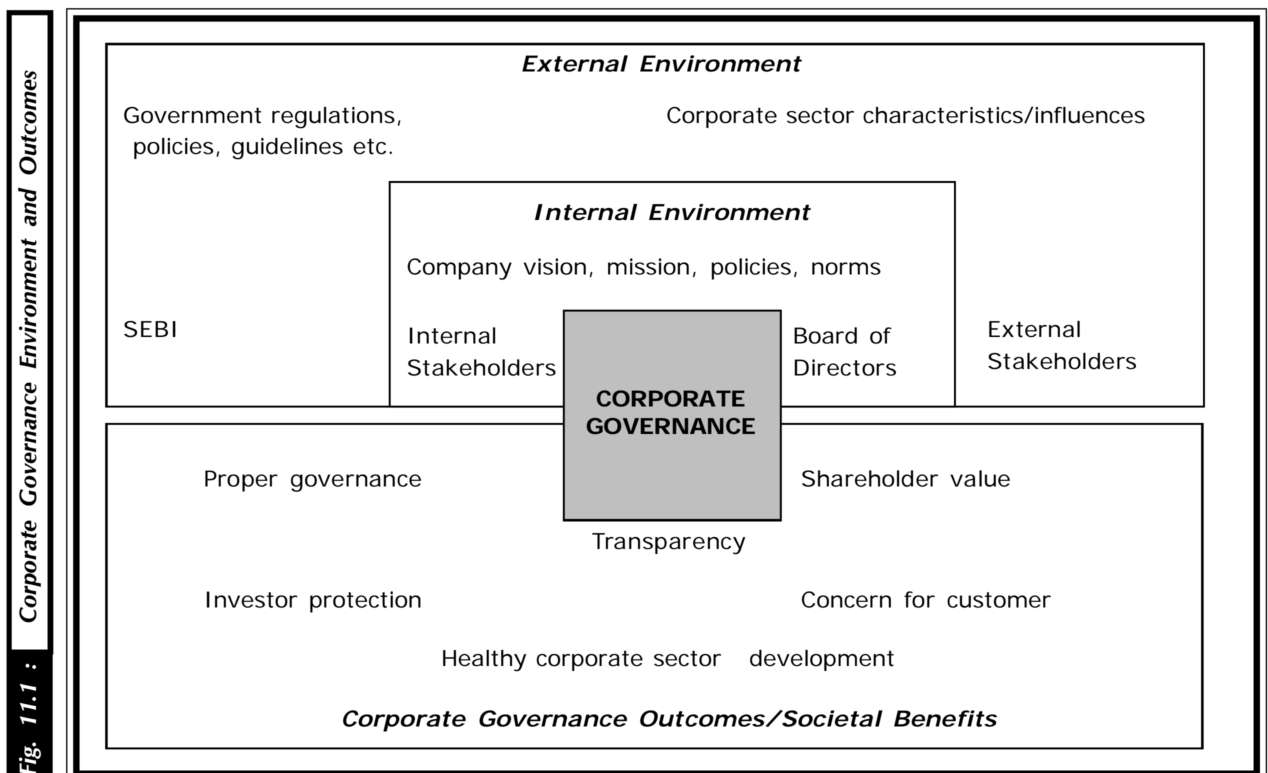

Fig. 11.1 : Corporate Governance Environment and Outcomes

- ***Fairness:*** protecting shareholder rights and ensuring the enforceability of contracts with resource providers.
- ***Transparency:*** requiring timely disclosure of adequate information on corporate financial performance.
- ***Accountability:*** clarifying governance roles and responsibilities and supporting voluntary efforts to ensure the alignment of managerial and shareholder interests, as monitored by a board of directors—or in certain nations, a board of auditors—with some independent members.
- ***Responsibility:*** ensuring corporate compliance with the other laws and regulations that reflect society's values, including a broad sensitivity to the objectives of the society in which corporations operate.

The report also stressed that regulations, however well enforced, are not enough to promote best practices. Equally important are the *voluntary actions* of firms in setting up codes of conduct and the influence of an array of "reputational" agents that can pressure firms to comply with good governance practices.

The real impulse for good corporate governance should come from within the top echelons of the organisation.

RECOMMENDATIONS OF BIRLA COMMITTEE

The Birla Committee Report is the first formal and comprehensive attempt to evolve a Code of Corporate Governance, in the context of prevailing conditions of governance in Indian companies, as well as the state of capital markets.

The Committee felt that some of the recommendations are absolutely essential for the framework of corporate governance and virtually form its core, while others could be considered as desirable. Besides, some of the recommendations may also need change of statute, such as the Companies Act, for their enforcement. In the case of others, enforcement would be possible by amending the Securities Contracts (Regulation) Rules, 1957, and by amending the listing agreement of the stock exchanges under the direction of SEBI. The latter, would be less time-consuming and would ensure speedier implementation of corporate governance. The Committee, therefore, felt that the recommendations should be divided into mandatory and non-mandatory categories.

The mandatory recommendations are those recommendations which are absolutely essential for corporate governance can be defined with precision and which can be enforced through the amendment of the listing agreement. Others, which are either desirable or which may require change of laws, are, for the time being, classified as ***non-mandatory***.

A right composition of the Board of Directors is essential for good corporate governance.

Applicability: The recommendations will apply to all the listed private and public sector companies, in accordance with the schedule of implementation. As for listed entities, which are not companies, but body corporates (*e.g.*, private and public sector banks, financial institutions, insurance companies etc.) incorporated under other statutes, the recommendations will apply to the extent that they do not violate their respective statutes, and guidelines or directives issued by the relevant regulatory authorities. The recommendations are applicable to all entities seeking listing for the first time, at the time of listing. It will be applicable to all the existing listed companies or entities in a phased manner, so that by March 2003 it will be applied to all listed companies with paid-up share capital of ₹ 3 crore and above. This is a mandatory recommendation.

Board of Directors: Both the Birla Committee Report and the CII Code, which have underscored the role of the Board of Directors in ensuring good corporate governance, have recommended that the Board of Directors should have an optimum combination of executive and

non-executive directors. The non-executive directors should comprise at least 30 per cent of the Board if one of them is the chairman. The non-executive directors should comprise at least 50 per cent of the board if the chairman and the managing director is the same person. The Birla Committee has also laid down that this minimum number of executive directors should also be independent executive directors. (Independent directors are directors who apart from receiving director's remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgement of the board may affect their independence of judgement. Further, all pecuniary relationships or transactions of the non-executive directors should be disclosed in the annual report). This is a mandatory recommendation. The Birla Committee has also suggested that, in principle, the chairman's role should be different from that of the CEO.

The Committee has also recommended that when a nominee of the institutions is appointed as a director of the company, he should have the same responsibility, be subject to the same discipline and be accountable to the shareholders in the same manner as any other director of the company.

The CII Code has also laid down that no individual should be a director on the boards of more than 10 companies at any given time; non-executive directors should be active, have defined responsibilities, and be conversant with P & L accounts; directors who have not been present for at least 50 per cent of board meetings should not be reappointed. The Board should be informed of operating plans and budgets, long-term plans, quarterly divisional results, and internal audit reports. Details of defaults, payments for intangibles, foreign exchange exposure, and managers' remuneration should be reported to the Board.

Audit Committee and Remuneration Committee: One of the items of the CII Code is that there should be an Audit Committee, which shall have access to all financial information. The Birla Committee has recommended an Audit Committee to act as a catalyst for effective financial reporting, with powers to investigate any activity within its terms of reference and to seek information from any employee. According to this mandatory recommendation, the major role of the Audit Committee appointed by the Board of Directors is the oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.

With a view that a company must have a credible and transparent policy in determining and accounting for the remuneration of the director, the Committee has made a non-mandatory recommendation that the Board should set up a remuneration committee to determine the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment.

The Companies (Amendment) Act, 2000, has incorporated provisions regarding Audit Committee. For details, see the section on *The Companies (Amendment) Act, 2000* in the chapter on *Indian Company Law*.

Accounting Standards and Financial Reporting: The Committee has made some recommendations with a view to upgrade the financial reporting and accounting standards in India. Accordingly, companies are required to give consolidated accounts in respect of all its subsidiaries in which they hold 51% or more of the share capital. Equally, in cases of companies with several businesses, it is important that financial reporting in respect of each product segment should be available to shareholders and the market to obtain a complete financial picture of the company. The Institute of Chartered Accountants of India is to be requested to issue the Accounting Standards for consolidation expeditiously. Disclosure and treatment of related party transactions norms are also to be finalised by the ICA.

Management: While the Board is responsible for ensuring that the principles of corporate governance are adhered to and enforced, the real onus of implementation lies with the management which is responsible for translating into action the policies and strategies of the Board and implementing its directives to achieve corporate objectives of the company framed by the Board. It is, therefore, essential that the board should clearly define the role of the management. The Committee, therefore, suggested that the management, which comprises the Chief Executive, Executive-directors and the key managers of the company, involved in day-to-day activities of the company, should carry out the following functions:

The management of the company is assigned a number of responsibilities for ensuring proper governance.

- Assisting the board in its decision-making process in respect of the company's strategy, policies, code of conduct and performance targets, by providing necessary inputs.
- Implementing the policies and code of conduct of the board.
- Managing the day-to-day affairs of the company to best achieve the targets and goals set by the board, to maximise the shareholder value.
- Providing timely, accurate, substantive and material information, including financial matters and exceptions, to the board, board committees and the shareholders.
- Ensuring compliance of all regulations and laws.
- Ensuring timely and efficient service to the shareholders and to protect shareholder's rights and interests.
- Setting up and implementing an effective internal control systems, commensurate with the business requirements.
- Implementing and complying with the Code of Conduct as laid down by the board.
- Cooperating and facilitating efficient working of board committees.

As a part of the disclosure related to Management, the Committee recommends that as part of the directors' report or as an addition thereto, a Management Discussion and Analysis Report should form part of the annual report to the shareholders. This Management Discussion and Analysis should include discussion on the following matters within the limits set by the company's competitive position: Industry structure and developments; opportunities and threats; segment-wise or product-wise performance; outlook; risks and concerns; internal control systems and their adequacy; discussion on financial performance with respect to operational performance; and, material developments in human resources/industrial relations front, including number of people employed.

These are mandatory recommendations.

Shareholders: The shareholders are the owners of the company and as such they have certain rights and responsibilities. A good corporate framework is one that provides adequate avenues to the shareholders for effective contribution in the governance of the company while insisting on a high standard of corporate behaviour without getting involved in the day-to-day functioning of the company.

The basic rights of the shareholders include right to transfer and registration of shares, obtaining relevant information on the company on a timely and regular basis, participating and voting in shareholder meetings, electing members of the board and sharing in the residual profits of the corporation.

The Committee believes that the General Body Meetings provide an opportunity to the shareholders to address their concerns to the board of directors and comment on and demand any explanation on the annual report or on the overall functioning of the company. It is important that the shareholders use the forum of general body meetings for ensuring that the company is being properly stewarded for maximising the interests of the shareholders. This is important especially in the Indian context. It follows from the above, that for effective participation, shareholders must maintain decorum during the General Body Meetings.

The effectiveness of the board is determined by the quality of the directors and the quality of the financial information is dependent to an extent on the efficiency with which the auditors carry on their duties. The shareholders must, therefore, show a greater degree of interest and involvement in the appointment of the directors and the auditors. Indeed, they should demand complete information about the directors before approving their directorship.

The Committee has, recommended that as shareholders have a right to participate in, and be sufficiently informed on decisions concerning fundamental corporate changes, they should not only be provided information as under the Companies Act, but also in respect of other decisions relating to material changes such as takeovers, sale of assets or divisions of the company and changes in capital structure which will lead to change in control or may result in certain shareholders obtaining control disproportionate to the equity ownership.

The Committee has recommended that information like quarterly results, presentation made by companies to analysts may be put on company's website or may be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own website.

The Committee has also recommended that the institutional shareholders take an active interest in the composition of the Board of Directors and evaluate the corporate governance performance of the company.

Conclusion: The Committee also took note of the various steps already taken by SEBI for strengthening corporate governance, some of which are:

- Strengthening of disclosure norms for Initial Public Offers following the recommendations of the Committee set up by SEBI under the Chairmanship of Shri Y.H. Malegam.
- Providing information in directors' reports for utilisation of funds and variation between projected and actual use of funds according to the requirements of the Companies Act; inclusion of cash flow and funds flow statement in annual reports.
- Declaration of quarterly results.
- Mandatory appointment of compliance officer for monitoring the share transfer process and ensuring compliance with various rules and regulations.
- Timely disclosure of material and price-sensitive information including details of all material events having a bearing on the performance of the company.
- Despatch of one copy of complete balance sheet to every household and abridged balance sheet to all shareholders.
- Issue of guidelines for preferential allotment at market-related prices.
- Issue of regulations providing for a fair and transparent framework for takeovers and substantial acquisitions.

With the Birla Committee Report, the stage is set for ushering in good corporate governance in India. The codes are to be implemented through the stock exchanges. While new listings would have to comply with the norms immediately, companies with a minimum capital of ₹ 10 crore and net worth of ₹ 25 crore would have to adhere to the corporate governance guidance by April 2000. It is heartening to note that even before many codes have been made mandatory, several companies have voluntarily adhered to the codes suggested by the CII. It is obvious that a vital missing factor was a generally accepted set of codes and guidepost.

BOX 11.3 : NATIONAL CORPORATE GOVERNANCE AWARD

While presenting the Union Budget for 1999-2000, the finance minister announced the institution of national award for excellence in corporate governance.

The award, instituted by the union finance ministry and sponsored by the Unit Trust of India (UTI), is aimed at strengthening investor confidence in the capital markets by encouraging Indian companies to follow internationally accepted practices of corporate governance.

The first award was bagged by Infosys Technologies. (See Box 1, in Chapter 1, for a brief description of Infosys.)

Tata Steel has won the award for 2000. According to the panel of judges for the selection of the company for the award, Tata Steel`s Board, comprising a large proportion of independent directors, enjoys the professional freedom to provide direction to the company. Further, the disclosures in its annual reports about its strategies, current state of affairs, plans, operations, finances and initiatives in the social domain, contributed to the award being announced in its favour.

The company also has an effective system of communicating with shareholders, stock exchanges and the general public. It has also set in place practices and procedures that enable it to maintain friendly investor relations.

Other reasons cited for bestowing the award on Tata Steel included employee relations, support of rural and community development programmes, implementation of the ISO 14001 environment management system and also the driving change within the company in terms of knowledge management systems, people processes and performance ethics.

LEGAL ENVIRONMENT OF CORPORATE GOVERNANCE IN INDIA

The legal framework of corporate governance in India is provided mostly by the Companies Act, 1956, which had been amended several times and which was replaced by the Companies Act 2013; the Securities and Exchange Board of India Act, 1992 and the Securities Contracts (Regulation) Act, 1956. Some other laws like the Depositories Act, 1996, and Competition Act, 2002, also have relevance to corporate governance.

The banking sector is regulated by the Reserve Bank of India (RBI) and the insurance companies by the Insurance Regulatory and Development Authority (IRDA), an autonomous body set up under the IRDA Act, 1999. The mission of IDRA is to protect the interests of policyholders, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto.

The Telecom Regulatory Authority of India (TRA/), established under the Telecom Regulatory Authority of India Act, 1997, regulates the telecommunication, and services, and matters connected therewith or incidental thereto.

The Companies Act is administered by the Ministry of Corporate Affairs (MCA) and the provisions of the Companies Act are enforced by the Company Law Board.

The stock exchanges, regulated by the Securities Contracts (Regulations) Act, 1956, and the Equity Listing Agreement under it, have a substantial role in corporate governance. Every listed company needs to comply with the provisions of the listing agreement as per Section 21 of this Act. Non-compliance with the same would lead to delisting or monetary penalties under Act. Further, the Securities and Exchange Board of India (SEBI) can prescribe conditions for listing. As mentioned earlier, SEBI introduced the Clause 49 in the Listing agreement of the Stock Exchanges in the year 2000 to enforce and advocate a number of corporate governance norms and practices.

The stock market regulator SEBI, established under the Securities and Exchange Board of India Act, 1992, has a profound role in ensuring good corporate governance. The SEBI is empowered to regulate the business in stock exchanges and any other securities markets to protect the interests of investors in securities. See *Appendix 4.1* for details of the functions of SEBI.

Companies Act, 1956, by amendments (particularly since 2000), has provided for basic framework for regulation of all the companies. Certain provisions were incorporated in the Act itself to provide for checks and balances over the powers of Board, *viz.*:

- Loan to directors or relatives or associated entities (need CG permission).
- Interested contract needs Board resolution and to be entered in register.
- Interested directors not to participate or vote.
- Appointment of director or relatives for office or place of profit needs approval by shareholders. If the remuneration exceeds prescribed limit, CG approval required.
- Audit Committee for Public companies having paid-up capital of ₹ 5 crore.
- Shareholders holding 10 per cent can appeal to Court in case of oppression or mismanagement.

In Companies Act, 1956, SEBI has been given power to administer provisions pertaining to issue and transfer of securities and non-payment of dividend.

In the Companies Act 2013, which has replaced the Companies Act, 1956, various new provisions have been included (which are not provided for in Companies Act, 1956) for better governance of the companies. Some of these new provisions are:

- Requirement to constitute remuneration and nomination committee and Stakeholders' Grievances Committee.
- Granting of More powers to Audit Committee.
- Specific clause pertaining to duties of Directors.
- Mode of appointment of Independent Directors and their tenure.
- Code of Conduct for Independent Directors.
- Rotation of Auditors and restriction on Auditors for providing non-audit services.
- Enhancement of liability of Auditors.
- Disclosure and approval of RPTs.
- Mandatory Auditing Standards.
- Enabling Shareholders Associations/Group of Shareholders for taking class action suits and reimbursement of the expenses out of Investor Education and Protection Fund.
- Constitution of National Financial Reporting Authority, an independent body to take action against the Auditors in case of professional misconduct.
- Requirement to spend on CSR activities.
- Provision that Central Government shall establish an office namely Serious Fraud Investigation Office to investigate frauds relating to a company).

The Companies Act, 2013, contains detailed provisions pertaining to corporate governance. The new Act would necessitate revisiting of the entire Clause 49 to make it consistent with the

Companies Act. However, SEBI can impose more stringent conditions to the listed companies through listing agreement, than those envisaged in the Companies Act, considering the need to have better governance practices in the listed companies, provided those provisions are not derogatory to the provisions of the enactment.

Present Status of Corporate Governance in India

There has been a very commendable progress on the corporate governance scenario in India, prompted by the regulatory developments and enlightened by the propagation (by international and national organisations, including industry associations) of the need for and virtues of proper corporate governance.

Two sets of factors have contributed to the advances on the corporate governance front. *There is a necessitating set of factors* and *a facilitating set of factors*.

One important necessitating factor is the mandatory requirements, enforced since the recommendations of the Birla Committee on Corporate Governance set up by the SEBI.

Another necessitating factor has something to do with the liberalisation. The foreign investors, collaborators and buyers have been demanding more transparency in respect of the functioning of the Indian corporates.

Thirdly, the Indian investors have become more keen on good corporate governance.

An important facilitating factor is that there is a growing awareness and enthusiasm in the corporate India to embrace good corporate governance. Many captains of industry, corporate leaders and top executives have been keen to usher in good corporate governance. In fact, a few years prior to the formation of the Birla Committee, the path for good corporate governance was paved by the Draft Code on Desirable Corporate Governance drawn up by the Confederation of Indian Industries (CII).

The developments described in this section have put in place in India a corporate governance framework on par with the best in the world. The corporate governance system, however, continues to evolve across the world.

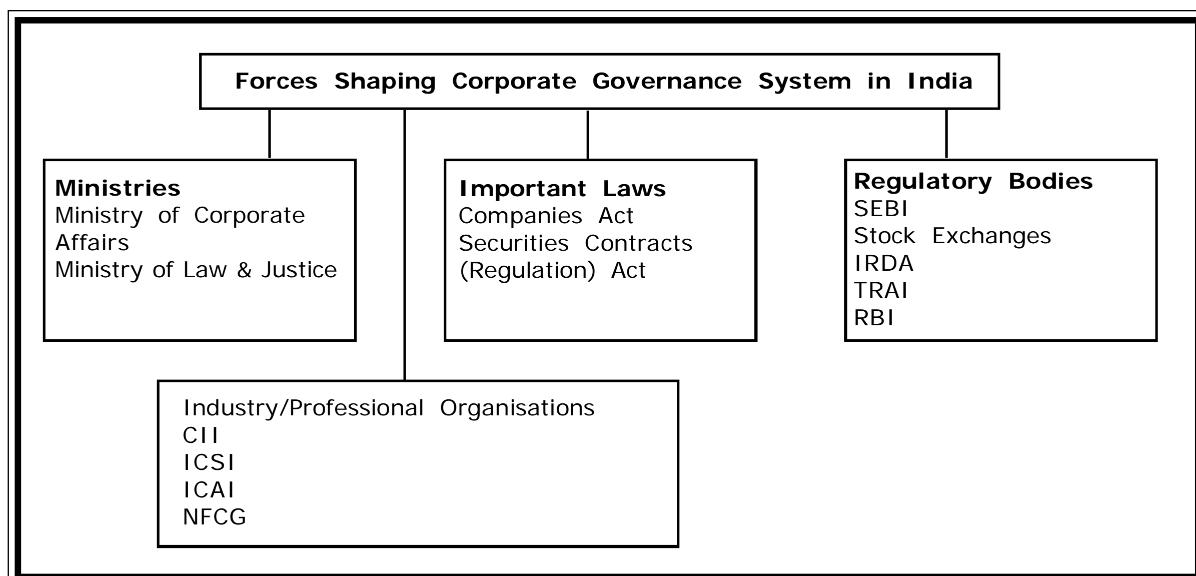

Fig. 11.2: The External Environment Shaping Governance in India

SUMMARY

Corporate failures and widespread dissatisfaction with the way many corporates function have led to the realisation, globally, of the need to put in place a proper system for corporate governance.

"Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations, and society. The incentive to corporations and to those who own and manage them to adopt internationally accepted governance standards is that these standards will help them to achieve their corporate aims and to attract investment. The incentive for their adoption by states is that these standards will strengthen the economy and discourage fraud and mismanagement."

Corporate governance is concerned with the values, vision and visibility. It is about the value orientation of the organisation, ethical norms for its performance, the direction of development and social accomplishment of the organisation and the visibility of its performance and practices. Corporate management is concerned with the efficiency of the resource use, value addition and wealth creation within the broad parameters of the corporate philosophy established by corporate governance.

There are some prerequisites for good corporate governance: (1) A proper system consisting of clearly defined and adequate structure of roles, authority and responsibility. (2) Vision, principles and norms which indicate development path, normative considerations, and guidelines and norms for performance. (3) A proper system for guiding, monitoring, reporting and control.

Birla Committee Report

The Report of the Committee on Corporate Governance, set up by the SEBI, under the chairmanship of Kumar Mangalam Birla, is the first formal and comprehensive attempt to evolve a Code of Corporate Governance, in the context of prevailing conditions of governance in Indian companies, as well as the state of capital markets.

A summary view of the salient aspects of the Birla Committee Report excerpted from the *Preface* to the Report is given below.

At the heart of the Committee's report is the set of recommendations which distinguishes the responsibilities and obligations of the boards and the management in instituting the systems for good corporate governance and emphasises the rights of shareholders in demanding corporate governance. Many of the recommendations are mandatory. For reasons stated in the report, these recommendations are expected to be enforced on the listed companies for initial and continuing disclosures in a phased manner within specified dates, through the listing agreement. The companies will also be required to disclose separately in their annual reports, a report on corporate governance delineating the steps they have taken to comply with the recommendations of the Committee. This will enable shareholders to know, where the companies, in which they have invested, stand with respect to specific initiatives taken to ensure robust corporate governance. The implementation will be phased. Certain categories of companies will be required to comply with the mandatory recommendations of the report during the financial year 2000-01, but not later than March 31, 2001, and others during the financial years 2001-02 and 2002-03. For the non-mandatory recommendations, the Committee hopes that companies would voluntarily implement these. It has been recommended that SEBI may write to the appropriate regulatory bodies and governmental authorities to incorporate where necessary, the recommendations in their respective regulatory or control framework.

The Committee, however, felt that under Indian conditions a statutory rather than a voluntary code would be far more purposive and meaningful, at least in respect of essential features of corporate governance. The Committee, however, recognised that a system of control should not so hamstring the companies so as to impede their ability to compete in the marketplace. The Committee believes that the recommendations made in this report mark an important step forward and if accepted and followed by the industry, they would raise the standards in corporate governance, strengthen the unitary board system, significantly increase its effectiveness and ultimately serve the objective of maximising shareholder value.

The Committee has identified the three key constituents of corporate governance as the Shareholders, the Board of Directors and the Management and has attempted to identify in respect of each of these constituents, their roles and responsibilities as also their rights in the context of good corporate governance. Fundamental to this examination and permeating throughout this exercise is the recognition of the three key aspects of corporate governance, namely; accountability, transparency and equality of treatment for all stakeholders.

The pivotal role in any system of corporate governance is performed by the board of directors. It is accountable to the stakeholders and directs and controls the Management. It stewards the company, sets its strategic aim and financial goals and oversees their implementation, puts in place adequate internal controls and periodically reports the activities and progress of the company in a transparent manner to the stakeholders. The shareholders' role in corporate governance is to appoint the directors and the auditors and to hold the board accountable for the proper governance of the company by requiring the board to provide them periodically with the requisite information, in a transparent fashion, of the activities and progress of the company. The responsibility of the management is to undertake the management of the company in terms of the direction provided by the board, to put in place adequate control systems and to ensure their operation and to provide information to the board on a timely basis and in a transparent manner to enable the board to monitor the accountability of Management to it.

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Part 3

INDUSTRIAL POLICIES AND REGULATIONS

The industrial policies and regulations determine, to a large extent, business opportunities and threats. They also set certain limits and norms for the conduct of the business.

Government of India's policies and regulations have affected the pattern and pace of development not only of the industrial sector but also the economy in general.

Until 1991, the scope of the private sector industry was very limited because of the prominence given to the public sector in the industrial policy. Large firms, in particular, were subjected to very severe restrictions. The industrial policy announced in 1991 marked the dawn of a new business environment in India.

This *Part* presents some of the salient features of the industrial policy and regulatory environment. It reviews the industrial policy and licensing, and the changing role/scope of the public and private sectors, including privatisation. It also deals with some specific regulations, *viz.,* the Company Law, regulations in respect of Patents and Trade Marks and Competition Law.

Chapter 12

INDUSTRIAL POLICY

Structure

Industrial Policy up to 1991

The New Industrial Policy

An Evaluation of the New Policy

Summary

Annexure 12.1: Schedules to Industrial Policy Resolution, 1956

The pattern and pace of development of the economy are significantly influenced by industrial policy.

There is no other economic policy in India which has so dominantly determined the pattern and direction of development of the economy as the Industrial Policy. To a large extent, the Industrial Policy reflected the socio-economic and political ideology of development. Indeed, the Industrial Policy Resolution of 1956, the fundamental principles of which reined until 1991, was described by some people as the Economic Constitution of India.

The Industrial Policy indicated the respective roles of the public, private, joint and cooperative sectors; small, medium and large scale industries and underlined the national priorities and the economic development strategy. It also expressed government's policy towards foreign capital and technology, labour policy, tariff policy etc. in respect of the industrial sector. In short, the industrial development, and thereby the economic development to a very significant extent, has been guided, regulated and fostered by the industrial policy.

The Industrial Policy of Government of India and the regulatory measures introduced to achieve the policy objectives had been matters of severe controversy. While the industrialists and many others in India and abroad and many foreign governments and international development organisations regarded the policy as too restrictive and the regulations and procedures too cumbersome and perplexing, the leftists in India had been demanding a more restrictive regime.

The industrial policy and regulation had grown more and more restrictive until about the mid-seventies. Having realised the deleterious effects of the restrictive regime, the 1980s saw a very slow process of liberalisation. In tune with the economic reforms ushered in 1991, the Industrial Policy too underwent a drastic change.

The industrial policy regime of India is broadly divided into controlled era (until 1991) and liberalised era.

The era deregulation ushered in by the Narasimha Rao government in 1991 is an open acknowledgement of the failure of the control regime to deliver the goods. The Indian planners were fascinated and influenced by the Russian model so that the development strategy in India was directed towards creating *socialist pattern of society*. It is interesting to note that, following the introduction of political and economic reforms in the erstwhile USSR, the Soviet newspaper *Izvestia,* which observed that many elements of the Indian economic system were borrowed from the Soviet model, stated that the main culprit for the present economic crisis in India was the obsolete economic system based on socialism.

The following pages provide the salient features of the industrial policy of India up to 1991, very briefly, and the new policy. A detailed account of the policy until 1991 is available in the old editions of the author's *Business and Government* and *Business Environment*.

INDUSTRIAL POLICY UP TO 1991

Until 1991, the industrial policy of India envisaged a dominant role for the public sector and a subordinate and supplementary role for the private sector.

The industrial policy of India prior to the liberalisation ushered in 1991 was characterised by the following features.

Reservation of Industries

1. Future development of most of the import industries was exclusively reserved for the public sector.
2. Manufacture of a large number (over 850 in 1991) of items was reserved for the small-scale sector.

Dominance of Public Sector

The policy of the Government was to ensure that the public sector gained control over the *commanding heights* of the economy. The *Industrial Policy Resolution of 1948* established public sector monopoly/near monopoly in 9 industries.

The *Industrial Policy Resolution of 1956,* brought out in the light of the adoption by the Parliament of the *socialist pattern of society* as the national goal and the Second Five Year Plan model which gave emphasis to the basic and heavy industries, further expanded substantially the role of the public sector.

Future development of 17 most important industries was exclusively reserved for the public sector (Schedule A). Further, public sector was assigned priority for establishment of new units in 12 most important of the remaining industries (Schedule B). See *Annexure 11.1* for the list of industries in Schedules A and B.

The public sector also established its monopoly or dominance in several other industries which did not belong to any of the above two categories of industries. This was done by the government by not giving licence to the private enterprises or by nationalisation.

Entry and Growth Restrictions

There were a number of entry and growth restrictions on the private sector (particularly on the large firms and foreign firms) even in respect of industries where the private sector was allowed. A licence was mandatory for establishing new units with investments above a specified limit, for manufacturing new products and for substantial expansion of existing undertakings.

Large firms (having assets, including those of interconnected undertakings, of ₹ 100 crore or more) and dominant undertakings (*i.e.,* those having a market share of 25 per cent or more) had to obtain clearance under the Monopolies and Restrictive Trade Practices (MRTP) Act, in addition to the industrial licence, for establishing new undertakings, substantial expansions and manufacture of new items. There were also restrictions on import of capital goods etc.

Restrictions on Foreign Capital and Technology

The scope of use of foreign capital and technology was limited. Even in industries where foreign capital was allowed, it was normally subject to a ceiling of 40 per cent of the total equity, although exceptions were allowed in certain cases. Operations of foreign companies in India and issue of securities abroad by Indian companies were regulated under the Foreign Exchange Regulation Act (FERA), 1973.

THE NEW INDUSTRIAL POLICY

The Industrial Policy announced on July 24, 1991, which heralded the economic reforms in India, has enormously expanded the scope of the private sector by opening up most of the industries for the private sector and substantially dismantling the entry and growth restrictions. Adjectives such as 'dramatic', 'revolutionary', 'drastic' etc. have been used to describe the nature of the change in the industrial policy.

The industrial policy reforms ushered in 1991 have reduced the industrial licensing requirements, removed restrictions on investment and expansion, and facilitated easy access to foreign technology and foreign direct investment.

The salient features of the new policy are the following.

Objectives

The major objectives of the new Industrial Policy package are:

1. To build on the gains already made.
2. To correct the distortions or weaknesses that may have crept in.
3. To maintain a sustained growth in productivity and gain full employment.
4. To attain international competitiveness.

It has been stated that the pursuit of these objectives will be tempered by the need to preserve the environment and ensure the efficient use of available resources. All sectors of industry, whether small, medium or large, belonging to the public, private or cooperative sectors will be encouraged to grow and improve on their past performance.

REDEFINITION OF THE ROLE OF PUBLIC SECTOR

The role of the public sector was redefined and the scope of the public sector has been drastically abridged.

The number of industries reserved for the public sector was reduced to eight and it was later pruned, in stages, to two (atomic energy and railway transport).

The policy also seeks selective privatisation and withdrawal of the public sector from industries which do not conform to its redefined role. See the chapter on *Public Sector* for more details.

Expansion of the Scope of Private Sector and Dismantling of Entry and Growth Restrictions

The scope of private sector has been expanded enormously by drastically reducing the number of industries reserved for the public sector and by substantially dismantling the barriers to entry and growth.

Delicensing: All but 18 industries were freed from licensing. The number was later reduced, in stages, to six. The industries subject to industrial licensing account for only a very small share of the value added in the manufacturing sector.

Removal of MRTPA Restrictions: Most of the provisions of the MRTP Act pertaining to concentration of economic power (*i.e.*, those requiring prior permission for establishment of new undertaking, substantial expansion, manufacture of new items and mergers and acquisitions) were scrapped.

Liberalisation of Foreign Investment

The policy towards foreign capital and technology has been modified very significantly and progressively liberalised. FDI is allowed in all industries, except industries falling in a small negative list, in varying levels, ranging from 26 per cent to 100 per cent of the total equity.

Since 1992-93, the Indian stock market is open for investment by Foreign Institutional Investors (FIIs) and Indian companies satisfying certain conditions may access foreign capital market by *Euro issues*. The chapter on *Foreign Capital and Technology* provides more details.

Related Measures

The industrial policy reforms have been supplemented and reinforced by reforms in related areas.

Progressive integration of the Indian economy with the global economy has been acknowledged as one of the objectives of the *Exim Policy*. The import policy has been made more liberal by drastically reducing the tariff levels and quantitative restrictions and by procedural reforms.

Another very significant change has been the reform of the foreign exchange rate policy. The Rupee was made partially convertible on current and later it was made fully convertible. Measures have been initiated to move towards capital account convertibility.

The Capital Issues Control Act and the office of the Controller of Capital Issues were scrapped and free pricing of capital issues was introduced.

Price controls have been gradually eased out.

Several restrictions imposed in respect of foreign investment, like phased manufacturing programme, foreign exchange balancing etc., have been, by and large, removed.

AN EVALUATION OF THE NEW POLICY

The economic reforms ushered in since 1991 are revolutionary indeed in comparison with the policy and procedural reforms hitherto attempted in India. It, undoubtedly, is a bold step in the direction of freeing the Indian industry from the shackles of abortive and crippling controls.

Although further policy changes and reforms are needed, changes already introduced, if implemented in real earnest, will certainly provide a considerable growth impetus. However, real debureaucratising is a challenging task. The bureaucracy has a tendency to attempt to defeat the measures aimed at deregulations.

A strong mandate and political will and bold administrative measures are essential for implementing several of the proposals. The government, however, often shows signs of confusion and lack of boldness on the face of opposition from trade unions, politicians and bureaucrats. There will certainly be strong opposition from these groups to protect their vested interests. *For example,* in the face of the strong opposition from the trade unions, the government's stand on privatisation has not been clear. In our country the might of the organised minority often gets prominence over the rights and welfare of the unorganised majority.

The new industrial policy has unleased the growth potential of the industrial sector and has tremendously enhanced its competitiveness.

The policy environment now in India is much more conducive for both domestic and foreign investments than in the past. However, there are now a host of countries trying to woo foreign investment with much more conducive economic environment than in India. Further, cultural factors also tilt the balance in favour of other nations as far as foreign investment is concerned. Further, foreign business still regard the policy and procedural system in India perplexing. Even many Indian entrepreneurs feel that the policy/procedural and development environments in countries like China are much superior to that in India and a number of them prefer to locate production bases abroad. The development of the infrastructural sector has been tardy in India even after the liberalisation. Because of these factors, one should not expect wonders out of the belated measures.

However, for the first time, the domestic industry has been given a considerable leeway to prove its mettle. This dynamism coupled with an enhanced external collaboration and competition should be expected to provide a considerable momentum for development. At the same time, the government should strive to remove the remaining lacunae and to implement the proposed reforms in letter and spirit.

Although the economic policy liberalisation of 1991 came in for scathing criticism by the opposition parties, when these parties drew up their election manifestos in April, 1996, their anti-liberalisation stand was conspicuous by its inconspicuousness. More interestingly, when the shortlived BJP government and the United Front government that followed announced their economic policies, they amounted not only to endorsing the liberalisation policy ushered in by the Congress Government under Narasimha Rao but also to carrying forward the process of deregulation and decontrol to achieve faster economic growth. The economic policy of the United Front (UF) government as expressed in the Common Minimum Programme (CMP), which observed that there was no substitute for growth, and that the country's GDP needed to grow at over seven per cent in the next 10 years in order to abolish endemic poverty and unemployment, stated that the UF government is committed to faster economic growth. The document on the CMP observed that further deregulation and decontrol might be required in the agricultural, industrial and other sectors to accelerate economic development. In short, India's economic liberalisation is almost unanimously accepted by all political parties so that it is irreversible.

The growth impulses generated by the industrial policy and other reforms made India one of the most vibrant economies in the world.

The Union Budget 2001-02 was hailed for initiating the second generation reforms. Whichever political party or combine comes to power in future, the difference will be, at the most, in its fine-tuning. In other words, the major differences between the political parties in India will no more be related to economic policies or ideologies; the differences will pertain rather to ethnic and related factors (including the issue of secularism and regional factors). The ubiquitous support to liberalisation seen now is due to the good liberalisation can do for the economic development of the country. Developments since 1991 have demonstrated the growth and competitive impulses that the liberalisation can generate. There is also a lot of lessons to be learnt from the Chinese experience of liberalisation.

SUMMARY

Until 1991, the industrial policy of India was characterised by a monopoly or dominant role for the public sector in strategic basic and heavy industries; preference for small-scale units and reservation of a large number of items for the SSI sector; preference for cooperative sector and joint sector in several areas; a host of entry, growth, and operational and functional restrictions on the private sector; and a very restrictive attitude towards foreign capital and technology.

The industrial policy announced in July 1991 along with other economic policy changes and measures ushered in a process of economic reforms in India. Now, there are no entry and growth restrictions on the private sector, except in a very small number of industries. The policy towards foreign capital and technology has been substantially liberalised. Imports have been very significantly liberalised; quantitative restrictions on imports, by and large, have been removed.

Table 12.1 gives a bird's eye view of the important policy changes.

TABLE 12.1 : INDUSTRIAL POLICY CHANGES

Pre-1991 Policy	*Current Policy*
Industrial licensing was the rule.	Licensing is an exception.
Public sector monopoly/dominance in basic and heavy industries.	All but two industries are open to the private sector.
MRTP Act restrictions on entry and growth of large companies.	No such restrictions.
Foreign investment allowed only in select industries, that too subject to, normally, a ceiling of 40 per cent of total equity and prior permission.	Foreign investment allowed in a large number of industries, including up to 100 per cent of equity in many of them. Automatic route available subject to specified conditions.
Restrictive policy towards foreign technology.	Very liberal policy towards foreign technology.
Reservation of large number of products for small-scale sector.	Reservation list is being pruned.

ANNEXURE 12.1

Schedules to Industrial Policy Resolution, 1956

Schedule A
(Industries Reserved for the Public Sector)

1. Arms and ammunition and allied items of defence equipment.
2. Atomic energy.
3. Iron and steel.
4. Heavy castings and forgings of iron and steel.
5. Heavy plant and machinery required for iron and steel production, for mining, for machine tool manufacture and for such other basic industries as may be specified by the Central Government.
6. Heavy electrical plant including large hydraulic and steam turbines.
7. Coal and lignite.
8. Mineral oils.
9. Mining of iron ore, manganese ore, chrome ore, gypsum, sulphur, gold and diamond.
10. Mining and processing copper, lead, zinc, tin, molybdenum and wolfram.
11. Minerals specified in the Schedule to the Atomic Energy (Control of Production and Use) Order, 1953.
12. Aircraft.
13. Air transport.
14. Railway transport.
15. Shipbuilding.
16. Telephones and telephone cables, telegraph and wireless apparatus (excluding radio receiving sets).
17. Generation and distribution of electricity.

Schedule B
(Industries Where Public Sector Had Priority in Establishing New Unit)

1. All other minerals except "minor minerals" as defined in Section 3 of the Minerals Concession Rules, 1949.
2. Aluminium and other non-ferrous metals not included in Schedule 'A'.
3. Machine tools.
4. Ferro-alloys and tool steels.
5. Basic and intermediate products required by chemical industries such as the manufacture of drugs, dye-stuffs and plastics.
6. Antibiotics and other essential drugs.
7. Fertilisers.
8. Synthetic rubber.
9. Carbonisation of coal.
10. Chemical pulp.
11. Road transport.
12. Sea transport.

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Chapter 13

IDRA AND INDUSTRIAL LICENSING

Structure

Industries (Development and Regulation) Act
Industrial Licensing
Summary

A policy can be effectively implemented and the objectives achieved only if the Government has the power to take the measures required for this purpose. It is with this purpose that the Industries (Development and Regulation) Act was passed in 1951. Until the economic liberalisation ushered in 1991, the entry into business, growth and expansion of firms were regulated by licensing exercised by the Central Government under this Act.

INDUSTRIES (DEVELOPMENT AND REGULATION) ACT

The Industries (Development and Regulation) Act, 1951, amended from time to time, is one of the most effective weapons the Government possesses to regulate the development and to control the activities of the industrial sector.

The IDRA has brought under Central control the development and regulation of a number of industries the activities which affect the country as a whole and the development of which must be governed by economic factors of all-India importance.

Objectives

The main object of the Act is to provide the Central Government with the means to implement their Industrial Policy. Thus, the principal objective of the IDRA is to empower the Government:

- To take necessary steps for the development of industries.
- To regulate the pattern and direction of industrial development.
- To control the activities, performance and results of industrial undertakings in the public interest.

Main Provisions

The IDR Act contains provisions to realise the above objectives. Some of the salient features of the Act are the following.

Development Measures: The Act provides for the establishment, by the Central Government, of a *Central Advisory Council,* consisting of representatives of the owners of industrial undertakings, employees, consumers, primary suppliers, etc., for the purpose of advising the Central Government on matters concerning the development of the industries.

It also provides for the establishment, for any scheduled industry or group of scheduled industries, a *Development Council* consisting of members representing the interests of the owners, employees, consumers, etc., and persons having special knowledge of matters relating to the technical or other aspects of the industries, for purposes such as recommending measures for improving the performance of the industries.

Regulation of Entry and Growth: The IDR Act empowers the Central Government to regulate the development of industries by means of licensing with suitable exemptions as decided by the Government. Accordingly, the entry into a business or the expansion of an existing business may be regulated by licensing.

Supervision and Control: The Government, under this Act, can make a full and complete investigation if it is of the opinion that — *(a)* in respect of any scheduled industry or undertaking, there has been or is likely to be a substantial fall in the volume of output, or a marked deterioration in the quality of output or an unjustifiable rise in the price of the output; *(b)* any industrial undertaking is managed in a manner highly detrimental to the scheduled industry concerned or to the public interest.

As per the IDRA, the central goverment can take measures to control the quality and price of products and production and distribution.

Consequent upon the investigation as mentioned above, the Government is empowered to issue such directions to the industrial undertaking or undertakings for all or any of the following purposes, namely,

(i) regulating the production of any article or class of articles by the industrial undertaking or undertakings and fixing the standards of production,

(ii) requiring the industrial undertaking or undertakings to take such steps as the Central Government may consider necessary to stimulate the development of the industry to which the undertaking or undertakings relates or relate.

(iii) prohibiting the industrial undertaking or undertakings from resorting to any act or practice which might reduce its or their production, capacity or economic value, and

(iv) controlling the prices, or regulating the distribution, of any article or class of articles which have been the subject-matter of investigation.

The Act also provides that any direction of the above nature may be issued by the Central Government at any time when a case relating to any industry or industrial undertaking or undertakings is under investigation. Such a direction shall have effect until it is varied or revoked by the Central Government.

For the purpose of ascertaining the position of working of any industrial undertaking or for any other purpose mentioned in the Act, or the rules made thereunder, any person authorised by the Central Government in this behalf can: *(a)* enter and inspect any premises; *(b)* order the production of any document, book, register or record in the possession or power of any person having the control of or employed in connection with, any industrial undertaking; and *(c)* examine any person having the control of, or employed in connection with, any industrial undertaking.

Takeover of Management: The power of control entrusted to the Central Government under the IDRA extends to that of the takeover of the management of the whole or any part of an industrial undertaking which fails to comply with any of the directions mentioned above. The Government can also take over the management of an undertaking which is being managed in a manner highly detrimental to the scheduled industry concerned or to public interest.

The power of the central government to control management of industrial undertakings also extends to takeover of the management or the undertaking itself.

Further, the Central Government can take over the management of industrial undertaking owned by a company under liquidation, with the permission of the High Court, if the Government is of the opinion that the running or restarting the operations of such an undertaking is necessary for the maintaining or increasing the production, supply or distribution in the public interest.

In respect of the industrial undertaking, the management of which has been taken over by the Government, the IDRA empowers the Government to take steps, in appropriate cases, to liquidate or reconstruct the company concerned in the public interest.

Price and Distribution Controls: For securing the equitable distribution and availability at fair prices of any article or class of articles relatable to any scheduled industry, the Central Government is empowered by the Act to control its/their supply, distribution and price.

Exemptions: The Central Government is empowered to exempt any industrial undertaking or class of industrial undertakings or any scheduled industry or class of scheduled industries from all or any of the provisions of the Act in certain cases in the public interest.

INDUSTRIAL LICENSING

The Industries (Development and Regulation) Act, 1951, empowers the Central Government to regulate the establishment and certain activities of the industrial undertakings by means of licensing. The licensing provisions of the IDRA may apply to industrial undertakings set up by any person or authority including the Government.

A licence is a written permission from the Government to an industrial undertaking to manufacture specified articles included in the Schedule to the Act. If a new company has to be formed, the industrial licence in the first instance, is issued in the name of the applicant, and later when the company has been formed, the necessary endorsement to that effect will be made in the licence.

A licence contains particulars of the industrial undertaking, its location, the articles to be manufactured, its capacity on the basis of the maximum utilisation of plant and machinery, and other appropriate conditions which are enforceable under the Act. It is also subject to a validity period within which the licensed capacity should be established.

If an application for licence is approved and further clearance (such as foreign collaboration and capital goods import) are not involved and no other prior conditions have to be fulfilled, an industrial licence is issued to the applicant. In other cases, a letter of intent is issued, which will later be converted into a licence on fulfilling the conditions stipulated in the letter of intent. In other words, a letter of intent conveys the intention of the Government to grant a licence subject to the fulfillment of certain conditions. The conditions to be fulfilled relate to the approval of foreign investment proposal, import of capital goods, application to be made to the financial institutions, taking of steps to control pollution, etc. A letter of intent enables the applicant to finalise and formulate the proposals on matters relating to the terms of foreign collaboration, import of capital equipment and/or issue of capital with the assurance that if the proposals are otherwise found satisfactory an industrial licence will be issued.

Prior to the economic liberalisation ushered in 1991, the licensing is a means to help achieve some of the objectives of the economic policy such as the desired pattern of industrial dispersal, encouraging new entrepreneurs and wider dispersal of industrial ownership, prevention of concentration of economic power, protection and promotion of the small-scale sector, regulation of foreign capital and technology, use of proper technology and scale economies, achieving demand-supply balance promotion of exports and import substitution, or employment generation etc.

Before the policy liberalisation of 1991, a licence was required for the following purposes: (i) Establishment of new undertaking,(ii) Manufacture of new item, (iii) Substantial expansion of capacity, (iv) Continuation of business in certain cases (COB licence), (v) Change of location.

Projects involving investment up to specified limits were exempted from licensing, subject to certain conditions. The exemption limit was periodically revised upwards. Before the announcement of the new policy in July 1991, this limit was ₹ 15 crore in non-backward areas and ₹ 50 crore in backward areas.

The New Policy

The industrial policy announced in July 1991 has abolished industrial licensing, irrespective of the levels of investment, for all industries exempt 18 specified industries. There has been subsequent liberalisations.

Now, all industrial undertakings are exempt from obtaining an industrial licence to manufacture, except for: *(i)* industries reserved for the Public Sector, *(ii)* industries retained under compulsory licensing, *(iii)* items of manufacture reserved for the small-scale sector and *(iv)* if the proposal attracts locational restriction.

Industries for which industrial licensing is compulsory now are the following:

1. Distillation and brewing of alcoholic drinks.
2. Cigars and cigarettes of tobacco and manufactured tobacco substitutes.
3. Electronic aerospace and defence equipment: all types.

4. Industrial explosives including detonating fuses, safety fuses, gun powder, nitrocellulose and matches.
5. Certain specified hazardous chemicals.

Note: The compulsory licensing provisions would not apply in respect of the small-scale units taking up the manufacture of any of the above items reserved for exclusive manufacture in small-scale sector.

A perusal of the above list would indicate that it is due to reasons of hazardous nature of the product/production, environmental concern, and health and social concerns that some industries are still subject to licensing.

Industrial undertakings exempt from obtaining an industrial license are required to file an Industrial Entrepreneur Memoranda (IEM) with the Secretariat of Industrial Assistance (SIA), Department of Industrial Policy and Promotion, Government of India, and obtain an acknowledgement. No further approval is required.

Locational Policy

Industrial undertakings are free to select the location of a project. In the case of cities with population of more than a million (as per the 1991 census), however, the proposed location should be at least 25 km away from the Standard Urban Area limits of that city unless, it is to be located in an area designated as an "industrial area" before the 25th July, 1991. Electronics, Computer software and Printing (and any other industry which may be notified in future as "non-polluting industry") are exempt from such locational restriction. Relaxation in the aforesaid locational restriction is possible if an industrial license is obtained as per the notified procedure.

The location of industrial units is further regulated by the local zoning and land use regulations as also the environmental regulations. Hence, even if the requirement of the locational policy stated above is fulfilled, if the local zoning and land use regulations of a State Government, or the regulations of the Ministry of Environment do not permit setting up of an industry at a location, the entrepreneur would be required to abide by that decision.

Conclusion

Using the provisions of the Industries (Development and Regulation) Act, 1951, the industrial sector was very extensively controlled by the Central Government until 1991. This Act has been regarded as a very draconian one by industrialists, many economists and others. It has been alleged that the Government was obsessed with the scope for regulations, under this *Development* and *Regulation* Act, relegating development to the backburner. The *licence permit raj* gave rise to rampant corruption.

The liberalisation has significantly diminished the importance of the IDRA.

Several people argue that the Act has lost its relevance and, therefore, this Central Act should be repealed. It may be noted that with the economic liberalisation, a lot of responsibility for the development of industries has shifted to the States. Under the controlled regime, the Central Government had a dominant say on the location of industries. Now that most of the entry and growth restrictions and the reservation of industries for the public sector have been dismantled, it is up to the State governments to promote industries in the States.

SUMMARY

A licence under the Act was required for making new investments above specified limit, manufacturing a new item (*i.e.,* an item not included in the existing licence) by an existing undertaking, substantial expansion of existing capacity and for certain other purposes. The Central government was also empowered to regulate the production, quality, supply, price and distribution of products of industrial undertakings. Under this Act, Government can also take over the management of industrial undertakings in the public interest. The salient features of this Act are depicted in Fig. 13.1.

Now only a small number of industries are subject to licensing. These industries continue to be under licensing due to reasons of hazardous nature of the product/production, environmental concern, and health and social concerns.

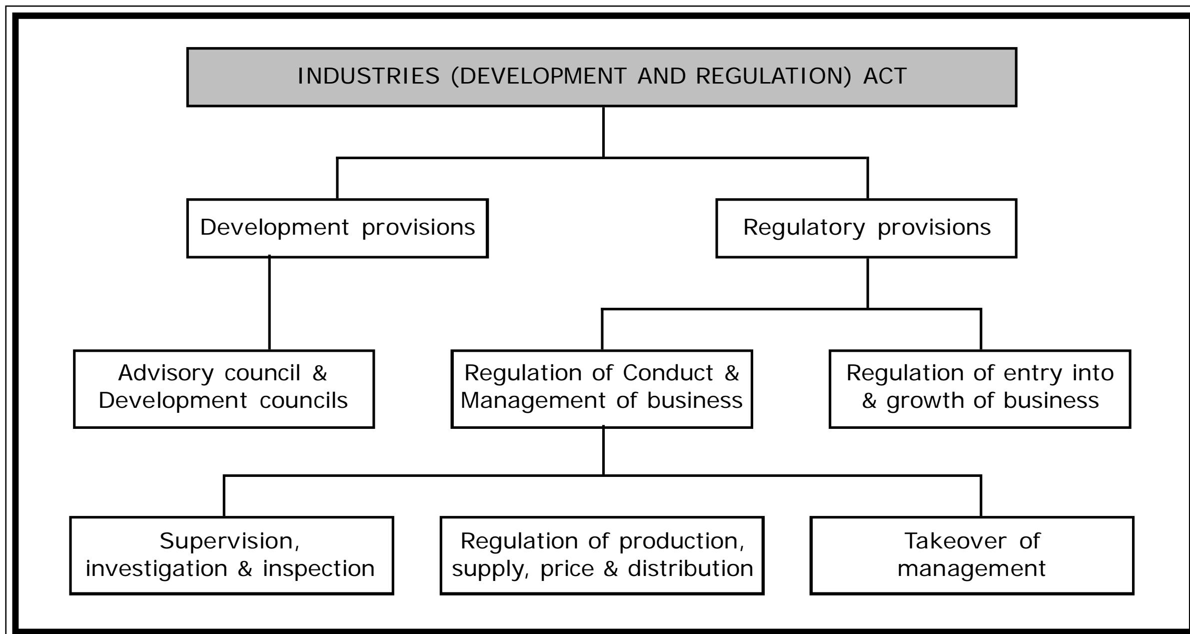

Fig. 13.1 : Salient Features of IDRA

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Chapter 14

PUBLIC, PRIVATE, JOINT AND COOPERATIVE SECTORS

Structure

Public Sector
The New Public Sector Policy
Public Sector Ratnas
Organisation of Public Enterprises
Pricing Policy in Public Enterprises
Government and Parliamentary Controls over Public Enterprises
Department of Public Enterprises
Nationalisation
Private Sector
Joint Sector
Cooperative Sector
Summary
References

The mixed economy of India is characterised by the co-existence of public, private, joint and cooperative sectors. The pattern of industrial development of the country has been influenced to a very significant extent by the roles given to these sectors by the industrial policy.

PUBLIC SECTOR

The objective of accelerating the pace of economic development and the political ideology which gave the public sector a dominant role in the industrial development of the nation led to rapid growth of the state-owned enterprises (SOEs) sector in India.

BOX 14.1 : IMPERATIVES OF PUBLIC SECTOR

Policy on the public sector has been guided by the Industrial Policy Resolutions 1956 and 1991 which gave the public sector a strategic role in the economy. At the time of India`s independence in 1947, there were various problems confronting the country which needed to be tackled in a planned and systematic manner. India was basically an agrarian economy with a weak industrial base, low level of savings and investment and near absence of infrastructural facilities. A vast percentage of population was extremely poor. There existed considerable inequalities in income, low level of employment opportunities, serious regional imbalances in economic attainments and lack of trained manpower in various fields of management. It was, thus, obvious that if the country was to speed up its economic growth and maintain it in the long run at a steady level, a big push was required. As such, State`s intervention in all the sectors of the economy, was inevitable because private sector had neither the necessary resources in terms of funds, managerial and scientific skill, nor the will to undertake risks involved in large long-gestation investments. Among the imperatives were removal of poverty, better distribution of income, expansion of employment opportunities, removal of regional, imbalances, accelerated growth of agricultural and industrial production, better utilisation of natural resources and a wider ownership of economic power to prevent its concentration in a few hands. Given the type and range of problems faced by the country on its economic, social and strategic fronts and the various imperatives, it became a pragmatic compulsion to deploy the public sector as an instrument for self-reliant economic growth so as to develop a sound agricultural and industrial base, diversify the public economy and overcome the economic and social backwardness.

The predominant considerations for continued large investments in public sector enterprises were to accelerate the growth of core sectors of economy; to serve the equipment needs of strategically important sectors like Railways, Telecommunications, Nuclear Power, Defence, etc., to enable the Government to exert countervailing power on the operation of private monopolies and multinationals in selected areas and to provide a springboard for the economy to achieve a significant degree of self-sufficiency in the critical sectors. Another category of public enterprises concerns essentially the consumer oriented industries such as drugs, hotels, food industries, etc. The rationale for setting up such enterprises was to ensure easier availability of vital articles of mass consumption, to introduce check on prices of important products and services and to help promote emerging areas like tourism, etc. Then, again, a large number of enterprises belong to the category of 'sick units` taken over from the private sector in order to sustain production and protect employment. There are a number of public enterprises operating in national and international trade, consultancy, contract and construction services, inland and overseas communications, etc. The overall profile of public sector enterprises in India is, thus, a heterogenous conglomerate of basic and infrastructural industries, industries producing consumer goods and industries engaged in trade and services, etc.

Courtesy: *Bureau of Public Enterprises, Public Enterprises Survey, 1998-99.*

As a result of the government strategy, public sector had come to occupy a monopoly or dominant position in basic and heavy industries.

As the Bureau of Public Enterprises observes, born as the outcome of the conscious policy of the government to speed up the industrialisation of the country with a view to give added impetus to economic growth as well as to achieve certain socio-economic goals as enunciated in the Industrial Policy Resolutions of the government, these enterprises came to cover a wide spectrum of activities in basic and strategic industries like steel, coal, minerals and metals, petroleum, heavy engineering, chemicals, fertilisers and pharmaceuticals etc. on the one hand, and consumer

goods, trading and marketing activities, transportation services, contracts and consultancy services, tourist services, financial services, development of small industries etc. on the other.[1]

Objectives

The public enterprises which were promoted as an instrument for implementation of the government's socio-economic policies, had a multitude of objectives set for them, *viz.,*

- To help in the rapid economic growth and industrialisation of the country and create the necessary infrastructure for economic development.
- To earn return on investment and thus generate resources for development.
- To promote redistribution of income and wealth.
- To create employment opportunities.
- To promote balanced regional development.
- To assist the development of small-scale and ancillary industries.
- To promote import substitution, save and earn foreign exchange for the economy.

Growth and Performance of Public Enterprises

There had been a phenomenal growth of the public sector since the commencement of planning. In fact, even before the commencement of planning and the adoption of the goal of the *socialistic pattern of society*, the public sector was assigned an important role in the industrialisation and economic development of the country. The *Industrial Policy Resolution of 1948* made it very clear that the manufacture of arms and ammunition, the production and control of atomic energy, and the ownership and management of railway transport would be the exclusive monopoly of the Central Government. It was resolved further that in another six industries the state alone would set up new undertakings. These six industries were: coal, iron and steel, aircraft manufacture, shipbuilding, manufacture of telephone, telegraph and wireless apparatus, excluding radio receiving sets, and mineral oils.

The public sector had been expected to gain control over the commanding heights of the economy.

The *Industrial Policy Resolution of 1956* enlarged the role of the public sector. It stated: "The adoption of the socialist pattern of society as a national objective as well as the need for planned and rapid development require that all industries of basic and strategic importance, or in the nature of public utility services, should be in the public sector. Other industries which are essential and require investment on a scale which only the State, in present circumstances, could provide, have also to be in the public sector. The state has, therefore, to assume direct responsibility for the future development of industries over a wide area." *Schedule A* to the Resolution enumerated 17 industries, the future development of which would be the exclusive right of the state. *Schedule B* to the Industrial Policy Resolution, 1956, contained a list of 12 industries which would be progressively state-owned and in which the state would, therefore, generally take the initiative in establishing new units. The Schedules A and B are reproduced in the Annexure to the chapter on *Industrial Policy*.

The four decades since the commencement of planning witnessed a substantial growth and expansion of the public sector in India. Investment in industrial undertaking by the Central government increased from ₹ 29 crore in five units at the commencement of the First Five Year Plan (1951) to ₹ 1,18,492 crore at the commencement of the Eighth Plan (1992) in 237 units. It further increased to over two lakh crore (₹ 2,01,500 crore) spread over 238 units at the commencement of the Ninth Plan (1997). At the end of March 2015, it was about ₹ 10,96,057 crore in 298 units.

TABLE 14.1 : GROWTH OF PUBLIC ENTERPRISES

		Investment (₹ crores)	*Total No. of Enterprises*
1	At the commencement of 1st Plan (1-4-1951)	29	5
2	At the commencement of 2nd Plan (1-4-1956)	81	21
3	At the commencement of 3rd Plan (1-4-1961)	953	48
4	At the commencement of 4th Plan (1-4-1969)	3902	85
5	At the commencement of 5th Plan (1-4-1974)	6237	122
6	At the commencement of 6th Plan (1-4-1980)	18,225	186
7	At the commencement of 7th Plan (1-4-1985)	42,811	221
8	At the commencement of 8th Plan (1-4-1992)	1,18,492	237
9	At the commencement of 9th Plan (1-4-1997)	2,01,500	238
10	At the commencement of 10th Plan (1-4-2002)	324,632	240
11	At the commencement of 11th Plan (1-4-2007)	421,089	244
12	At the commencement of 12th Plan (1-4-2012)	729,298	260
13	As on 31 March 2015	10,96,057	298

There are also a large number of State level public enterprises (SLPEs).

Major part of the Central public sector investment was in the steel, coal, minerals and metals, power and petroleum sectors.

The wide range of product and activities of Central public sector enterprises (CPSEs) included manufacturing of steel, mining of coal and minerals, extraction and refining of crude oil, manufacture of heavy machinery, machine tools, instruments, heavy machine building equipment, heavy electronical equipment for thermal, and hydel stations, transportation equipment, telecommunication equipment, ships, 'sub-marines, fertilisers, drugs and pharmaceuticals, petro-chemicals, cement, textile, and a few consumer items such as bread, newsprint/paper, footwear and contraceptives, operation of air, sea, river and road transport, operation in national and international trade, consultancy, contract and construction services, inland and overseas telecommunication services, hotel and tourists services, etc.

At the beginning of the 1990s, the public sector was dominant in many industries. The PSEs contributed the entire output in the case of petroleum, lignite, copper and primary lead, about 98 of zinc, with over 90 per cent of coal, more than half of steel and aluminium and about one-third of fertilisers. The public sector, thus, came to occupy a commanding position in several critical industries. While setting up of new enterprises was mainly responsible for the fast growth of the public sector, nationalisation of certain industries like coal, copper, insurances, major part of commercial banking sector and a number of sick units has also contributed to this growth.

The public sector had been expected to gain control over the commanding heights of the economy.

A significant feature of the public sector investment is the predominance of investment in few crucial sectors, namely, steel, minerals and metals, petroleum, coal and chemicals and fertilisers.

The public sector certainly had a very important role to play in the development of this vast and populous developing economy characterised by dearth of capital, entrepreneurship and technology. However, keeping the private sector completely out of many industries and giving the private sector only a secondary role in many other industries have had severe adverse effects on growth and competition. The new economic policy, characterised by scope for a substantial

privatisation, including dereservation of industries for the public sector, in fact, amounts to an acceptance of this.

The performance of many public enterprises has been far from satisfactory. One can, of course, speak of the contribution of the public sector towards GDP, employment generation, exports etc. The pertinent question, however, is have these contributions been adequate when compared to the massive investments that have gone into the PSEs and at what level of efficiency these enterprises have been operating? Further, to what extent these enterprises, particularly the monopolies, have been customer-friendly?

The accumulated losses of CPCEs was ₹ 73,147 crores in 2005-06.

A large number of PSEs, including several monopolies, have made huge losses. Despite the huge losses incurred by a number of enterprises, the PSEs as a whole could make profits mainly because of the enormous profits made by several public sector monopolies.

Several of the loss-making PSEs have been either in non-priority sectors or in sectors where the private sector has proved to be more efficient. A number of loss-making units are sick units.

A variety of factors have been identified for the unsatisfactory performance of a large number of public enterprises. While the project formulation has improved over the years, huge cost and time overruns continued to take place in project implementation. This was on account of problems of land acquisition, procurement of equipment, civil work and other imponderables. Further, the locational and investment decisions in some sectors and projects are observed to have adversely affected performance. It has been noticed that inappropriate location irrational product-mix and imposed marketing arrangements critically affected the performance of some projects. In the fertiliser sector, choice of technology having been tied to availability of foreign financing had adversely affected their operations. On the other hand, in power sector, excessive investment in generation capacities with incommensurate attention to transmission networks had created serious imbalances. Uneconomical pricing/tariff rates signifying large cross-subsidies reduced the internal resource generation in this sector. This had direct implications for reinvestment on the one hand, and raised demand for power, on the other. These also contributed, among other things, to the heavy losses incurred by most of the State Electricity Boards which continuously failed to realise the three per cent statutory rate of return on assets.

A number of other problems including allocation of resources, delays in the filling up of top-level posts, tight regulations and procedures for investment and restrictions on functional autonomy of the enterprises (*e.g.*, in respect of labour and wage policy), etc. have for long been noticed as serious constraints on PSE operational efficiency.

The public sector is generally criticised for inadequate generation of internal resources. The Department of Public Enterprises points out that generation of internal resources by public enterprises is constrained by the following factors.

1. Public Sector Enterprises were set up not only for commercial consideration but also for factors such as generation of employment, promoting balanced regional development, etc.
2. Low return on investment on account of price constraints imposed on certain infrastructural goods and services of public enterprises.
3. A number of sick units in the private sector facing closure had to be taken over by the Government and these units form sizeable part of the Central Public Sector.
4. Number of industries promoted in the public sector with long gestation period.
5. The impact of escalation in the prices of various inputs and periodical wage revision.

THE NEW PUBLIC SECTOR POLICY

After the initial exuberance of the public sector entering new areas of industrial and technical competence, a number of problems have begun to manifested themselves in many of the public enterprises. Serious problems were observed in the insufficient growth in productivity, poor project management, overmanning, lack of continuous technological upgradation and inadequate attention to R&D and human resource development. The low rate of return on capital invested has inhibited the ability of the public enterprises to regenerate themselves in terms of new investments as well as in new technology development. This resulted in many of the public enterprises becoming a burden rather than an asset to the Government.

It was, therefore, decided to redefine the role of the public sector, in tandem with the economic liberalisation. According to the industrial policy announced on 24-7-1991, the following have been set as the priority areas for growth of public enterprises.

The role of the public sector has been substantially reduced by the industrial policy effective since 1991.

1. Essential infrastructure goods and services.
2. Exploration and exploitation of oil and mineral resources.
3. Technology development and building of manufacturing capabilities in areas which are crucial in the long-term development of the economy where private sector investment is inadequate.
4. Manufacture of products where strategic considerations predominate such as defence equipment.

Accordingly, the number of industries reserved for the public sector was pruned to 8. These 8 industries were: *(i)* Arms and ammunition and allied items of defence equipment, defence aircraft and warships, *(ii)* Atomic energy, *(iii)* Coal and lignite, *(iv)* Mineral oils, *(v)* Mining of iron ore, manganese ore, chrome ore, gypsum, sulphur, gold and diamond, *(vi)* Mining of copper, lead, zinc, tin, molybdenum, wolfram, *(vii)* Minerals specified in the schedule to the Atomic Energy (Control of Production and Use) Order, 1958 and *(viii)* Railway transport.

The list has been further pruned subsequently and now only atomic energy and railway transport are reserved for the public sector. In May 2001, the sensitive defence production which was hitherto reserved for the public sector was thrown open to the private sector. Foreign investment up to 26 per cent has also been allowed in this sector.

The new industrial policy also indicated that the public sector would withdraw from the following cases:

1. Industries based on low technology
2. Small-scale and non-strategic areas
3. Inefficient and unproductive areas
4. Areas with low or zero social responsibility or public purpose
5. Areas where private sector has developed sufficient enterprise and resources.

The main elements of the current Government Policy towards Public Sector Undertakings (PSUs) are:

- Bringing down Government equity in all non-strategic PSUs to 26 per cent or lower, if necessary.
- Restructure and revive potentially viable PSUs.
- Close down PSUs which cannot be revived.
- Fully protect the interest of workers.

In order to give thrust to the process of disinvestment in PSUs, a new Department of Disinvestment was set up. The Department is responsible for all matters related to disinvestment of Central Government equity in Central Public Sector Undertakings, implementation of disinvestment decisions and implementation of the erstwhile Disinvestment Commission.

The new Policy also made it clear that the Government will ensure that the public sector is run on business lines as envisaged by in the Industrial Policy Resolution of 1956. It was also decided to close down unviable sick public undertakings.

The new public sector policy marks a much-needed change for accelerating the pace of development by better utilisation of the national resources (including entrepreneurial resources) and for increasing competition and efficiency.

The Industrial Policy Statement of July 1991 observed that in the 1950s and 1960s, the principal instruments for controlling commanding heights of the economy was investment in key industries. Today, the State has other instruments of intervention, particularly fiscal and monetary instruments.

PUBLIC SECTOR RATNAS

Government in July 1997 unfolded its strategy to grant autonomy to some PSUs on an experimental basis. The objective of the new approach was to select some vanguard PSUs to support them in their drive to become global giants. The Government, after a detailed and in-depth inter-ministerial discussions selected nine PSUs for making them truly world-class entities and it euphemistically named these as *Navaratnas*.

These are Bharat Heavy Electricals Ltd. (BHEL), Bharat Petroleum Corporation Ltd. (BPCL), Hindustan Petroleum Corporation Ltd. (HPCL), Indian Oil Corporation Ltd. (IOC), Indian Petrochemicals Corporation Ltd. (IPCL), National Thermal Power Corporation Ltd. (NTPC), Oil and Natural Gas Corporation Ltd. (ONGC), Steel Authority of India Ltd. (SAIL) and Videsh Sanchar Nigam Ltd. (VSNL). Later two more enterprises, GAIL and MTNL, were later given the same status. In June 2007, Bharat Electronics Ltd. (BEL), Hindustan Aeronautics Ltd. (HAL), and Power Finance Corporation (PEC) were also accorded Navaratna status. It was decided that these PSEs would have freedom to incur capital expenditure, decide upon joint ventures, set up subsidiaries/offices abroad, enter into technological and strategic alliances, raise funds from capital markets (international and domestic) and enjoy substantial operational and managerial autonomy. In 2009, a special category – Maharatnas – was introduced.

The Boards of these PSEs have been broad-based with induction of non-official part-time professional directors. All the measures have been taken with the objective of making the PSEs competitive.

Greater operational, financial and managerial autonomy were also granted to a number of other profit-making enterprises referred to as Mini-Ratnas, for making them more efficient and competitive. At the beginning of 2014, there were 7 Maharatnas, 14 Navaratnas and 72 Miniratnas.

ORGANISATION OF PUBLIC ENTERPRISES

Public enterprises in India have been organised in the following forms:

Ministry

For the management of the Indian Railways, there is a full-fledged Ministry of Railways in the Government of India. The Ministry of Railways undertakes and manages all the investments and enterprises connected with the railway transport of the country, and has its own Annual

Budget which has to be presented to Parliament and approved by it. The Ministry has a Minister for Railways and the body of management consists of the Railway Board, headed by a Chairman. Besides the Chairman, the Board has three members and a Financial Commissioner. All these five personnel have the status of secretary to the Government of India.

Departmental Undertakings

The Study Team on Public Sector Undertakings has mentioned the following as the principal characteristics of Departmental Undertakings.[2]

(a) It is financed by annual appropriations from the treasury and all, or a major share, of its revenues are paid into the treasury.

(b) It is subject to the budget, accounting and audit controls applicable to government activities.

(c) Its permanent staff consists of civil servants, and the conditions of recruitment and service are the same as for other civil servants.

(d) It can be sued only by following the procedure prescribed for filing suits against the government.

The Departmental Undertaking is directly subordinate to a Ministry.

The need for secrecy, strategic importance and similar conditions make the departmental form the most suitable form of organisation in certain areas (for example, defence industry).

The ordinance factories, such as the Army Clothing Factory, the Harness and Saddlery Factory, the Gun Carriage Factory and the Ishapore Ordinance Factory under the Ministry of Defence; the Chittaranjan Locomotive Works and the Integral Coach Factory under the Ministry of Railways; and the Posts and Telegraphs under the Ministry of Communications are examples of the departmental form of organisation and management.

While the departmental system ensures effective government control, it suffers from a number of disadvantages, such as too much governmental and political interference, lack of authority and initiative in decision-making, etc.

Government Company

The principal characteristics of the Government Company, as mentioned by the Study Team on Public Sector Undertakings, are the following.[3]

1. It has most of the features of a private limited company.
2. The whole of the capital stock, or 51 per cent or over of it, is owned by the government.
3. All the directors, or a majority of them, are appointed by the government, depending upon the extent to which private capital is participating in the enterprise.
4. It is a body corporate created under a general law, *viz.*, the Companies Act.
5. It can sue and be sued, enter into contract, and acquire property in its own name.
6. Unlike the public corporation, it is created by an executive decision of the government without Parliament's specific approval having been obtained, and its Articles of Association, though conforming to an Act, are drawn up and are revisable by the government.
7. Its funds are obtained from the government and, in some cases from private shareholders, and from revenues derived from the sale of its goods and services.
8. It is generally exempt from the personnel, budget, accounting and audit laws and procedures applicable to government departments.
9. Its employees, excluding those who are on deputation, are not civil servants.

The Industrial Policy Resolution of 1948 had declared that the "management of state enterprises will, as a rule, be through the medium of public corporations under the statutory control of the Central Government, which will assume such powers as may be necessary to ensure this." But most of the public sector undertakings have been organised as companies.

The company form of organisation for public enterprises had come in for much criticism in the beginning. Since the government, in most cases, was the only shareholder, it was said that the provisions of the Company Law did not have much relevance to a government company. Another objection was that the organisation of public enterprises as companies reduced their accountability and diluted audit control. But this criticism was largely met by writing special provisions into the Companies Act in 1956 with regard to the submission of Annual Reports and Accounts and audit by the Comptroller and Auditor-General.

The Study Team on Public Sector Undertakings has pointed out that the principal defects generally attributed to a government company are the following.[4]

1. It evades the constitutional responsibilities which a state-owned enterprise should have to government and Parliament.
2. The law regulating limited companies become a mere fiction because all or most of the functions normally vested in the shareholders and in the management are reserved to government.
3. A meeting of shareholders in the case of a government company is meaningless, for the declaration of profits and the appointments to the Board are naturally reserved to the government.
4. The extent of autonomy that it provides can be materially affected or altered by the executive agencies of the government.

Mainly relying on the above considerations, most of which had emerged from a UN seminar held at Rangoon in 1954 (and later endorsed by another UN seminar held at New Delhi in December, 1959), the Estimates Committee recommended[5] that all wholly state-owned public undertakings should generally be in the form of statutory corporations, and the company form should be an exception to be resorted to only:

1. When the government may have to take over an existing enterprise in an emergency;
2. Where the state wishes to launch an enterprise in association with private capital; or
3. Where the government wishes to start an enterprise with a view eventually to transferring it to private management.

The government, however, did not accept this recommendation on the ground that the "company form was advantageous in that it allowed the flexibility and autonomy necessary for the successful operation of commercial enterprises and also provided for parliamentary control over the companies under the special provisions of the Companies Act."[6]

The decision taken by the government in 1961 on the recommendations of the Krishna Menon Committee on the form of organisation reads as follows: "Government consider that the form of management of the undertakings should be determined by the requirements of each case. Accordingly, from the point of view of flexibility of operations, the company form of management would be preferable. In some instances, it would be necessary to form statutory corporations, while in a few others, for various reasons, it would be desirable to run the undertakings as departmental organisations."[7]

From the characteristics of the government company mentioned above, it is clear that when the whole capital stock is not owned by the government, it is still generally regarded as a government company provided that the government owns not less than 51 per cent of the capital stock. Such companies are also described as "mixed" or "joint" companies. In such concerns, the government usually enjoys a substantial control of the management. Examples of such companies include Ashok Hotel and Hindustan Shipyard Ltd.

However, there were also examples of the management of the government companies being entrusted to private hands. Hindustan Machine Tools Ltd., Hindustan Shipyard Ltd., Hindustan Housing Factory Ltd., and Indian Telephone Industries Ltd., were, in the beginning, given out to foreign private firms for management.

PUBLIC CORPORATION

The important features of the public corporation (also known as statutory corporation) as mentioned by the Study Team on Public Sector Undertakings are given below:[8]

1. It is owned by the State.
2. It is created by a special law defining its objectives, powers and privileges and prescribing the form of management and its relationship with government departments.
3. It is a body corporate and can sue and be sued, enter into contracts and acquire property in its own name.
4. Except for appropriations to provide capital or to cover losses, it is usually independently financed; it obtains funds by borrowing either from the government or, in some cases, from the public and through revenues derived from the sale of goods and services, and has the authority to use and reuse its revenue.
5. It is ordinarily not subject to the budget, accounting and audit laws and procedures applicable to government departments.
6. Excluding the officers taken from government departments on deputation, the employees of public corporations are not civil servants, and are not governed by government regulations in respect of conditions of service.

As the Study Team has pointed out, in most democratic countries, the public corporation has been the common form of organisation for public enterprises. "In the United Kingdom, the USA and Canada, the form of public corporation has been adopted. In Italy, the company form has been retained for concerns brought within the public sector; but it is confined to the subholding companies and operating units. The two top management institutions that control all the operating units and subholding companies are the ENP[9] and IRII[10] and they are statutory corporations. Thus, it is only in India that the government seems to have adopted the method of running companies by directly holding shares in them. In Italy, the state holdings are administered by public corporations which, in turn, hold shares in a number of companies. In India, the government companies have been subjected to both. While it is sometimes claimed that the advantages of the two systems, state managements and private enterprises, have been combined in government companies in India, many witnesses who appeared before us held the view that government companies had merely succeeded in accumulating the disadvantages of both."[11]

Preferring the public corporation to the company, the Team has pointed out that though "from the government pronouncements on the subject it appears that the company form is conducive to greater autonomy, the reports of the Parliamentary Committees indicate the very opposite."[12] In support, it has also quoted the following comments made by the Estimates Committee: "The Committee has noticed that in the relations between these undertakings and the Ministry,

the former are treated in the same manner as departments and offices of government, controlled and supervised by the secretariat. The state undertakings have thus become adjuncts to Ministries and are treated more or less on the same lines as any subordinate organisation of office".[13] The Team, therefore, felt that "the setting up of the public corporation will ensure a measure of real autonomy for the public enterprise."[14]

Holding Company

One of the important recommendations of the Study Team has been that integral public authorities should be created for particular sectors of industry and entrusted with the task of the general development of the respective sectors, including the running of undertakings in those sectors and the setting up of new projects. The Team recommended that, to promote this integration, it was necessary to amalgamate public undertakings in such a manner that one integral corporation functioned in each major area of public enterprise, operating the existing units and setting up new projects in the field of the industry entrusted to the corporation.

According to the Study Team, the setting up of the integral public corporation in the industrial and manufacturing field would result in the following advantages.[15]

1. It will end the fragmentation of the industrial effort in the public sector and promote the integration of the efforts to develop each industry in the public sector.
2. It will reduce the span of government control, for many of the functions that are co-ordinative *per se* will be taken care of at the level of the integral corporation.
3. It will make government control more effective by confining it to a higher level and concentrating it on the few vital and strategic points that the government should control to discharge its responsibility for the formulation of policy and for ensuring that the policy is implemented by the management.
4. It will secure for the management at the operating level greater detachment from direct bureaucratic control and political influence, both of which are inimical to initiative experimentation and vigorous management.
5. It will enable public enterprises to establish otherwise expensive staff organisation in fields like designing and consultancy, cost and management, accounting, industrial engineering, and research.
6. It will lead to better personnel management in public enterprises, and greater uniformity in the terms and conditions of service of the employees.
7. It will enable the corporation to avail of the economies of large-scale operations and to establish common service facilities like training for the particular requirement of the industry and purchase and sales organisations with effectiveness and economy.
8. It will provide much wider prospects to the managerial and technical personnel of public enterprises, increasing the capacity of these enterprises to attract and retain suitable personnel.
9. It will result in a more rational deployment and utilisation of designing and construction engineering personnel and expensive construction equipment.

Suitable Form of Organisation

While each type of organisation has its own advantages and disadvantages, for a particular category of undertakings one form may be more suited than the others. The recommendations of the Study Team on Public Sector Undertakings in this respect are as follows:

1. ***Industrial and Manufacturing Undertakings:*** All public undertakings in the industrial and manufacturing field should be entrusted to public corporations, each governing a number of operating units in the same area of industry. It would be advantageous to retain the company form for units in which there is an element of private participation but in such cases, the state-owned shares held in the company should be owned not by the government directly but in the name of the public corporation.

However, the departmental form is generally regarded as the one suitable for undertakings that provide the services that affect the totality of the community or the security of the country.

2. ***Public Utilities and Services:*** It has been generally recognised that public utilities and services require greater statutory authority for their operations. Their operations also serve the community in general or a primary need of industry. The public corporation form is, therefore, more suitable for undertakings falling in the category of public utilities and services. The statutes of existing corporations in this category should be revised with a view to ensuring that they are in accord with the needs of autonomy and flexibility.

3. ***Promotional and Developmental Undertakings:*** The company form is not suitable for promotional and developmental undertakings. The very nature of these undertakings signifies that the accent is on non-commercial objectives, although the operations are sought to be carried on commercial lines and not on departmental lines. The government may re-examine the desirability of continuing these undertakings as government companies.

4. ***Commercial and Trading Concerns:*** A common objective of these undertakings is to act as instruments for the social regulation of trade and business in the field of their operation. Since these undertakings operate in competition with their counterparts in the private sector, there is perhaps some justification for retaining the company form of organisation for these undertakings.

PRICING POLICY IN PUBLIC ENTERPRISES

The public sector pricing policy is an issue that has been widely debated. Should the public sector undertakings earn profits? If they should earn profits, what should be the level of the profits? In areas where there are good prospects for making profits, should they exploit the market to the maximum or should there be a limit to profit rates? Should all the undertakings be run on commercial lines, or is it sufficient if the public sector as a whole makes profit?

If the public sector undertakings are not required to make a profit, what should be the pricing policy? Should it be marginal cost pricing, average cost pricing, or no-profit, no-loss pricing? What should be the factors that should determine the choice of any of the above policies?

These are the basic issues in public sector pricing. An understanding of the important theories of public sector pricing would make some of these issues more clear.

THEORIES OF PRICING

Marginal Cost Pricing

Marginal cost pricing refers to the method of setting prices in which price is made equal to the marginal cost of production. The marginal cost pricing implies that the price is set at the point at which the demand curve cuts the marginal cost curve.

The marginal cost pricing theory was first advocated by Professor Harold Hotelling in his article, "The General Welfare in Relation to Problems of Taxation and of Railway and Utility Rates", published in *Econometrica* in 1938. In this article, he argued that, by adopting the

marginal cost pricing even if the public utilities ran at a loss which had to be financed by lumpsum payments by the state, total economic welfare would be increased by such a pricing policy.

When production is subject to the law of decreasing costs (or increasing returns), the marginal cost price is lower than other prices (average cost price, no-profit, no-loss price, etc.). This lower price enables the poor sections of the society to increase their consumption of public utilities. That is why Hotelling argued that marginal cost pricing would improve economic welfare.

When production is subject to the law of decreasing costs, if marginal cost pricing is adopted, the total revenue will obviously be less than the total cost. It has been argued that this deficit in revenue should be made good by taxing the rich. When this is done, a part of the cost of the public utilities consumed by the poor is paid by the rich. Thus, marginal cost pricing would achieve an income redistribution in favour of the poor and thereby an enhancement in total economic welfare.

But it should be pointed out here that it is not always possible to cover the revenue gap by progressive taxation. In India, and in many developing countries, there is a limit to the amount that can be raised by means of direct taxes. The situation may necessitate higher commodity taxation, which may turn out to be regressive and/or deficit financing. If commodity taxation and deficit financing cause a rise in prices, it is likely to make the plight of the poorest sections more miserable, for the poorest strata usually do not have the economic capacity to consume even the subsidised public utilities. The marginal cost pricing, therefore, sometimes reduces the total economic welfare even under conditions of decreasing costs.

When production is subject to the law of increasing costs (decreasing returns), the marginal cost price represents at higher price than the average cost price or no-profit, no-loss price. Hence, marginal cost pricing under conditions of increasing costs will reduce the total economic welfare, for this higher price will reduce the poor people’s consumption of public utilities.

If marginal cost pricing is adopted when production is subject to the law of increasing costs, the enterprise can generate some surplus.

There are some practical difficulties in marginal cost pricing. “Where there are multiple products or services, the determination of detailed costs of each item may be a very costly and complicated affair. There may, as a result, be large economies of administration if services involving unequal costs are charged at a uniform rate. This is the reason why the post office charges the same price for carrying letters from one street to another or from one corner of the country to another.

“The marginal cost cannot be accurately assessed because the factors are indivisible and the various charges on new factor intakes are not the charges on factor use needed for additional increments of output. Marginal costs would be high at points where capacity gets exhausted and for additional production new capacities have to be created. In such cases, the costs incurred at such points are abnormally high and thus the marginal cost cannot be a basis for price fixation.

“If the price is to equal marginal cost, fluctuations in demand and supply would lead to frequent fluctuations in prices, which is not very desirable.”[17]

Average Cost Pricing

Average cost pricing refers to the method of setting prices in which price is equal to the average cost of production. Under average cost pricing, the total revenue equals total cost. Average cost pricing, thus, ensures the absorption of the full cost of production into the price.

When calculating the total cost, it is usual to include normal profit in it. Hence the average, cost includes also the normal profit. The average cost price is, therefore, a little higher than the no-profit, no-loss price.

It has been argued that, in the case of the railways, posts and telegraphs, multi-purpose projects, etc., the average cost can be more easily calculated than the marginal cost.

Thiemeyer considers the average cost pricing to be fair and just because of the following reasons.[18]

1. Public undertakings are expected primarily to meet needs, that is, to provide an optimum volume of supplies cheaply without seeking any profit.
2. Every purchaser pays the entire cost of the unit or units consumed by him instead of paying only the additional cost of producing these units.
3. Since nobody is required to pay more for the goods he purchases than the amount it actually costs to produce those goods, there is no exploitation.
4. The average cost price is a reliable criterion for investment in many cases.
5. The average cost principle ensures that the entire expenditure of the undertaking is covered and thereby secures the viability and the autonomy of the undertaking.

Under conditions of decreasing costs, the average cost price is higher than the marginal cost price. Hence, the demand for goods or services will be lower if the average cost is the criterion for fixing the price. It will, it has been argued, adversely affect the interests of the consumers.

When production is subject to the law of increasing costs, the average cost is lower than the marginal cost, and hence the average cost pricing will benefit the poor.

The INRICE Theory Committee points out that "the recommendation...that price should be fixed in terms of average unit costs is in practice inapplicable. To take one example, in the transport sector "... no satisfactory method of allocating costs according to their origin has yet been found. The problem is at present insoluble on account of practical considerations; moreover, the task of correctly allocating cost elements is fraught with theoretical difficulties of principle, which cannot be overcome by any degree of improvement of the accounting systems of individual economic units and the economy as a whole."[19]

No-profit, No-loss Pricing

As the name indicates, the no-profit, no-loss theory holds that the price should be fixed in such a way that there will be neither any profit nor any loss. In other words, the price should just cover all the costs of production.

The average cost price usually includes the normal profit. The no-profit, no-loss price, however, does not provide for normal profit.

Unlike the marginal cost price, the no-profit, no-loss price does not require any subsidy for in this case there is no deficit in the revenue because of the equality between the total revenue and total cost. In other words, there is no need for any "cross subsidisation".

When the price is fixed on the no-profit, no-loss basis, the non-consumers of the commodity or service are not compelled, directly or indirectly, to bear a burden for the benefit of the consumers. At the same time, the consumers are given a fair deal, for they bear nothing more than the actual cost of their consumption.

Like the average cost price, the no-profit, no-loss price relieves the state of the burden of mopping up resources to make good the deficit incurred when marginal cost pricing is adopted — when the production is subject to the law of decreasing costs.

Professor Arthur Lewis argues that if the corporation makes a profit or loss, it should be required to adjust its prices so as to eliminate the profit or loss. He advocates this principle on the ground that it will prevent overexpansion or underexpansion of the industries concerned and will avoid inflationary or deflationary tendencies.

Profit-making Pricing

The theory of making profits purports that the prices should be high enough to provide some surplus after absorbing all the costs.

That the public sector enterprises should generate a surplus with which to finance future development plans has been widely accepted today.

Many developing countries have assigned a very important role to the public sector in national development plans. Since the taxable capacity is low and the scope of domestic resource mobilisation through other means is limited, the public sector, which has absorbed large chunks of investment, should be expected to make a significant contribution to the pool of investible funds.

PSEs have been expected to play a major role in resource mobilisation.

Many economists and planners argued that as the public sector acquired a more prominent position, the role of taxation, deficit, financing, etc., in resource mobilisation should decline and the surplus provided by the public sector should increase. In an economy where the public sector occupies an important position in production and supply, there is good scope for mopping up resources by an appropriate public sector pricing policy. As a matter of fact, in communist countries, most of the financial requirements of the government are met by the surpluses generated by public enterprises through a pricing strategy that serves this purpose.

It may be pointed out here that had the public sector in India generated a reasonable return on the enormous capital investment in them, the pace of economic progress would have been faster. In the absence of a satisfactory level of surpluses from the public sector, we were compelled to put up with more taxes, more deficit financing (which are inflationary in nature) and the slow pace of economic growth.

Indian Public Sector and Profit Objective

It is quite clear from the plan documents and the pronouncements of people like the Prime Minister that the public sector in India is expected to augment resource availability for national development by making profits. According to the late Prime Minister, Mrs. Gandhi, we advocated the public sector for three reasons: "to gain control of the commanding heights of the economy; to promote critical development in terms of social gain or strategic value rather than primarily on consideration of profit; and to provide commercial surpluses with which to finance further economic development."[20] Thus, making profits to make resources available for investment has been certainly an important objective of the Indian public sector.

A 12 per cent return on investment in the public sector was generally regarded as reasonable.

V.K.R.V. Rao, a well-known economist, who was also a Union Minister and a member of the Planning Commission, pleaded that the pricing policy of the public enterprises "should be such as to promote the growth of national income and the rate of this growth ...Public enterprises must make profits, and the larger the share of public enterprises in all enterprises, the greater is the need for their making profits. Profits constitute the surplus available for savings and investments on the one hand and contribution to national social welfare programmes on the other; and if

public enterprises do not make profits, the national surplus available for stepping up the rate of investment and the increase of social welfare will suffer a corresponding reduction... Hence, the need for giving up the irrational belief that public enterprise should, by definition, be run on a no-profit basis."[21]

As the Taxation Enquiry Commission has remarked, "in certain cases, where the state has made a substantial investment, a policy of regulating prices so as to secure an adequate return on the capital invested is not only unobjectionable but may, indeed, be desirable. This is particularly so in the conditions of economically underdeveloped countries, where public enterprise itself, fostered at state expense, may in turn play a role in financing the country's development."[22] The Industrial Policy Resolution, 1956, states: "It is to be expected that public enterprises will augment the revenues of the state and provide resources for further development in fresh fields".

Our Five Year Plan documents have pointed out that the public sector should make a significant contribution to the pool of investible funds by generating commercial surpluses. As one Plan document has observed, "substantial investments have been made in the public sector,... and every effort must be made to ensure that they yield an adequate surplus on the basis of which to plan a further advance. Development has, in due course, to become self-financing; the surpluses from past investments constitute the source for further development. It is important that in choosing their projects for implementation, the Central as well as State Governments keep constantly in mind the needs to get results from these investments as quickly as possible".[23]

The Fourth Plan mentioned that the government had accepted in principle the recommendation of the Committee on the Working of State Electricity Boards (Venkataraman Committee) that the rate of return on capital employed should be raised to 11 per cent per annum on the basis of a phased programme. As regards the irrigation charges, the Plan document cited the important recommendations of the Committee to Suggest Ways and Means of Improving Financial Returns from Irrigation Projects (Nijalingappa Committee), and underscored the need to mop up resources from the beneficiaries of the irrigation projects. The Plan document further suggested: "Efforts should be directed to raise the rate of returns on capital employed to 15 per cent by industrial and commercial undertakings other than public utilities."[24]

The Fifth Plan also emphasised the need to ensure a reasonable return on public sector investments by improving their operational efficiency. The Draft Five Year Plan, 1978-83, suggested that the Central Government's non-departmental undertakings should aim at earning a return on investment of 10 per cent per annum.

The Sixth Plan has suggested: "Almost all the Central and State enterprises would need to adopt appropriate pricing policies in order to achieve an adequate rate of return on capital employed. Although a substantial revision of tariffs, freight rates and prices had been undertaken in the past, the additional receipts have largely been absorbed by escalation of working expenses due to the revision of emoluments to their employees, rise in input costs, etc. It is, therefore, essential to ensure that the additional resources generated by these enterprises during the Sixth Plan period by way of revision of prices, tariffs, etc., are not eroded by cost increases and that efforts are made simultaneously to secure the maximum feasible improvement in the functioning and efficiency of these enterprises."[25]

There are some public enterprises which are not specifically required to operate on commercial basis, while most of the enterprises are expected to generate commercial surpluses. For instance, the agreements between the Government of India the WHO and the UNICEF require the Hindustan Insecticides and the Hindustan Antibiotics to operate on no-profit, no-loss basis. The ECGC has also been intended to be run on the same principle. Most of public enterprises, including the Road Transport Corporations, Electricity Boards and State Financial Corporations, have been expected to conduct their business on commercial lines.

PSEs have been expected to make a profit to step up the level of investment and accelerate the pace of economic progress. This, however, does not mean that each and every enterprise is expected to make a contribution by way of profit.

In short, public enterprises as a whole should generate commercial surpluses to augment the pool of investible funds.

Influences and Guidelines on Pricing Policy

A uniform price for all the public enterprises is ruled out because the nature of goods or services they produce or provide, the production function and the market situations are not uniform. On the basis of the nature of the business, public enterprises in India may be classified into the following categories.

Pricing policies differ according to the nature of the enterprises.

1. Enterprises engaged in the production or provision of public utilities and services.
2. Enterprises engaged in the production of consumer goods.
3. Enterprises engaged in the production of basic and capital goods.
4. Enterprises engaged in the trading business.
5. Financial enterprises.

The determinants of the pricing policies of these different classes of enterprises, obviously, differ.

The Administrative Reforms Commission has recommended that the following principles should be kept in view in formulating the pricing policies of public enterprises.[26]

1. Public enterprises in the industrial and manufacturing field should aim at earning surpluses to make a substantial contribution to capital development out of their earnings, besides making a contribution to the national exchequer.
2. Public enterprises should in any event pay their way and should not run into losses except in pursuance of the express directive issued by the government in public interest.
3. In the case of public utilities and services, greater stress should be laid on output than on return on investment, the former being extended up to a level at which marginal costs is equal to price.
4. While determining the price structure commensurate with the surpluses expected from them, public enterprises should keep the level of output as near the rated capacity as possible, subject, of course, to the volume of demand for the product.

The Bureau of Public Enterprises is intimately concerned with the problems of pricing. Its main activity is directed towards dealing with specific cases as they arise, rather than with general industry studies. It also issues guidelines to public enterprises on pricing policies. The BPE issued the following guidelines.[27]

1. For enterprises which produce goods and services in competition with other domestic producers, the normal market forces of supply and demand will operate, and their products will be governed by the prevailing market prices.
2. For enterprises which operate under monopolistic or semi-monopolistic conditions, the landed cost of comparable imported goods would be the ceiling. Within this ceiling, it would be open to the enterprises to have price negotiations and fix prices at suitable levels. If the landed cost is found or believed to be artificially low, or in other exceptional circumstances it is considered necessary to have higher prices, then the matter should be referred to the Administrative Ministry, the BPE (now DPE), and the Ministry of Finance.

3. Ministries and government departments and public sector enterprises should invariably purchase their requirements from public sector undertakings to the maximum possible extent. Quality requirements and reasonable delivery schedules should of course be enforced, subject to negotiation for agreement on price. Price preference not exceeding 10 per cent will be admissible to public sector undertakings. Where a public sector undertaking requires price preference of more than 10 per cent, the Purchasing Ministry, department or public enterprises should endeavour to reach an agreement by negotiation; where such an agreement is not possible within a reasonable time, the cases have to be submitted to the Cabinet Committee for Economic Coordination. Price preference even up to 10 per cent cannot be permanent or taken for granted.

Every effort should be made to bring down costs and achieve competitiveness.

The pricing policies and practices are profoundly influenced by the competitive situation, the nature of the industry, the supply-purchase relationship with other public enterprises and government departments, etc. "Even a cursory examination of the market conditions under which the public enterprises produce and sell their goods and services would reveal several types of situations. Some enterprises come under a system of price control and regulation, while others operate in the open market; still others operate in international markets. For some enterprises, the Central Government is the sole buyer, others are linked to State Governments and other public enterprises which are their main customers. One can easily see that the managements of public enterprises are not entirely free to set their prices without some constraints".[28]

On the basis of the pricing criteria and practices of different kinds of enterprises, the Bureau of Public Enterprises has made the following broad classifications.[29]

1. Enterprises under a system of price control by the government.
2. Enterprises which sell their products entirely to the government.
3. Enterprises which sell their products mainly to State government enterprises or to other public sector enterprises.
4. Enterprises selling their products in the international market.
5. Enterprises operating in the open market.
6. Steel.
7. Price fixation by arbitration and award by the government.

Pricing Practices

Some examples of the pricing policies and methods followed by public enterprises are given below:

1. ***Administered Prices:*** In the past, prices of certain commodities like steel, coal, oil, fertilisers, etc., were fixed by the government. As a part of the economic reforms, most of the goods have been freed from the administered prices.
2. ***No-profit, No-loss Prices:*** Some undertakings like the Hindustan Antibiotics price the products on the no-profit, no-loss basis.
3. ***Cost-plus Prices:*** Several enterprises fix prices on a cost-plus basis.
4. ***Competitive Prices:*** The liberalisation has increased the relevance of this strategy.
5. ***Following the Leader:*** Price decisions of a few public enterprises are based on the behaviour of the leader. For instance, the Kerala Soaps and Oils followed this strategy in respect of some of their products.

6. ***Parity Pricing:*** For the products of some of the enterprises which had a monopoly position in the domestic market, parity with the landed cost of the imported product was sought. This was, for instance, true of the Hindustan Shipyard which established the UK parity.

7. ***Subsidised Prices:*** Some enterprises which enjoy the benefit of a subsidy from the government sell their products below the cost of production. An example was the price of the contraceptive produced by the Hindustan Latex.

8. ***Trade Association Pricing:*** Air-India International, like other international airlines, adopts the fares and freights determined by the International Air Transport Association (IATA). Similarly, the Shipping Corporation of India fixes its prices on the basis of the recommendations of the Shipping Conference.

9. ***Discriminatory Pricing:*** Many public enterprises practice price discrimination. This has been true of public sector financial institutions, Electricity Boards and the Railways.

GOVERNMENT AND PARLIAMENTARY CONTROLS OVER PUBLIC ENTERPRISES

Public control over PSEs is exercised through the government and Parliament, the representatives of the people.

A certain amount of autonomy is a necessary condition for the efficient functioning of any enterprise; and the public enterprises are no exception to this. But public enterprises have been established with public funds to serve social purposes, and hence, there should be public control over them to ensure that they discharge their duties promptly and efficiently and fulfil their objectives. Government and Parliament controls over public enterprises do not mean that the enterprises should not have any autonomy. They should necessarily have a certain amount of autonomy. It is the general policy, overall performance and decisions with long-term implications that are generally sought to be controlled by the Government and Parliament. *Autonomy vs. Accountability* has been, however, one of the unsettled issues in public enterprises.

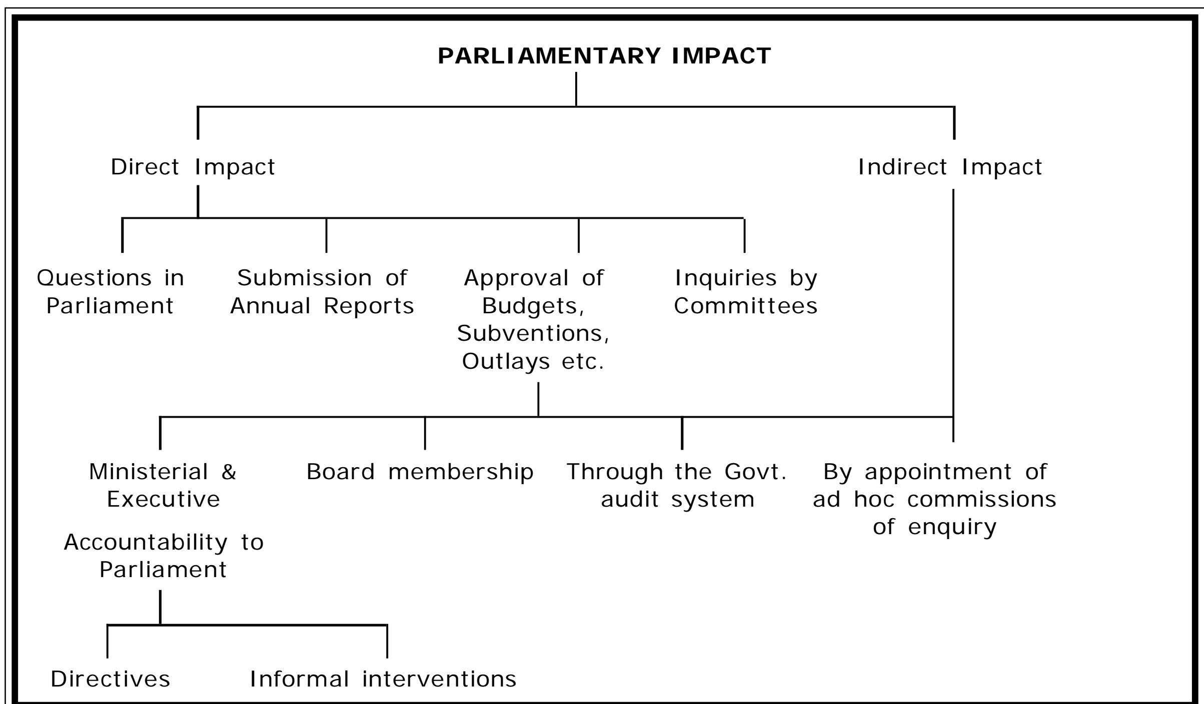

Fig. 14.1 : Parliamentary Impact on the Public Sector

(Adopted from the United Nations Publication, Organisation, Management and Supervision of Public Enterprises in Developing Countries – A Study prepared by V.V. Ramanandhan)

Pandit Nehru observed: "I have no doubt that the normal governmental procedure applied to a public enterprise will lead to the failure of that public enterprise. Therefore, we have to evolve a system for working public enterprises where, on the one hand, there are adequate checks and protection and on the other, enough freedom for that enterprise to work quickly and without delay. Ultimately, it has to be judged by the results, though one cannot judge a government enterprise by financial results alone. In judging big enterprise, one has to judge by final results. Of course, there are checks and audit and all that, but checks come afterwards. The chief man on the top must be able quickly to do what he wants to do."[30]

Government control over public enterprises is usually exercised by giving guidelines and directions for the functioning of the enterprise; appointing the top managerial and administrative personnel like the Chairman, Managing Director and members of the Boards of Directors; requiring government approval for long-term plans, large investments and major policy changes; calling for periodic reports and returns; accounts and audit control etc. Parliamentary control is exercised by discussions in Parliament and parliamentary committees.

In the early days, the government tended to exercise too much control and only limited powers were delegated to enterprises. However, on the recommendations of the Administrative Reforms Commission, it was decided to reserve only the following well-defined powers for the government.

1. Appointments of chief executives and full-time and part-time members of the Boards of Directors.
2. Sanctioning of capital programmes involving expenditure of a certain magnitude.
3. Approval of five-year annual plans of development and capital budgets.
4. Authorisation of capital to be raised and the conditions thereof.
5. Approval of the revenue budget where a deficit was required to be met by the government.
6. Calling for returns, accounts and other information on the activities of the enterprise.
7. Giving directions to the enterprise on matters involving national security or substantial public interest.

Except the chief executives and members of the Boards of Directors who are appointed by the government, appointments to all posts are made by the enterprises. Government nominates on the Board of Directors usually two government officials, one representing the administrative ministry and the other representing the Ministry of Finance. These part-time directors, by providing a two-way channel, are expected to facilitate liaison between the government and the public enterprise.

The limit of the expenditure the management of the enterprise can incur by itself without requiring the approval of the government usually varies with the size of the enterprise. All the investments beyond the specified limit require the approval of the Public Investment Board, which is headed by the Secretary (Expenditure) in the Ministry of Finance. To evaluate the investment proposal, the Public Investment Board can avail of the professional expertise and advice of the Project Appraisal Division of the Planning Commission and the Department of Public Enterprises. The important criteria adopted by the Planning Commission are the relevance of the proposed investment to be overall National Plan, the availability of resources and the social cost-benefit analysis. The Department of Public Enterprises, on the other hand, evaluates the proposal from the point of view of its financial, technical and economic viability. Thus, the Planning Commission's appraisal pertains to the macro aspects and that of the BPE to the micro aspects of the project.

In India, public enterprises are placed under the control of different functional ministries. The ministries have the responsibility to ensure that enterprises under their administrative control function effectively and in a manner conducive to the achievement of the objectives underlying their formation. For this purpose, they lay down, in consultation with the management of the enterprises, their annual targets of production/turnover, and carry out a periodical appraisal of their performance at review meetings.

Baveja[31] points out that although the government is empowered to issue directives to enterprises to conform to its policies, this is not the normal practice followed except in certain very special cases. The compliance by the enterprises with the policies of the government is achieved by the issue of instructions which are in the nature of guidelines or model rules, and it is left to the judgement of individual enterprises to adopt the suggested course of action with or without adjustments. The guidelines issued by the government relate to various matters, such as personnel and wage policies, general conditions of the service of employees, model conduct rules, economy in the field of construction, and provision of amenities in townships, etc.

PARLIAMENTARY CONTROL AND PUBLIC ACCOUNTABILITY

The rationale of parliamentary control over PSEs is that they employ public resources.

Parliamentary control is a very important aspect of the performance appraisal of public enterprises in India. One of the former Speakers of the Lower House of Parliament, Shri G.V. Mavalankar, once observed: "Merely because the system makes them autonomous, it does not follow that the system can take away the jurisdiction of Parliament for having a full probe into the administration of the autonomous body."[32]

There are three important methods by which Parliamentary control over public enterprises is exercised in India.

1. ***Holding Debates in Parliament:*** A debate on the performance or some other issue pertaining to public enterprises may be initiated during the budget debates, or on a discussion of the President's address, or by moving resolutions on any topic, by raising an half-hour discussion on a public undertaking, by moving a motion for adjournment on a matter of public importance, by short discussions on matters of urgent public importance, or "calling the attention" of the House to some urgent matter during discussions on reports of enquiries, or while introducing or amending the statutes of a corporation, or on a presentation of the annual reports.

2. ***By Interpellation:*** This means interrupting the proceedings in Parliament and demanding a statement or explanation from the Minister.

There is a practice of setting apart one opening hour of Parliament's meeting time for questions and answers. Members of the House give due notice of their questions to the Ministers and the Ministers concerned give the House the answers which they may prepare with the help of civil servants.

3. ***By Parliamentary Committees:*** Special Committees of Parliament, consisting of the members belonging to various parties, examine the various aspects of the functioning of public enterprises.

The CPU

In the earlier years, the Public Accounts Committee and the Estimates Committee of Parliament examined the working of public enterprises. But as these committees were overburdened with work, and also because the criteria for the appraisal of performance of public enterprises had to be different from those applied to the work of the government departments with which these committees were concerned, the Committee on Public Undertakings was set up in 1964. The members of the CPU are drawn from both the Houses of Parliament. The terms of reference of the Committee are as follows.

(i) To examine the reports and accounts of public enterprises.

(ii) To examine the reports, if any, of the Comptroller and Auditor General of India on public enterprises.

(iii) To examine, in the context of the autonomy and efficiency of public enterprises, if their affairs are managed in accordance with sound business principles and prudent commercial practices, and to exercise such other functions in relation to public enterprises as may be allotted to it by the Speaker from time to time.

At the beginning of each financial year, the Committee on Public Undertakings selects for examination-in-depth some 8 to 10 enterprises. These studies cover in great depth every aspect of the working of the enterprises. The secretaries of the administrative ministries, the chief executives of public enterprises and other senior officials are required to appear before the Committee to give oral evidence. The reports of the Committee are presented to the Parliament. An examination of the working of an enterprise by the Parliamentary Committee is essentially in the nature of an evaluation of the performance of that enterprise, and it enables the Committee to make recommendations on how the working of that enterprise may be improved to enable it to discharge more effectively the role assigned to it.[33]

Apart from examining the working of individual enterprises, the CPU undertakes horizontal studies affecting public enterprises as a whole. Some of the horizontal studies of the Parliamentary Committee conducted include foreign collaboration in the public enterprises, financial management, public relations and publicity, personnel policies and the role and achievements of public undertakings.

There is a mechanism available with the Committee to follow up the implementation of its recommendations. The government is required to furnish the Committee within six months the replies showing the action taken on its recommendations. The replies are further processed by the Committee and a report is submitted to Parliament with the Committee's comments on the government's replies. In the words of Jyotirmoy Basu, over the years, this Committee, like its counterpart, the Select Committee on Nationalised Industries in Britain, has become an effective watchdog of Parliament to oversee the functioning of public undertakings and to ensure that they play a stabilising role in the economy of the country."[34]

The annual reports and balance sheets of all the enterprises are required to be laid on the table of both Houses of Parliament within a period of nine months from the close of the accounting year. This provision is contained in the enactments relating to the setting up of statutory corporations as well as in the Companies Act. A consolidated annual report of the working of industrial and commercial undertakings of the Central Government is also required to be placed on the table of the House. It must, however, be noted that Parliament, as a matter of principle, does not generally extend its supervision to matters of day-to-day administration."[35]

The accountability of enterprises is also ensured by a systematic appraisal of their performance by the Audit Boards functioning under the Comptroller and Auditor-General. The accounts of the enterprises are subject to audit by commercial auditors (firms of chartered accountants) appointed on the advice of the Comptroller and Auditor-General. The latter is also authorised to conduct a supplementary or test audit through the Audit Board.

These Audit Reports, together with the comments of the Comptroller and Auditor-General, are presented to Parliament and are available for the use of the Committee on Public Undertakings in its examination of the performance of public enterprises."

DEPARTMENT OF PUBLIC ENTERPRISES

The Bureau of Public Enterprises was set up in the Ministry of Finance in 1965 to provide a central focal point of reference and consultation to deal with matters of common interest to public enterprises, like organisational patterns, methods of management, personnel policies, collaboration agreements, project scrutiny and clearance, project and corporate planning, etc. In 1985, the BPE was brought under the Ministry of Industry. In 1990, the BPE was conferred the status of a full-fledged Department and is now known as the Department of Public Enterprises (DPE) in the Ministry of Industry.

The Department of Public Enterprises acts as a nodal agency for all PSEs and assists in policy formulation pertaining to the role of PSEs in the economy as also in laying down policy guidelines on performance improvement and evaluation, financial accounting, personnel management and in related areas. It also collects, evaluates and maintains information on several areas in respect of PSEs. DPE also provides an interface between the Administrative Ministries and the PSEs. In fulfiling its role, it associates itself with other Ministries and organisations as also premier management institutes in the country.

Role and Tasks

The important role and task of the Department are the following.

1. General Policy relating to Public Sector.
2. Matters relating to issue of Presidential Directives and guidelines to Public Sector enterprises.
3. Formulation of policy guidelines pertaining to Public Sector Enterprises in areas like performance improvement and evaluation, financial management, personnel management, board structures, wage settlement, training, industrial relations, vigilance, performance appraisal etc.
4. Matters relating to reservations of posts in the Public Sector Enterprises for certain classes of citizens.
5. All matters relating to Memorandum of Understanding between the Public Sector Enterprises and the Administrative Ministries/Departments.
6. Matters relating to delegation of powers to Board of Directors.
7. To undertake in-depth studies in respect of significant areas of functioning of Central PSEs.
8. Matters relating to International Centre for Public Enterprises (ICPE).
9. Matters relating to Standing Conference of Public Enterprises (SCOPE).
10. To monitor and evaluate the performance of PSEs and to act as a repository of data and to bring out an Annual Survey for the Parliament.
11. Settlement of disputes among public sector enterprises and between public sector enterprises and Government Departments except disputes relating to tax matters.
12. Advise on establishing new centrally sponsored enterprises including their capital and organisational structure and Memorandum and Articles of Association.
13. All policy matters relating to composition of Board of Director of PSEs, categorisation of top posts, scheduling of PSEs and notification of revised pay scales and DA admissible therein at periodical intervals.

14. Disinvestment implementation of policy on Public Sector Enterprises.
15. Notify revised scales of pay for Board level executives and the DA admissible thereon at periodical intervals.
16. Coordination of training programmes for managerial personnel in Public Sector Enterprises.
17. Policy relating to deputation of Government officers to PSEs.
18. Assist any committee appointed by the Government to examine any aspect relating to PSEs.
19. Monitoring of performance of sick PSEs and preparing for PMO and Cabinet Secretariat appraising latest development regarding PSEs referred to BIFR.

NATIONALISATION

One of the important contributory factors to the growth and expansion of the public sector was the nationalisation of certain industries as a whole and certain undertakings in some of the other industries.

Nationalisation was conspicuous in the Indian industry and financial sector in the early decades after independence.

"Nationalisation is the establishment of the public ownership of the means of production by taking them over from private proprietors or foreign states, and subsequently transferring them to the control of the national government. Nationalisation is a complex process. Since it is initiated by the state, it always reflects changes in the alignment of political forces and interests, and is, therefore, primarily a political move. Since nationalisation brings about a change in the economic position of various groups, classes and forces and entails a redistribution of resources, it has far-reaching economic consequences; which is why, of course, it is undertaken. Naturally, nationalisation also affects social relations and brings about a change in the correlation of social forces. Finally, it affects political and economic relations with other states and groups."[36]

The earlier nationalisations in India had been in the strategic and critical sectors; but later the scope of nationalisation was widened. The Industrial Policy Resolution of 1948 clearly stated that, 'in any emergency, the government would always have the power to take over any industry vital for national defence", and that the state will not "hesitate to intervene whenever the progress of an industry under private enterprise is unsatisfactory." And there had been a series of nationalisations.

The important objectives of nationalisation were:

1. To have effective control over the strategic and basic sectors of the economy.
2. To put an end to mismanagement by private capitalists.
3. To ensure better utilisation of the productive resources and to serve the genuine needs of the priority sectors and weaker sections.
4. To maintain employment and to safeguard the interests of the workers.
5. To protect the interests of consumers.
6. To take the necessary action for the development of the concerned industry or business.

We may recall here some of the important nationalisations, that took place after independence.

The banking sector witnessed four important nationalisations, including the nationalisation of the Reserve Bank of India in 1949. The Imperial Bank of India was nationalised and the State

Bank of India was established in 1955. In 1969, fourteen major commercial banks in the private sector were nationalised. With the nationalisation of another six banks in 1980, more than 90 per cent of the commercial banking business came in the public sector.

The government has also established monopoly in the insurance business. In 1956, life insurance companies and in 1972 general insurance companies were nationalised.

The government acquired the Mazgaon Docks, Bombay, and the Garden Reach Workshop, Calcutta, in 1960, and the Hindustan Shipyard in 1961.

The coking coal mines were taken over in 1972 and the non-coking mines in 1973. The next three years witnessed the nationalisation of foreign oil companies.

Apart from the nationalisation of certain industries, wholly or partially, individual undertakings in some other industries had also been nationalised to protect the interests of the workers and consumers to fulfil certain other objectives. The National Textile Corporation (NTC), set up in 1968, took over many sick mills. Under the Industries (Development and Regulation) Act, 1951, the government had taken over the management of a number of sick units. Thirteen sick units, earlier managed under the IDRA, were nationalised in 1980.

State governments, too, have been showing interest in the nationalisation of certain important sectors. Road transport was a common area of nationalisation. Some States like Kerala had nationalised private forests and plantations owned by foreign companies.

Since the early 1990s, nationalisation has been reversed by privatisation.

A lot of criticisms have been directed against the performance of the nationalised sectors and undertakings. The nationalised business, by and large, failed to rise up to expectations.

As part of the economic reforms ushered in 1991, Government is trying to correct the past mistake by privatisation. (Also refer to the *New Public Sector Policy* described elsewhere in this chapter).

PRIVATE SECTOR

Until 1991, the scope and growth of private sector were constrained by the industrial policy.

In a mixed economy, the private sector, too, has an important role to play. Indeed, it is because of the appreciation of the positive role the private sector can play, and certain limitations of the public sector, that many socialists advocate a mixed economic system. The Industrial Policy Resolution of 1956, which still remained the core of India's industrial policy and which assigned a dominant role to the public sector in a number of vital industries, has made it very clear that, *as an agency for planned national development, in the context of the country's expanding economy, the private sector will have the opportunity to develop and expand.* It is, thus, clear that the adoption of the principle of the socialist pattern of society did not mean the end of the private sector. Instead the private sector was assigned, and was expected to play, a very important role.

According to the Industrial Policy Resolution, 1956, it was expected that the development of the industries outside the Schedules A and B would be undertaken ordinarily through the initiative and enterprise of the private sector, though it was open to the state to start any industry even in this category. It was "the policy of the state to encourage the development of these industries in the private sector, in accordance with the programmes formulated in successive Five Year Plans, by ensuring the development of transport, power and other services, and by appropriate fiscal and other measures. The state will continue to foster institutions to provide financial aid to these industries, and special assistance will be given to enterprises organised on cooperative lines for industrial and agricultural purposes." While shortcomings still exist, it must be said to the credit of the government that a remarkable progress has been achieved on these lines. It may also be pointed out here that a number of private sector enterprises that already existed in the industries included in the Schedule A have been allowed to develop further.

The Industrial Policy Resolution of 1956 has also made it clear that, "industrial undertakings in the private sector have necessarily to fit into the framework of the social and economic policy of the state and will be subject to control and regulation in terms of the Industries (Development and Regulation) Act and other relevant legislation. The Government of India, however, recognises that it would, in general, be desirable to allow such undertakings to develop with as much freedom as possible, consistent with the targets and objectives of the national plan. When there exist in the same industry both privately and publicly-owned units, it would continue to be the policy of the state to give fair and non-discriminatory treatment to both of them."

The scope and role of private sector in India increased tremendously with the economic reforms ushered in 1991.

The preceding paragraphs give some idea of the government's policy towards the private sector and the industrial spheres open to that sector. Even in the areas where the private sector has been allowed, its operations and development have been regulated by the government in the public interest. The large industrial houses and foreign concerns, particularly, had been subject to a number of checks and controls. Their role had been confined to certain important areas like the heavy investment sector, the core sector, the export sector and backward areas development. The government's policy was to prefer small and new entrepreneurs to large industrial houses in the private sector, wherever possible.

The private sector has been dominant in most of the consumer goods industries. It plays an important role in a number of capital goods industries, too. In a number of important industries, it functions side by side with the public sector.

The joint sector also reflects to some extent the importance of the role of the private sector.

With the new industrial policy announced on July 24, 1991, and modifications introduced thereafter, the role of the private sector has been substantially expanded. Now, private enterprises are allowed in all but two industries. Only a very small number of industries are now industrial licensing (*i.e.*, except in these industries there are no entry and growth restrictions on the private sector). The scope of private sector is increased by the withdrawal of the State from many industries and privatisation (See the section on the *New Public Sector Policy*).

JOINT SECTOR

The term *joint sector* refers to the enterprise owned and managed jointly by the private sector and the government/public sector undertakings. The Dutt Committee (Industrial Licensing Policy Inquiry Committee) has defined the concept of the joint sector in the following terms: "The joint sector would, in our view, include units in which both public and private investments have taken place and where the state takes an active part in direction and control."

Joint sector brings together the resources and capabilities of the public and private sectors.

Formation of Joint Sector Enterprises

Joint sector enterprises may be brought into being by any one of the following ways.

1. The Central Government and private entrepreneurs may jointly set up new enterprises. Sometimes, the Central Government and one or more State Governments together may set up enterprises in partnership with the private sector. (It may be pointed out that the public may also hold shares in joint sector enterprises).
2. State governments or their industrial development corporations may set up new companies jointly with private partners, involving equity participation by both the partners.
3. Public financial institutions may, through equity participation or conversion of loans or debentures into equity, transform enterprises promoted by private entrepreneurs into joint sector companies.

4. The existing private enterprises may be transformed into joint sector enterprises by the government or government companies acquiring a part of the equity or converting debt into equity or by contributing to an increase in the share capital.

5. The existing public sector companies may be transformed into joint sector enterprises through the sale of some equity shares to private entrepreneurs or the general public. The disinvestments policy of the Government has been resulting in the transformation of several PSEs to joint sector enterprises.

Industrial investment corporations and industrial development corporations in a number of states have actively promoted joint sector enterprises. In a number of these cases, 26 per cent of the equity is held by the SIIC/SIDC, 25 per cent by private promoter(s) and 49 per cent of the shares are offered to the public.

In pre-independence days, the Princely States of Mysore and Hyderabad had established several industrial enterprises in which equity participation by the general public was permitted. In the years following Independence, a number of companies were floated by the government in collaboration with the private sector by sharing ownership, management and control with them. This form of industrial organisation was found appropriate for the import of foreign technology and capital, as in Cochin Refineries (1963), Madras Refineries (1965), and Madras Fertilisers (1966); for the utilisation of indigenous entrepreneurial and managerial resources, as in Air-India (1947); for the use of organisational capabilities of existing industrial houses, such as the Bird Heilgers group in Bolani Ores (1957); and the mobilisation of financial resources from the public, as in the Gujarat State Fertiliser Company (1965).[37]

RATIONALE OF JOINT SECTOR

Joint sector has been viewed as an effective means of achieving a mixed economy.

The joint sector is conceived as a marriage between the managerial expertise of the private sector and the financial resources and social orientation of the public sector. "In a sense, joint sector enterprises represent an application of the concept of mixed economy at the micro level."

The main objectives and advantages of the joint sector are the following.

1. ***Curbing Concentration of Economic Power:*** The Dutt Committee advocated the joint sector, viewing it as an important means of curbing the increasing concentration of economic power. The Committee even regarded the joint sector as possibly more effective than licensing in achieving this objective. This was regarded as a very important rationale of the joint sector in the past.

2. ***Social Control of Industry:*** Government participation in equity and management is expected to give a social orientation to the enterprise. The joint sector would ensure that the management of industry is conducted according to the overall policies laid down by the government, and that public interest and not merely private profit would guide the operations of the enterprises. "Used effectively and with care, the joint sector can be a more useful instrument than all rules and regulations and penal powers of the state in ensuring that development is according to plan. The concept of the joint sector has thus the potential, if properly used, to get the best advantages out of the mixed economy which has been accepted in our country as a matter of state policy."[38]

3. ***Acceleration of Economic Development:*** The joint sector, by mobilising and augmenting the productive resources, can accelerate the pace of economic development. It enables private entrepreneurs and the state agencies to promote or invest in a greater number of projects than would otherwise be possible. "The resources of the private sector in savings, investments and entrepreneurship can be harnessed in the joint sector with active state help to supplement the efforts made by the state in the public sector without the private profit motive being allowed to vitiate the effort."[39]

4. *Promotion of Mixed Economy:* It is also expected that the joint sector will promote the mixed economy and help achieve development objectives. "The basic justification of the idea of mixed economy is to harness all the productive forces of society, state as well as private, to the task of economic development with a view to accelerating the process. By allowing the private sector to play its part in the process, the state is able to develop entrepreneurship outside the government, and enlist it to supplement its entrepreneurial role. *Similarly,* a mixed economy allows the state to take advantage of voluntary savings in society for purpose of investment to supplement the resources it is able to mobilise for this purpose."[40]

5. *Broadbasing of Entrepreneurship:* Another advantage of the joint sector is that it helps broadbase entrepreneurship by encouraging new and small entrepreneurs. The joint sector enables potential entrepreneurs with small financial resources and less experience to participate in large enterprises as the public sector shares investment and the risk. "Many private entrepreneurs, whose means are not comparable with those of large companies, may come forward and take advantage of joint sector opportunities because the government's support and facilitating roles that are assured to them. There is some evidence of this at the state level, where the industrial development corporations seem to be playing the role of broadbasing entrepreneurship."[41]

EVOLUTION OF GOVERNMENT POLICY

The concept of *the joint sector* became very popular after the Report of the Industrial Licensing Policy Inquiry Committee was submitted in 1969. However, this was not a new idea. The industrial policy pronouncements even before the Dutt Committee Report had conceived the idea of the joint sector. Indeed, the joint sector as a form of business existed in India even before Independence.

The idea of the joint sector was implicit in the Industrial Policy Resolutions of 1948 and 1956. The Industrial Policy Resolution of 1948 indicated the possibility of the state securing the cooperation of private enterprise for the establishment of new units even in the six industries where only the state was to have the right to set up new units, subject to such control and regulation as the Central Government might prescribe. The Industrial Policy Resolution of 1956 indicated "the possibility of the state securing the cooperation of private enterprises in the establishment of new units when the national interest so requires" in the industries listed in Schedule A (*i.e.,* industries, the future development of which had been exclusively reserved for the state). The Resolution also made it clear that, "whenever cooperation with private enterprise is necessary, the state will ensure, either through majority participation in the capital or otherwise, that it has the requisite power to guide the policy and control the operations of the undertaking". It was stated that when the state granted financial assistance to the private sector, "such assistance, especially when the amount involved is substantial, will preferably be in the form of participation in equity capital, though it may also be, in part, in the form of debenture capital."

Some laconic references to the joint sector concept are found in the Five Year Plan documents, beginning with the First Five Year Plan. The Second Plan (1956-61) observed, for instance, that "public ownership, partial or complete, and public control or participation in management are specially required in those fields in which technological considerations tend towards concentration of economic power and wealth".

The Companies Act, 1956, contains provisions relating to government companies under which equity in such companies can be shared by Central and State Governments and private parties. The Companies Act defines a government company as a company in which not less than fifty-one per cent of the paid-up share capital is held by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary of a Government company thus defined. The Companies Act, by the definition of the government company, recognises the

possibility of joint participation in the equity of a company by the state and private parties (including general public) in the proportion of 51 : 49 respectively in extreme cases.

The concept of the joint sector received greater attention after the Industrial Licensing Policy Inquiry Committee's (ILPIC) Report. The Dutt Committee, in its Report, which followed the unpleasant disclosures made by the Monopolies Inquiry Commission and Professor Hazari, viewed the joint sector as an important means of curbing the increasing concentration of economic power.

The concept of joint sector received a lot of attention around 1970.

The ILPIC recommended that public financial institutions should have the option to convert the whole or part of their financial assistance to private enterprises into equity so as to bring such enterprises in the joint sector in the mainstream of social interest. Following the guidelines issued by the government in 1971, the all-India industrial financial institutions had been reserving the right of converting a part of their loans into equity. With the economic liberalisation, the conversion loans in to equity clause was given up.

In February 1970, the government accepted the joint sector concept, taking into consideration the recommendations of the Dutt Committee. Accordingly, the joint sector was expected to function in two broad areas, *viz.*, the *core sector* (consisting of basic, critical and strategic industries), excluding those industries illustrated in 'Schedule A' of the Industrial Policy Resolution, and the *heavy investment sector,* with investment exceeding ₹ 5 crore. Government clarified that "the joint sector will not be permitted to be used for the entry of larger houses, dominant undertakings and foreign companies in industries in which they are otherwise precluded on their own. In all the different kinds of joint sector units, the government will ensure for itself an effective role in guiding policies, management and operations, the actual pattern and mode being decided as appropriate in each case."

The Concept of National Sector

In early 1975, T.A. Pai, the then Union Minister for Industries, suggested the replacement of the public sector by that of the national sector. For the establishment of the national sector, Pai proposed that the public sector undertakings might sell 49 per cent of their shares to the public. He advocated that the shares should be sold, as far as possible, to workers and middle-income groups.

This proposal came in for scathing criticism on the ground that it would facilitate the penetration of private capitalists into the public sector. But a national sector in which workers and the middle class have a considerable stake might be expected to work more efficiently than the public sector. This concept, however, is gaining much acceptance now.

COOPERATIVE SECTOR

One of the important aspects of the development of the cooperative sector in India, as in a number of the other countries, is state participation.

In India, the cooperative sector has been assigned an important role in the development of many sectors. The First Five Year Plan envisaged the cooperative sector to cover a number of vital areas like agriculture, rural and small-scale industry, retail distribution, housing etc.

The important objectives of the development of the cooperative sector are prevention of concentration of economic power, wider dispersal of ownership of productive resources, active involvement of people in development programmes, augmentation of the productive resources and speedier economic development, liquidation of unemployment and poverty, etc.

According to Weerman, the following are the main background factors or influences which lead to a relationship between the state and cooperatives in developing countries.[44]

1. The need to give legal recognition to cooperative societies and to provide for their proper management and supervision in the interest of the movement.
2. The need to safeguard the rights of the people *vis-à-vis* these societies.
3. The need to prevent any abuse or privileges accorded to co-operatives.
4. The need to promote the movement because:
   (a) It *is, per se,* desirable and nobody other than the government is likely to take the initiative in promoting it.
   (b) It is the best means of national development.
   (c) It solves the problem of lack of leadership and local personnel for the diffusion of new ideas and techniques.

The important ways in which the state patronises the cooperative movement in India are:

State partnership in the share capital of cooperatives; loans to societies; subsidies and grants; guarantees; contribution to risk fund; tax concessions; legal concessions and sanctions; training and education; help from the Reserve Bank and other banking organisations that help the cooperatives; and supply of government officers on deputation.

The cooperative idea took a concrete shape in India for the first time in 1904, when the Cooperative Credit Societies Act — a measure designed to combat rural indebtedness and provide for the registration of credit societies — was passed. Later, in 1912, the Cooperative Societies Act provided for the registration of non-credit societies as well as federations of cooperatives. Since then, the cooperative movement has made progress, especially in the fields of agricultural credit, marketing and processing of agricultural produce, supply of farm inputs and distribution of consumer goods. By far, the largest number of societies are in the agricultural credit sector. The primary agricultural credit societies cover over 96 per cent of the rural areas.

Processing and Industrial Cooperatives

Our industrial policy statements have emphasised the role of the cooperative sector in the industrialisation of the country, especially by developing cottage, village and small-scale industries. In the large and medium industries sector, certain agro-industries like sugar, jute and cotton have been considered to be ideally suited for the cooperative sector. At one time, the Government of India had also made it a policy new sugar factories would be allowed only in the public and cooperative sectors.

The National Federation of Industrial Cooperatives assists in the marketing of the products of member societies.

Today, there are a large number of industrial cooperatives with a membership of several millions.

The structure of processing units established in the cooperative sector conforms to two distinct patterns, namely, (a) Units established by independent processing units; and (b) Units established as adjuncts to cooperative marketing societies.

Under the first category fall the larger units, such as cooperative sugar factories, spinning mills and solvent extraction plants. Medium and small units, such as rice mills, oil mills, cotton ginning and pressing units, jute baling units, etc., fall under the second category.

The cooperative sector has significant presence in certain industries like cotton textiles, sugar and fertiliser. The Indian Farmers Fertiliser Cooperative Ltd. (IFFCO) is a unique venture of the cooperative movement in India in the field of large-scale fertiliser manufacture.

The cooperatives have also diversified their activities to cover new lines of business, like the production, processing and distribution of improved agricultural implements and the setting up of agro-service centers.

Storage, Distribution and Marketing Cooperatives

The National Cooperative Development Corporation is responsible for the planning, promotion and financing of the programme of augmenting the storage capacity of the cooperatives at various levels. There are a very large number of rural godowns and marketing godowns. There are also a number of cold storage units.

Cooperatives in India play a significant role in the distribution of agricultural inputs, such as fertilisers, seeds, pesticides, agricultural implements and credit. A large share of the total fertilisers distributed in India are sold through the cooperative distribution system.

The cooperative marketing structure consists of a large number of primary cooperative marketing societies, covering all the important agricultural markets in the country.

The National Agricultural Cooperative Marketing Federation (NAFED), which represents the cooperative marketing societies in the country, promotes inter-State and export trade of farm produce.

Functional Cooperatives

Cooperatives for the weaker sections of society provide increased employment and income opportunities to different sections of the community, such as small and marginal farmers and fishermen. Functional cooperatives for dairy, fishery and poultry mainly relate to the service of the weaker sections.

There are also a very large number of primary housing cooperatives in the country.

Multi-purpose Cooperatives

As part of the programme of economic development of tribals, primary cooperatives in tribal areas were reorganised to enable them to function as multi-purpose societies providing short, medium and long-term credit to tribals, undertaking collection and marketing of agricultural and minor forest produce, arranging for supply of agriculture inputs as well as essential consumer goods. State level cooperative tribal development corporations/federations have been established in a number of States to serve as apex organisations for the marketing of minor forest produce and consumer goods.

National Level Cooperative Federations: A major development over the past one decade has been the emergence of national cooperative federations which have added a new dimension to the cooperative infrastructure. With the National Cooperative Union of India at the apex, the other national level cooperative organisations, include the National Agricultural Cooperative Marketing Federation, the All-India State Cooperative Banks Federation, the National Federation of Cooperative Sugar Factories, the National Cooperative Land Development Banks Federation, the National Cooperative Consumer's Federation, the National Federation of Industrial Cooperatives, the All-India Federation of Cooperative Spinning Mills, the National Cooperative Housing Federation, the National Cooperative Dairy Federation of India and the National Federation of Cooperative Urban Banks and Credit Societies.

In the context of a national pattern which is being evolved, the system of workers' participation in management is being introduced in large cooperative industrial units. Special cooperative programmes directed towards increasing employment and income opportunities for the vulnerable sections have been evolved and are being implemented. The National Cooperative Development Corporation has also extended its activities to cover cooperative programmes for weaker sections.

Many cooperative societies are virtually defunct. Many others are languishing due to financial, organisational and administrative problems.

PROBLEMS

While the overall progress of the cooperative movement appears to be striking, there are wide regional disparities. The level of development of agricultural cooperatives is not uniform in all the states.

The cooperative movement in India is very adversely affected by political overshadowing. Many cooperatives are controlled by politicians and/or the economically powerful members.

SUMMARY

On the basis of the ownership pattern, the industrial sector of India consists, broadly, of public, private, joint and cooperative sectors. The development of these sectors was directed by the Industrial policy. The industrial policy until 1991 was characterised by a dominant role assigned to the public sector.

The *Industrial Policy Resolution of 1948* reserved eight industries to the public sector. The *Industrial Policy Resolution of 1956* enlarged the role of the public sector by increasing this list to seventeen and earmarking twelve industries to be progressively state-owned and in which the state would, therefore, generally take the initiative in establishing new units.

The four decades until 1991 witnessed a substantial growth and expansion of the public sector in India. Nationalisations also contributed to the growth and expansion of the public sector. The public sector gained control over the commanding heights of the economy. The performance of the public sector, however, was far from satisfactory. The industrial policy announced in 1991 which heralded the economic liberalisation substantially contracted the role of the public sector. The number of industries reserved for the public sector was reduced to eight and by 2001 May, all industries except atomic energy and railway transport was thrown open to the private sector. Privatisation of public sector units is also an important aspect of the new policy. In short, the industrial development of the country is now left mostly to the private sector.

Besides the public sector, the joint sector and cooperative sectors had been promoted by the Government as a strategy to prevent concentration of economic power in the private sector. With almost all industries open to the private sector without any entry and growth restrictions, the current industrial policy has no specific tenets in favour of the public, joint or cooperative sectors.

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Chapter 15

PRIVATISATION AND DISINVESTMENT

Structure

Expansion of Public Sector and its Defects

Ways of Privatisation

Obstacles to Privatisation

Conditions for Success of Privatisation

Benefits of Privatisation

Arguments against Privatisation

Sins and Pitfalls of Privatisation

Privatisation/Disinvestment in India

Summary

References

Privatisation amounts to replacement of public ownership and management by private ownership and management.

A strong reversal of the trend of the statist economic expansion set in, globally, since around the 1980 and has become the hallmark of the new wave of economic reforms that has been sweeping across the world.

Privatisation means transfer of ownership and/or management of an enterprise from the public sector to the private sector. It also means the withdrawal of the State from an industry or sector, partially or fully. Another dimension of privatisation is opening up of an industry that has been reserved for the public sector to the private sector.

Privatisation marks a change from dogmatism to pragmatism and amounts to a reversal of policy.

EXPANSION OF PUBLIC SECTOR AND ITS DEFECTS

Regardless of whether socialist or market-oriented, a large number of countries in the 1960s and 1970s saw an expansion of the public sector, and in particular an expansion of State-owned enterprises, across a broad front.[1] In the 1960s, there was a trend towards nationalisation in Britain. But, since the late 1970s, the trend was towards privatisation by selling State-owned enterprises (SOEs). It indeed became a universal trend.

The performance of SOEs in many countries was, by and large, been far from satisfactory. They often put large burdens on public budgets and external debt.

The heavy financial burden imposed by the SOEs and the growing public discontent against them due to their inefficiency, indifferent, irresponsible and sometimes even arrogant attitude and lack of concern for the customer needs; and corruption, nepotism and squander associated with their organisation and management led to the growing interest in privatisation. As Professor Samuel Paul points out,[2] in country after country, unbridled state expansion has led to:

1. Economic inefficiency in the production activities of the public sector, with high costs of production, inability to innovate, and costly delays in delivery of the goods produced;
2. Ineffectiveness in the provision of goods and services, such as failure to meet intended objectives, diversion of benefits to elite groups, and political interference in the management of enterprises; and
3. Rapid expansion of the bureaucracy, severely straining the public budget, causing problems in labour relations within the public sector, inefficiency in government, and adverse effects on the whole economy.

These problems have led many governments to undertake programmes of public sector reform, and pushed by a need to curb public expenditure, to reevaluate the possibilities for shifting publicly managed activities into the private sector.

The Privatisation Reaction

Privatisaion is an inevitable historical reaction to the indiscriminate expansion of the State sector and the associated problems.

Even in the 'communist' countries, privatisation became a vital measure of economic rejuvenation.

It may be noted that as a result of privatisation, the number of people owning shares in Britain almost tripled from 7 to 20 per cent of the adult population between 1978-89. Interestingly, in 1988, Britain experienced a symbolic cross over—for the first time in history more British citizens were holders of shares than were members of unions.[3] Further, as the proportion of shareholders in the total population increases and as the economic lot of the workers and the poor improves, leftist parties increasingly lose their ground. In 1988, for instance, the Labour Party in Britain lost 8 per cent of its members, the biggest exodus since 1981.[4]

Privatisation can encompass a whole organisation or certain functions only.

WAYS OF PRIVATISATION

There are different ways of achieving privatisation. "Each country has its own gimmicks. In Britain, the staff of the privatised company have a priority in buying shares, and are entitled to a discount. For instance, 96 per cent of British telecom employees took a share in their company in defiance of the trade union opposition. Although some of them later sold them (at a higher rate), they derived certain benefits (at least financial ones) from privatisation. The use of the US ESOP (Employees' Share Ownership Plan) practices is another interesting example. ESOP provides for forming special fund which takes bank credit to buy a company's shares and distribute them among employees at the real value or free of charge. The credit is paid back out of the company's profit."[5]

One of the important ways of privatisation is *divestiture,* or privatisation of ownership, through the sale of equity. In countries where there are well-functioning capital markets, this entails selling stock to the public. In industrial countries, privatisation has come mainly through divestiture of government economic activities.

There are a large number of cases where privatisation has taken the form of *denationalisation or reprivatisation.* A considerably large number of enterprises were denationalised in countries like Chile, Bangladesh and Pakistan.

Another way of privatisation is *contracting.* Governments may contract out services they have planned and specified to other organisations that produce and deliver them.

Franchising—authorising the delivery of certain services in designated geographical areas—is common in utilities and urban transport. Contracting is common in public works, defence and many specialised services. Where suppliers compete for contracts and there is no loss of economies of scale, contracting is efficient. But there is scope for corruption in contracting, and long-term contracts tend to encourage monopolistic behaviour by the private supplier.[6]

Another option for the government is to *withdraw* from the provision of certain goods and services leaving them wholly or partly to the private sector.

Privatisation may also take the form *of privatisation of management,* using *leases* and *management contracts.*

Government can shed the burden also by *liquidation* which can be either formal or informal. Formal liquidation involves the closure of an enterprise and the sale of its assets. Under informal liquidation, a firm retains its legal status even though some or all of its operations may be suspended.

OBSTACLES TO PRIVATISATION

Underdevelopment of capital market and political factors pose problems for privatisation in developing countries.

When compared to the industrial countries, the progress of privatisation has been slow in the developing countries. As the World Bank points out, governments confront several obstacles, like those mentioned below, when they decide to divest SOEs.[7]

(i) Governments usually want to sell the least profitable enterprises, those that the private sector is not willing to buy at a price acceptable to the Government.

(ii) Divestiture tends to arouse political opposition from employees who may lose their jobs; from politicians who fear short-term unemployment as a consequences of liquidation or of cost reduction by private owners; from bureaucrats who stand to lose patronage; and from those sections of the public that fear that national assets are being cornered by foreigners, the rich, or a particular ethnic group. Sometimes the opposition of employees

is due to the fact that they will have to bid good by to the 'easy going' culture in the public sector and produce result if the enterprise is privatised.

(iii) Relatively undeveloped capital markets sometimes make it difficult for governments to float shares and for individual buyers to finance large purchases.

CONDITIONS FOR SUCCESS OF PRIVATISATION

Professor Samuel Paul points out that if privatisation is to succeed, in the sense of raising efficiency or effectiveness in the production or delivery of goods and services, the following seven conditions must be met.[8]

First, privatisation cannot be sustained unless the political leadership is committed to it, and unless it reflects a shift in the preferences of the public arising out of dissatisfaction with the performance of other alternatives. Privatisation has in the past worked best when a government was strongly committed to a change, or when a new government vowed to reverse the actions of its predecessors, as has happened in Chile and the United Kingdom. Some governments that had faced severe economic crises, with massive budgetary deficits, had turned to privatisation and divestiture as a part of their adjustment strategy.

Second, any alternative institutional arrangements chosen should not stifle competition among suppliers. Replacement of a government monopoly by a private monopoly may not increase public welfare—there must be a multiplicity of private suppliers. This can be a difficult problem where there are few competent suppliers. Though government may wish to contract out a service, if there are only one or two qualified contractors, the benefits of competition are unlikely to follow.

In this context, most developing countries' systems of regulation need major review and reform. Overregulation of industry discourages private initiative; overregulation of urban land use of building construction retards urban development; and unduly low ceilings on the prices of industrial products and utilities, such as bus transport and electricity, inflate demand and depress the incentives for production.

The third, related, condition is freedom of entry to provide goods and services. Long-term contracts and franchises limit competition and consumers' choice. In some services that are capital-intensive, freedom of entry is difficult to achieve. But in others, such as refuse collection or health services, the public will be better served by several private suppliers competing than by one agency monopolising the market through a long-term contract.

There are a number of prerequisites for the success of privatisation.

Fourth, public services to be provided by the private sector must be specific or have measurable outcome. Physical construction or utility services, *for example,* can be measured, but most educational services and police protection are not easy to quantify, even though their inputs can be measured. Lack of specificity makes it more difficult to control services provided by the private sector, especially if the public served is illiterate, unorganised, and unassertive. Service delivery by non-governmental organisations or local governments may be more appropriate under these conditions.

Fifth, consumers should be able to link the benefits they receive from a service to the costs they pay for it, since they will then shop more wisely for different services. User charges are one way of establishing this link. The importance of educating consumers and disseminating information to the public cannot be overemphasised here.

Sixth, privately provided services should be less susceptible to fraud than government services if they are to be effective. Services provided through collective or cooperative action at the community level are probably the least susceptible to fraud.

Seventh, equity is an important consideration in the delivery of public services. Broadly speaking, the benefits of privatisation can accrue to the capital owner who supplies the service; to the consumer, who receives a more efficient service; and to the public at large, through a reduction in the public sector deficit, and hence in taxes or the rate of inflation, or both. Privatisation will be counter-productive if the ability of the public to pay, determined by the prevailing income distribution, becomes the sole guide for the delivery of services. And, if the benefits of privatisation are likely to be reaped solely by local elites, expatriate groups, or multinational corporations, political resistance to reform is likely to increase.

BENEFITS OF PRIVATISATION

Privatisation benefits the society in several ways.

Countries like the UK have shown how it could help solve the fiscal crisis of the State and to usher in a new industrial democracy. The benefits of privatisation may be listed down as follows.

The fact that privatisation is an important strategy of economic rejuvenation of even the 'communist' nations is a testimony to the economic role of privatisation.

1. It reduces the fiscal burden of the State by relieving it of the losses of the SOEs and reducing the size of the bureaucracy.
2. Privatisation of SOEs enables the government to mop up funds. Government of India's Budget for 2000-01 proposed to raise ₹ 10,000 crore during the year through privatisation. (The achievement, however, was dismal as the privatisation plan could not be carried out in real earnest due to various reasons).
3. Privatisation helps the State to trim the size of the administrative machinery.
4. It enables the government to concentrate more on the essential State functions.
5. Privatisation helps accelerate the pace of economic development as it attracts more resources from the private sector for development.
6. It may result in better management of the enterprises.
7. Privatisation may also encourage entrepreneurship.
8. Privatisation may increase the number of workers and common man who are shareholders. This could make the enterprises subject to more public vigilance.

ARGUMENTS AGAINST PRIVATISATION

Some of the important argument against privatisation are as follows:

Opposition to privatisation are based on economic, political, social and management rational and vested interests.

1. The public sector has been developed with certain noble objectives and privatisation means discarding them in one stroke.
2. Privatisation will encourage concentration of economic power to the common detriment.
3. If privatisation results in the substitution of the monopoly power of the public enterprises by the monopoly power of private enterprises, it will be very dangerous.
4. Privatisation many a time results in the acquisition of national firms by foreign firms.
5. Privatisation of profitable enterprises, including potentially profitable, means foregoing future streams of income for the government.

6. Privatisation of strategic and vital sectors is against national interests.
7. There are well managed and ill-managed firms both in the public and private sectors. It is not the sector that matters, but the quality and commitment of the management.
8. The capital markets of developing countries are not developed enough for efficiently carrying out privatisation.
9. Privatisation in many instances is a half-hearted measures and therefore it is not properly carried out, with the result that the expected results may not be achieved.
10. In many instance, there are vested interests behind privatisation and it amounts to deceiving the nation. The UNDP's *Human Development Report 1993* observes that in many countries privatisation often has been a 'garage sale' to favoured individuals and groups.

SINS AND PITFALLS OF PRIVATISATION

Dubious objectives, tainted privatisation process etc. may lead to failure of privatisation.

Privatisation does not guarantee unconditional success. Privatisation in many countries has been found to be often fraught with many sins and pitfalls.

The commonly observed flaws of privatisation are the following:

1. ***Lack of Proper Strategy:*** An important reason for failure of privatisation is absence of a proper strategy or norms regarding the industries/units to be privatised, the method of privatisation, extent of divestment, selection of buyer/investor etc.
2. ***Ambiguity of Objectives:*** The real objective of privatisation is another problem. Is it for raising revenue? Is it for making the enterprise competitive? If there are multiple objectives, what is the priority list?
3. ***Connivance:*** Sometimes, politicians have hidden objective behind privatisation. The UNDP Report cited above points out that in too many cases it has taken place for the wrong reason, under the wrong conditions and in the wrong way.
4. ***Wrong Timing:*** Many privatisation schemes could not get a good price because of the wrong timing. A good price can be obtained if privatisation is done when the performance, market capitalisation and the industry prospects are good. It is pointed out the *Maruti* could have got a good price had it been privatised when the goings were good.
5. ***Lack of Political Consensus:*** Privatisation is a political process too. As there are opposing views regarding privatisation, there are likely to have some opposition to privatisation. The privatisation BALCO is a case in point. The government shall try to make clear the need for and objectives of privatisation and shall bring about as broad a consensus is possible.
6. ***Wrong Labour Strategies:*** Most public enterprise have surplus labour, getting rid of which is essential for success of the enterprise. But, to overcome labour resistance to privatisation, often unrealistic promises are given that the labour will not be affected by privatisation. A more open and realistic handling of the labour is needed for making privatisation meaningful. Prospects of retraining and redeployment of the labour are yet to be properly explored in countries like India.
7. ***Lack of Political Will:*** Privatisation is not carried out in real earnest and properly because of lack of political will and/or vested interests. *For example,* some ministers

oppose privatisation of enterprises under their ministry and some politicians oppose privatisation of undertakings in their Constituencies or States.

8. ***Poor Financial Strategies:*** Many privatisations are carried out without a good financial strategy.
9. ***Wrong Environment:*** Mere transfer of ownership does not help improve the performance of an enterprise. Where the market functions poorly and enterprises are still vulnerable to arbitrary government edicts, transferring ownership to the private sector is unlikely to achieve much.
10. ***Prevalence of Monopoly Elements:*** If privatisation results in the conversion of a public sector monopoly to a private sector monopoly, privatisation may not produce much beneficial effects, it could even worsen the situation.
11. ***Problem of Cultural Change:*** Improvement of performance of an enterprise after the privatisation will depend, *inter alia,* on bringing about a change in the work culture and the total enterprise culture. This is no easy task.

PRIVATISATION/DISINVESTMENT IN INDIA

In India, although there were some isolated cases of privatisation, no definite policy decision was taken until the new economic policy was been ushered in.

The industrial policy changes since 1991 in respect of the public sector in India is one of the most significant privatisation moves in the world.

DISINVESTMENT POLICY

The policy of the Government on disinvestment has evolved over a period. A brief account of it is given below in the chronological order:

Initial Phase

The divestment policy, as enunciated by the Chandrashekhar Government in the Interim Budget 1991-92, was to divest up to 20 per cent of the Government equity in selected PSEs in favour of public sector institutional investors. The objective of the policy was stated to be to broadbase equity, improve management, enhance availability of resources for these PSEs and yield resources for the exchequer.

The Industrial Policy Statement of 24th July, 1991 stated that the government would divest part of its holdings in selected PSEs, but did not place any cap on the extent of disinvestment. Nor did it restrict disinvestment in favour of any particular class of investors. The objective for disinvestment was stated to be to provide further market discipline to the performance of public enterprises. However, Budget speech 1991-92, reinstated the cap of 20 per cent for disinvestments and the eligible investors' universe was again modified to consist of mutual funds and investment institutions in the public sector and the workers in these firms. The objectives too were modified, the modified objectives being: "to raise resources, encourage wider public participation and promote greater accountability".

In 1993, Government of India set up a Committee on Disinvestment in Public Sector Enterprises under the chairmanship of C. Rangarajan.

The Common Minimum Programme of the United Front Government, 1996, sought to carefully examine the public sector non-core strategic areas and to set up a Disinvestment Commission for advising on the disinvestment related matters; to take and implement decisions to disinvest in a transparent manner; and to ensure job security, opportunities for retraining and redeployment. No disinvestment objective was, however, mentioned in the policy statement.

Pursuant to the above policy of the United Front Government, a Disinvestment Commission was formed in 1996. It made recommendations on 58 PSEs. The recommendations indicated a shift from public offerings to strategic/trade sales, with transfer of management.

The Second Phase

In its first budgetary pronouncement (1998-99), the new Government decided to bring down Government shareholding in the PSUs to 26 per cent in the generality of cases (thus facilitating ownership changes, as was recommended by the Disinvestment Commission). It, however, stated that the Government would retain majority holdings in PSEs involving strategic considerations and that the interests of the workers would be protected in all cases. The policy for 1999-2000, as enunciated by the Government in the Budget Speech, was to strengthen strategic PSUs, privatise non-strategic PSUs through gradual disinvestment or strategic sale and devise viable rehabilitation strategies for weak units. A highlight of the policy was that the expression 'privatisation' was used for the first time.

Strategic and Non-strategic Classification: On 16th March, 1999, the Government classified the Public Sector Enterprises into strategic and non-strategic areas for the purpose of disinvestment.

It was decided that the Strategic Public Sector Enterprises would be those in the areas of arms and ammunitions and the allied items of defence equipment, defence aircrafts and warships; atomic energy (except in the areas related to the generation of nuclear power and applications of radiation and radio-isotopes to agriculture medicine and non-strategic industries); and, railway transport.

All other Public Sector Enterprises were to be considered non-strategic. For the non-strategic Public Sector Enterprises, it was decided that the reduction of Government stake to 26 per cent would not be automatic and the manner and pace of doing so would be worked out on a case-to-case basis. A decision in regard to the percentage of disinvestment, *i.e.*, Government stake going down to less than 51 per cent or to 26 per cent, would be taken on the following considerations: Whether the industrial sector requires the presence of the public sector as a countervailing force to prevent concentration of power in private hands, and whether the industrial sector requires a proper regulatory mechanism to protect the consumer interests before public sector enterprises are privatised.

The main objective of disinvestment is to put national resources and assets to optimal use and in particular to unleash the productive potential inherent in our public sector enterprises.

The highlights of the policy for the year 2000-01 were that for the first time the Government made the statement that it was prepared to reduce its stake in the non-strategic PSEs even below 26 per cent if necessary, that there would be increasing emphasis on strategic sales and that the entire proceeds from disinvestment/privatisation would be deployed in social sector, restructuring of PSEs and retirement of public debt.

RANGARAJAN COMMITTEE

The recommendations of the Report of the Committee on the Disinvestment of Shares in PSEs (Rangarajan Committee), submitted in April 1993, emphasised the need for substantial disinvestment. The Committee suggested that the percentage of equity to be divested could be up to 49 per cent for industries explicitly reserved for the public sector. It recommended that in exceptional cases, such as the enterprises which had a dominant market share or where separate identity had to be maintained for strategic reasons, the target public ownership level could be kept at 26 per cent, that is, disinvestment could take place to the extent of 74 per cent. In all other cases, it recommended 100 per cent divestment of Government stake. Holding of 51 per cent or more equity by the Government was recommended only for 6 Schedule industries, namely, coal and lignite; mineral oils; arms, ammunition and defence equipment; atomic energy; radioactive minerals, and railway transport.

Other important recommendations of the Committee include the following:

1. The best method for disinvestment is offering shares to the general public at a fixed price through a general prospecting. However, since these shares have not been traded so far on the stock markets, it would be difficult to decide the 'fixed rate' at which they should be offered to the public. Once a reasonable time had elapsed and a normal trading atmosphere established in the market, this indeed would be the best method. Till then, the auction method with wide participation may be adopted.
2. Instead of year-wise targets of disinvestment, a clear action plan should be evolved.
3. Disinvestment shall be in stages and sales shall be staggered so as to get the best possible price.
4. A number of steps need to be undertaken for efficiently carrying out privatisation. These may include corporatisation of the public enterprises, restructuring of finance with a proper debt-equity gearing and on independent Regulatory Commission for the concerned sector if necessary.
5. A Scheme of preferential offer of shares to workers and employees may be devised.
6. Ten per cent of the proceeds of the privatisation may be set apart for lending to the public enterprises on concessional terms for meeting their expansion and rationalisation needs.

DISINVESTMENT COMMISSION

In pursuance of the Common Minimum Programme of the United Front, Government of India constituted a Public Sector Disinvestment Commission on 23rd August, 1996, with the following broad terms of reference:

1. To draw a comprehensive overall long-term disinvestment programme within 5-10 years for the PSUs referred to it by the Core Group.
2. To determine the extent of disinvestment (total/partial indicating percentage) in each of the PSU.
3. To prioritise the PSUs referred to it by the Core Group in terms of the overall disinvestment programme.
4. To recommend the preferred mode(s) of disinvestment (domestic capital markets/ international capital markets/auction/private sale to identified investors/any other) for each of the identified PSUs. Also to suggest an appropriate mix of the various alternatives taking into account the market conditions.
5. To recommend a mix between primary and secondary disinvestments taking into account Government's objective, the relevant PSU's funding requirement and the market conditions.
6. To supervise the overall sale process and take decisions on instrument, pricing, timing, etc. as appropriate.
7. To select the financial advisers for the specified PSUs to facilitate the disinvestment process.
8. To ensure that appropriate measures are taken during the disinvestment process to protect the interests of the affected employees including encouraging employees' participation in the sale process.

9. To monitor the progress of disinvestment process and take necessary measures and report periodically to the Government on such progress.
10. To assist the Government to create public awareness of the Government's disinvestment policies and programmes with a view to developing a commitment by the people.
11. To give wide publicity to the disinvestment proposals so as to ensure larger public participation in the shareholding of the enterprises; and
12. To advise the Government on possible capital restructuring of the enterprises by marginal investments, if required, so as to ensure enhanced realisation through disinvestment.

The Disinvestment Commission is an advisory body and its role and function would be to advise the Government on Disinvestment in those public sector units that are referred to it by the Government. The Commission shall also advise the Government on any other matters relating to disinvestment as may be specifically referred to it by the Government, and also carry out any other activities relating to disinvestment as may be assigned to it by the Government. In making its recommendations, the Commission is also required to take into consideration the interests of workers, employees and others stakeholders, in the public sector unit(s). The final decision on the recommendations of the Disinvestment Commission vests with the Government.

The Commission has recommended disinvestment at varying levels for a number of PSUs (*e.g.*, MFIL, GAIL, MTNL, CONCOR, PHL, ET&T, HVOC, HCIL, RICL, R-Ashok and U-Ashok and NALCO).

Strategic sales in various proportions have been recommended for many enterprises, like BALCO, ITI, HTL, KIOCL, ITDC, BRPL, MFL, HCL, SCI, EIL, EPIL, HPL, IBP, NEPA, HZL, PPCL, FACT, HLL, IPCL, NFL and SAIL.

PROGRESS

The privatisation process began in India 1991-92 with sale of minority stakes in some PSUs. From 1999-2000 onwards, the focus shifted to strategic sales. The total receipts from privatisation till March 2013 amounted to ₹ 1,16,616 crore.

EVOLUTION OF DISINVESTMENT POLICY

The policy of disinvestment has largely evolved through the policy statements of Finance Ministers in their Budget Speeches. It may be construed to be an integral part of the reforms triggered post-1990's economic crisis. In brief, the policy on disinvestment can be divided into three phases, *viz.,*

(i) 1991 to 1999: When the focus was on disinvestment of minority shareholding in favour of financial institutions.

(ii) 1999-2000 to 2003-04: In this period, the focus was on disinvestment through strategic sale.

(iii) Since 2004-05: The focus is on disinvestment of minority stakes in the domestic market to the general public in conjunction with issue of fresh equity by the company.

The new Government lead by the BJP, which assumed office on 26th May 2014, is likely to announce its divestment policy.

SUMMARY

Privatisation, which has become a universal trend, means transfer of ownership and/or management of an enterprise from the public sector to the private sector. It also means the withdrawal of the State from an industry or sector, partially or fully. Another dimension of privatisation is opening up of an industry that has been reserved for the public sector to the private sector.

Privatisation is an inevitable historical reaction to the indiscriminate expansion of the State sector and the associated problems. Even in the 'communist' countries, it became a vital measure of economic rejuvenation.

The society may benefit from privatisation in several ways. It would help reduce the fiscal burden of the State by relieving it of the losses of the SOEs and reducing the size of the bureaucracy; enable the government to mop up funds; result in better management of the enterprises; encourage entrepreneurship; and, help accelerate the pace of economic development as it attracts more resources from the private sector for development. Privatisation may increase the number of workers and common man who are shareholders and this could make the enterprises subject to more public vigilance. Privatisation enables the government to concentrate more on the essential State functions.

The important ways of privatisation are the following:

1. Divestiture, or privatisation of ownership, through the sale of equity.
2. Denationalisation or reprivatisation.
3. Contracting under which Government contracts out services to other organisations that produce and deliver them.
4. Franchising—authorising the delivery of certain services in designated geographical areas—is common in utilities and urban transport.
5. Government withdrawing from the provision of certain goods and services leaving them wholly or partly to the private sector.
6. Privatisation of management, using leases and management contracts.
7. Liquidation which can be either formal or informal. Formal liquidation involves the closure of an enterprise and the sale of its assets. Under informal liquidation, a firm retains its legal status even though some or all of its operations may be suspended.

Governments may confront several obstacles to privatisation. Trade unions and political parties may oppose privatisation. In developing countries, the relatively undeveloped capital markets sometimes makes it difficult for governments to sell shares. Another problem is that Governments usually want to sell the least profitable enterprises, those that the private sector is not willing to buy at a price acceptable to the Government.

Privatisation will be successful only if certain conditions are satisfied. The policy should be very clear and there should be proper privatisation strategies. Equally important are the commitment and political boldness on the part of the government.

Privatisation was a very important aspect of the economic reforms in India. The privatisation, however, has got a setback because of the influence of the leftist parties on the UPA Government which came to power in May 2004.

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Chapter 16

MICRO, SMALL AND MEDIUM ENTERPRISES (MSME) SECTOR

Structure

Definitions

Promotional Measures

Institutional Support Structure

State Industrial Policies

Khadi and Village Industries

Ancillary Industries

Drawbacks and Problems

Summary

References

The importance of developing the micro, small and medium enterprises (MSME) sector has been emphasised by all the industrial policy resolutions and statements and a number of protective and promotional measures have been taken accordingly to support their survival and to encourage their growth.

THE VSI SECTOR

The VSI sector in India consists of a very wide spectrum of industries categorised under small, tiny and cottage segments.

The village and small industries (VSI) sector encompasses a continuum of artisans/handicraft units at one end and modern production units with significant investments on the other producing a wide range of over 7500 products.

The VSI sector consists, broadly, of:

- Traditional cottage and household industries (*viz.*, handloom, khadi and village industries, sericulture, handicrafts and coir).
- Modern small-scale industries including tiny units and powerlooms.

While traditional industries are generally artisan based, located mostly in rural and semi-urban areas, involve lower levels of investment in machinery and provide largely part-time employment, modern small-scale units and powerlooms use mostly power-operated appliances and machinery, have some technological sophistication and are generally located close to or in the urban areas including large industrial centres. However, as a part of the industrial dispersal policy and rural industrialisation, governments have been encouraging modem small-scale units in rural areas.

There has also been an increase in the variety of products manufactured by the small-scale sector. They have ventured into the manufacture of many new and sophisticated items.

According to the data obtained by the second SSI census, over 80 per cent of the units were proprietary concerns. About 17 per cent were partnerships and limited companies formed less than two per cent of the total number of units.

DEFINITIONS[1]

The first official definition of SSI in India was coined, in 1950, in terms of the size of gross investment in fixed assets (plant and machinery, land, building), as well as on the strength of the workforce in the unit concerned. This criterion underwent a number of modifications over the years.

In the latter part of the fifties, the change reflected in defining an SSI unit was mainly a shift from a workforce criterion to an investment criterion. In 1966, the original value in plant and machinery was adopted as the sole norm for defining a unit as small scale or otherwise.

Similarly, the concepts of ancillary and tiny units were introduced in 1960 and 1977, respectively.

Small-scale Service Establishments (SSSEs) were first classified in 1985 and later redefined, in 1991, as Small-scale Service and Business Enterprises (SSSBEs). The definition of Women Entrepreneurs' Enterprise was brought out in 1988 and modified in 1991.

For the current definition of various terms, see the subsection *Micro, Small and Medium Enterprises Development Act, 2006*.

The term Small-scale Industry evokes different meanings for different agencies.

The Planning Commission, Government of India, views the entire Village and Small Industries (VSI) Sector as a part of the SSI sector. The National Sample Survey Organisation under the Central Statistical Organisation (CSO), Government of India, defines the entire industry sector in terms of organised and unorganised segments, as well as in terms of industrial enterprises run by households and non-households. The Central Excise Department, on the other hand, distinguishes SSIs on the basis of the annual turnover of the units (up to a maximum limit of ₹ 30 million). The Reserve Bank of India (RBI) adopts an expanded definition of SSIs which includes traditional industries as well. The industrial policy planners in the Small-scale Industries Board define SSI on the basis of investment in plant and machinery (an upper limit of ₹ 30 million) and cover residual units which do not fall under the assistance programmes of any of the Statutory Boards.

Women Entrepreneurs' Enterprise: An SSI unit/industry related service or business enterprise, managed by one or more women entrepreneurs in proprietary concerns, or in which she/they individually or jointly have a share capital of not less than 51 per cent as Partners/Shareholders/ Directors of Private Ltd. Company/Members of Cooperative Society is treated as Women Entrepreneurs' Enterprise.

Export Oriented Units (EOU): A unit with an obligation to export at least 30 per cent of its annual production by the end of third year of commencement of production and having investment ceiling in fixed assets – plant and machinery – up to ₹ 10 million is regarded as an EOU.

***Organised and Unorganised Sectors*:** Units in the factory sector are termed as organised sector units. These units are registered under the Factories Act, 1948. The remaining units of the SSI segment and other traditional industries fall under the VSI sector and are termed as unorganised sector units. Such units are not registered under the Factories Act as they employ either less than 20 workers (if power is not used) or less than 10 workers (if the unit is using power) in the industrial unit. In other words, Central Statistical Organisation's (CSO) categorisation of organised and unorganised sector units is based on the criteria of employment in combination with the use/ non-use of electric power.

The definition of SSI is linked to the question of ownership. SSI units cannot be controlled or owned a subsidiary of any other industrial undertaking. This implies that in Proprietary/ Partnership firms, the combined investment of all the units set up by the same proprietor/partners should not exceed the total investment limit fixed for an SSI.

As regards the formation of an SSI as a limited company, the equity investment by other companies in SSIs should not exceed 24 per cent.

Small industry has been subjected to various controls and regulations in terms of the IDR Act, 1951 and other relevant statutes. The restriction on ownership is unique in the Indian context and has been introduced primarily to prevent large companies from obtaining fiscal and other concessions by setting up of SSI units as "fronts". This also discourages the misuse of incentives by establishing more than one SSI unit, in the same line of production, by the same set of entrepreneurs.

SMEs in Other Countries

In India, there exists no definition of medium enterprises and as such, there is no specific definition for small and medium enterprises (SMEs). What prevails here, is only the concept of small-scale, ancillary and tiny industry which are related to the historical value of the investment in plant and machinery.

In other countries, SMEs are defined on the basis of both quantitative and qualitative elements, such as, the number of workers employed and/or annual turnover or the level of fixed investment.

However, employment is an omnipresent criterion for determining the size of the unit in these countries.

Importance

The khadi, village and small-scale industries have a very important role in the Indian economy characterised by its vast spatial spread, unemployment and underemployment, rapidly rising labour force, capital scarcity, numerous market segments and diverse demand patterns, broad and diverse resource base and supply, predominance of widely scattered numerous village settlements, growing modern large industrial sector giving scope for ancillarisation and so on.

BOX 16.1 : SMALL ENTERPRISES, BIG PART

The SSI sector, as an important segment of the Indian economy, accounts for:

- *95 per cent of the industrial units*
- *45 per cent of output in the industrial sector*
- *40 per cent of total exports*
- *Employ about 40 per cent of the workforce.*

The distinguishing features and major advantages of these industries particularly khadi and village industries, are the following:

Local linkages, labour intensity and employment flexibility, and wider dispersion of economic activities and income are major advantages of VSIs.

1. In an economy, like India, characterised by abundant labour supply and the concomitant unemployment and underemployment and rapidly rising labour force, khadi, village and small industries assume special significance because of its high employment potential.
2. Another major advantage is their ability to provide employment in the off-season. To a large number of people, agriculture provides only seasonal employment. Khadi, cottage and some other village industries provide employment opportunities during the off-season and help many households to mitigate their problems during the off-season.
3. Khadi, cottage and certain other village industries provide vast scope for employment of special categories of people like women, children, old aged, physically handicapped, etc. It is also an avenue for part-time employment for those who are employed elsewhere, either full-time or part-time.
4. Some of these industries provide employment opportunities within the household premises and some others near the place of residence. The locational advantage of these industries are, thus, very great.
5. A major advantage of these industries is that the capital-output and capital-labour ratios are comparatively very low. That is, the amount of capital investment required per unit of employment and the capital investment required per unit of output are comparatively very low. In other words, the khadi and village industries in particular and the small-scale units in general maximise employment and output for a given amount of capital. This is of particular importance to a labour-abundant and capital-scarce economies.
6. Because of the low capital-output ratio and low gestation period they promote non-inflationary growth.
7. Khadi and village industries have been found to be of particular help to the weaker sections of the society. The participation of the scheduled castes, scheduled tribes, women and other weaker sections of the society in this sector is significant.

8. These industries promote economising of resource utilisation and conservation of resources. They are expected to ensure maximum utilisation of locally available raw materials by adopting easily adaptable techniques. In some cases, non-conventional raw materials are used, thereby converting waste into wealth.
9. These industries can develop in almost all areas including backward, tribal, hilly and inaccessible areas. They are, thus, helpful in achieving wider spatial dispersal of industrial activities and thereby reducing the regional economic imbalances.
10. They help increase the pace of rural development through the generation of additional employment opportunities and income and through its inputs and output linkages with the other sectors of the rural economy.
11. The small industries have acquired more attention in recent years due to the very less ecological problems they create, compared to the large industries.
12. As khadi and village industries do not use or use only very little electric power or oil, they do not cause energy crisis and foreign exchange crisis.
13. The fact that the village and small industries account for about one-third of our total export earnings shows how important they are to the Indian economy constrained by shortage of foreign exchange.

Development of VISs under the Plans

All our Five Year Plans and Industrial Policy resolutions/statements have stressed the need to accelerate the development of village and small industries to create large-scale employment opportunities, promote decentralisation and dispersal of industries, achieve diffusion of ownership and prevention of concentration of economic power, promote entrepreneurship, develop agro-based and ancillary industries, improve the skills of artisans and quality of their products, reduce the role of subsidies and to step up the productions of essential articles and those having potential for exports.

The Government, Central and States, have taken a number of measures to help solve the age-old problems of these industries, such as lack of credit facilities, outmoded methods and techniques, absence of organised marketing, unsatisfactory raw material supply and competition from large-scale units.

The Governments, Central and State, have taken a number of steps, including the establishment of a number of agencies to foster the development of the VSI.

Objectives

The main objectives of the development of village and small industries have been the following.

1. To assist in the growth and widespread dispersal of industries.
2. To increase the levels of earnings of artisans.
3. To sustain and create avenues of self-employment.
4. To ensure regular supply of goods and services through use of local skills and resources.
5. To develop entrepreneurship in combination with improved methods of production through appropriate training and package of incentives.
6. To preserve craftsmanship and art heritage of the country.

It is estimated that the number of small and medium enterprises (SMEs) in India increased from about 39 million in 2008 to nearly 49 million in 2013. They create about 1.3 million jobs every year.

The performance of the small-scale sector should be evaluated in the light of the fact that the Plan allocation for this sector has come down from 2 to 4 per cent in the earlier Five Year Plans to about 1.5 per cent.

PROMOTIONAL MEASURES

A number of measures have been taken by the governments, Central and State, to protect this sector from the onslaught of the large sector and to promote its growth.

Measures taken by the Government, from time to time, include reservations, upward revision of investment ceilings in the definition, reservation of products for the SSIs, increasing credit flows, preference in Government purchases, modernisation, technology upgradation and improving export performance.

In the post-reform period, a number of new steps have been initiated by the Government with regard to foreign direct investment, development of infrastructural facilities, establishment of growth centres, export promotion, marketing, etc.

The important protective and promotional measures include the following:

The number of items reserved for the small-scale sector increased from 47 in 1967 to 873 in 1984 and then declined, reaching 239 by 2007.

1. ***Reservation of Products:*** Protection has ben provided to the small-scale units by the reservation of items for exclusive production in the small-scale sector. Over the years, there had been an increase in the number of items so reserved, but has significantly reduced it recently.

2. ***Reservation and Preference in Government Procurement:*** SSIs have been given protection from competition in the matter of purchases of different products by the DGS&D. A large number of items have been reserved for exclusive purchase from the VSI sector while a number of items have been provided price preference up to 15 per cent over units in the large-scale sector.

3. ***Infrastructural and Institutional Support:*** Infrastructural and institutional supports are provided through industrial estates, district industries centres (DICs), Small Industries Service Institute, Khadi and Village Industries Commission (KVIC) and other specialised institutions which provide technical assistance, testing facilities, etc.

4. ***Machinery on Hire Purchase:*** The National Small Industries Corporation (CNSIC) arranges supply of machines on hire purchase to small-scale units.

5. ***Marketing Assistance:*** Marketing assistances including export promotion assistance are provided by institutions such as the NSIC, the Small Industries Development Organisation (SIDO), Handicrafts and Handlooms Export Promotion Corporation, KVIC etc.

6. ***Financial Assistance:*** Financial assistance is provided at concessional terms by commercial banks, state level financial institutions, etc.

In order to step up the flow of assistance to the small sector and to provide a focal point to coordinate at the apex level the availability of both financial and non-financial inputs required for the orderly growth of this sector, the Small Industries Development Bank of India (SIDBI) was established in 1990.

7. ***Training:*** Training for existing and potential entrepreneurs and others associated with the working of the small units are offered by Entrepreneurship Development Institute of India (EDII), Technical Consultancy Organisations (TCOs), financial institutions and commercial banks, management institutes, NSIC etc.

8. ***Supply of Raw Materials:*** Arrangements have also been made for the supply of raw materials, particularly of scarce items, to the small-scale units.

9. ***Promotion of Ancillarisation:*** The Industrial policy also gives importance to ancillarisation. This has been recognised as one of the objectives of the public sector industry. One of the factors considered by the government while evaluating application from the private sector for industrial licence was the scope for ancillarisation by the proposed project.

A more detailed account of some of the promotional aspects is given below.

Promotional measures in respect of the small scale sector include, broadly facilitation of financial, production and marketing assistances and protection from competition from large-scale sector.

Industrial Estates (IE) Programme

With a view to encouraging entrepreneurs to set up small industries and to expand existing units, a programme for the establishment of industrial estates was started in the year 1955. This programme envisaged the following facilities for entrepreneurs: *(i)* the acquisition of suitable land and its development; *(ii)* the construction of factory sheds; *(iii)* the provision of infrastructure like water, electricity, transport, banks, canteens, watch and ward, all-weather approach roads.

The important objectives of this programme were to: *(i)* facilitate the growth of SSIs; *(ii)* shift industries from congested areas to estate premises; *(iii)* achieve decentralised development in small towns and villages; *(iv)* develop sub-contracting relationship with large industries; *(v)* establish common facility Service Centers, etc.

The rationale of industrial estates is to provide the basic facilities for the growth of small enterprises.

This was a centrally-sponsored programme till 1979. Thereafter, it was transferred to the State Industrial Development Corporations (SIDCs). This encouraged, the State Governments, to continue with the development of Industrial Estates/Areas through the SIDCs.

Additional facilities were extended by the different States to entrepreneurs who were setting up new units as well as to those units which were moving out of non-conforming areas and relocating to the developed IEs/Areas. These facilities included subsidy on rent for factory accommodation, allotment of sheds on hire-purchase as well as on outright sale. Other incentives like concessional charges for water and power, exemption from Sales Tax and Octroi (building material, transport subsidy, etc.) were also offered.

EPZs/SEZs/Export Industrial Parks

Special incentives for firms, small or large, to undertake manufacturing of export items for export from India have been provided by the Government of India through the establishment of Export Processing Zones (EPZs), recently modified as Special Economic Zones (SEZs) or through 100 per cent export oriented units (EOUs) set up outside of such zones.

There are also several Technology Parks with focus on specific industries, like the Electronics Hardware Technology Parks (EHTPs), Software Technology Parks (STPs), Bio-tech Park, Leather Park, etc. with specialised infrastructure, technology back-up and escort services.

Integrated Infrastructural Development Scheme (IID)

Consequent to policy measures for the promotion and strengthening of small and tiny village enterprises announced on 6 August, 1991, the scheme of Integrated Infrastructural Development (IID) (including technological back-up services) in rural/backward areas was announced by the Government of India on 7 March, 1994.

The Scheme aimed at augmenting infrastructural facilities in the rural and backward areas with a special emphasis on the linkage between agriculture and industry. The scheme covered centrally developed backward districts other than those covered under the Growth Centre Scheme.

The objectives of the IID Scheme were: (1) To establish approximately 50 IID centres in rural areas/backward districts in the country; (2) To promote SSI and tiny unit clusters with a view to the creation of employment opportunities and to develop exports, (3) To promote stronger linkages between agriculture and industry; (4) To provide Common Service facilities and technological back-up services in selected centres, and, (5) To create/upgrade infrastructure facilities like power, water, telecommunication etc. in new/existing centres/industrial areas.

Cluster Development

Clusters encourage specialisation in manufacturing processes, inter-firm relationships in production activities, division of labour, sharing of information/experiences. Such an atmosphere provides productivity gains on a continued basis and develops a network of sub-contracting between firms.

SSIs operating in clusters, derive their strength through a unique state of togetherness. They also benefit from backward and forward economic linkages since such units have similar cultural and social backgrounds, clusters provide an active base for business and social interaction. The economies of agglomeration ensure a network of suppliers that provide raw materials, equipment, machinery, spares, repairs and other to units, which would otherwise have not been possible.

It has been noticed that clusters have normally emerged for such products as may be produced in a traditional manner and which have no exposure to technology changes, design and manufacturing processes. Initially, units are set up to benefit from the locally available skills, raw materials etc. Gradually, similar types of industries grow in number by utilising the existing pool of trained workers who shift from one unit and to another. Such clusters classified as *natural clusters*. These centres have grown spontaneously and are not consequent to a policy framework of the government nor that of any other institution for establishing such clusters in specific products.

Because of the advantages of clusters, Government and other agencies have been promoting clusters, through the creation of infrastructure, which is accompanied by a range of technical services (designed to cater to a group of units in the local area/industry). Such clusters are termed as *induced clusters*.

The Expert Committee on Small Enterprises (Abid Hussain Committee) observed that "the centrepiece of the new approach is an increasing public-private partnership in setting up support systems for small-scale enterprises. Such public-private partnership would thrive particularly in clusters of small-scale enterprises. Agglomeration of SSEs is a source of informational economies, accretion of skills and economies in infrastructure development. As a matter of fact, spontaneous growth of over 300 clusters has already taken place in the country mostly unaided by the state. This growth has been fuelled by access to domestic and international markets and cheap labour. However, further progress in clusters is hamstrung by decrepit infrastructure, environmental degradation, technological obsolescence and meagre skills of the workforce. Worldwide experience confirms that growth in clusters can be buttressed by institutional development, and aided by the abundant provision of services and infrastructure development. The thrust of the future policy for SSEs should be to bolster growth in existing clusters by redirecting current investments in regional development (*i.e.,* backward areas) to such centres of growth which are spreading to less developed regions. The Expert Group, therefore, recommends that state governments identify the existing SSE clusters and then promote new types of organisations which are joint ventures between the state governments or local authorities and business associations in these clusters."

The emerging issues/basic facilities required for the Promotion of Clusters are the following.

- Infrastructure – Common facility services, space, water, power, across to raw inputs, pollution control.

- Manpower training.
- Technical know-how.
- Finance – working capital funds.
- Marketing/Packaging – competition from substitutes, advertisement, sales promotion.
- Information access.
- Product Quality/Standardisation – Testing Facilities.
- Formulation of a specific policy for the development and promotion of new small industry Clusters and Industrial Districts.
- Support policies for existing clusters.
- Common information systems (located within the cluster) that provide software databases on the status of units.
- Access to Internet for worldwide trade information.
- Research and Training Wing.
- R&D Centres.
- Provision for procuring and storing inputs in bulk for each group of units.
- Liaison Department to interact with traders, exporters and government agencies.
- A wing for the organisation of Trade Fairs, Exhibitions, group advertisements and the common branding of cluster products.

Industrial Growth Centres Schemes

For the promotion of industries in the backward areas, the scheme of establishing Growth Centres was envisaged in 1988 for the establishment of 100 Growth Centres around the country. The criteria for location of centres are as follows: *(i)* Outside 50 kms of cities with a population above 2.5 million; *(ii)* Outside 30 kms of cities with a population of above 1.5 million but below 2.5 million; *(iii)* Outside 15 kms of cities with a population of 0.75 million but below 1.5 million.

The objective of the scheme has been to provide the best of the infrastructure facilities in these Growth Centres nationwide. The other criteria for the establishment of Growth Centres were the proximity to rail heads, National or State highway, access to adequate and dependable sources of water, power, telecommunication facilities, educational and health facilities and sufficient land for the development of housing and for the promotion of tertiary activities. Growth Centres should not lie located in ecologically sensitive areas.

The important prerequisite for the identification of a Growth Centre has been that its sphere of influence should cover an area of 400 to 800 hectares.

Recent Measures

Recent initiatives and measures taken by the Government of India to enable micro, small and medium enterprises (MSME) to enhance their competitive strength, address the challenges of competition and avail of the benefits of the global market include a promotional package and certain legislative measures. Capacity building of MSME Associations and support to women entrepreneurs are also important features of this package.

The promotional package seeks to address the concerns in the areas such as credit, cluster-based development, infrastructure, technology, and marketing.

The Khadi and Village Industries Commission Act, 1956, was amended during 2006-07, introducing several new features to facilitate professionalism in the operations of the Commission as well as field-level formal and structured consultations with all segments of stakeholders.

Micro, Small and Medium Enterprises Development Act, 2006

The Micro, Small and Medium Enterprises Development Act, 2006 (MSMED Act), provides the first-ever legal framework for recognition of the concept of "enterprise" (comprising both manufacturing and services) and integrating the three tiers of these enterprises, *viz.*, micro, small and medium. The following are the salient features of the Micro, Small and Medium Enterprises Development Act, 2006 (MSMED Act), are given below.

The MSMED Act classifies SMEs into manufacturing and service enterprises with different investment limits fixed for various categories of enterprise under them.

Categorisation of SMEs Under the Act, enterprises have been categorised broadly into those engaged in: (i) manufacturing and (ii) providing/rendering of services. Both categories have been further classified into micro, small and medium enterprises, based on their investment in plant and machinery (for manufacturing enterprises) or in equipment (in case of enterprises providing or rendering services) as under:

Manufacturing Enterprises The investment limits of various categories of manufacturing enterprises are as follows:

- Micro Enterprises: investment up to ₹ 25 lakh.
- Small Enterprises: investment above ₹ 25 lakh and up to ₹ 5 crore.
- Medium Enterprises: investment above ₹ 5 crore and up to ₹ 10 crore.

Service Enterprises The investment limits of various categories of manufacturing enterprises are as follows:

- Micro Enterprises: investment up to ₹ 10 lakh
- Small Enterprises: investment above ₹ 10 lakh and up to ₹ 2 crore.
- Medium Enterprises: investment above ₹ 2 crore and up to ₹ 5 crore.

Other Features The other important features of the Act include the following:

1. Provision for a statutory consultative mechanism at the national level with wide representation of all sections of stakeholders, particularly the three classes of enterprises, and with a wide range of advisory functions, and an Advisory Committee to assist the Board and the Centre/State Governments.
2. Establishment of specific funds for the promotion, development and enhancement of competitiveness of these enterprises.
3. Notification of schemes/programmes for this purpose.
4. Progressive credit policies and practices.
5. Preference in Government procurements to products and services of the micro and small enterprises.
6. More effective mechanisms for mitigating the problems of delayed payments to micro and small enterprises.
7. Simplification of the process of closure of business by all three categories of enterprises.

INSTITUTIONAL SUPPORT STRUCTURE

There is a network of organisations to support the development of the VSIs.

The institutional system for promotion of VSIs encompass diverse organisations established by central and state governments.

The Small-scale Industries Board is an apex advisory body constituted by the Government of India to render advice on all the issues pertaining to the SSI sector. The Board was constituted in 1954 to facilitate coordination and provide inter-institutional linkages for the development of the sector. The Union Industries Minister is the Chairman of the Board which consists of State Industries Ministers, select members of Parliament, Secretaries of various departments of Central Government, Heads of financial institutions, industries associations and eminent experts in the SSI field.

The Department of SSI and Agro and Rural Industries (SSI and A&RI) was created under the Union Ministry of Industry to formulate policy framework and initiate appropriate programmes and schemes for the promotion of SSIs in the country.

The range of functions of the department include the setting up of a network of institutions to render services of a varied nature like, techno-economic and managerial aspects, training, testing facilities, marketing assistance, etc. These activities are supported by a host of other Central/State Departments, Agencies, and Autonomous Institutions all over the country.

The office of the Development (Commissioner Small-scale Industries), known as the Small Industries Development Organisation (SIDO) set up in 1951, is the nodal agency for implementation of Central Government policies and plays a constructive role in the strengthening of the SSI sector.

The SIDO functions through a network of Small Industry Service Institutes (SISIs) and a host of other field centres. The major SSI-related activities of SIDO include evolving all-India policies and programmes, coordinating policies and programmes of State Governments, liaisoning with different State and Central Ministries, Planning Commission, RBI and Financial Institutions. SIDO also provides a comprehensive range of extension services through allied institutions and monitors Government-sponsored programmes.

At the State level, the Commissioner/Directorate of Industries implement policies for the promotion and development of small-scale, cottage, medium- and large-scale industries. The Central policies for the SSI sector serve as the guidelines, but each State evolves its own policy and package of incentives.

The State departments also oversee activities of the field offices, *viz.,* District Industries Centres (DICs), etc. In addition, State Financial Corporations, State Small Industries Development Corporations (SIDCs), and Technical Consultancy Organisations (TCOs) operate at the State level to assist the promotion and development of SSIs. Other regional level agencies include State Infrastructure Development Corporations, State Cooperative Banks, Regional Rural Banks, State Export Corporations, Agro Industries Corporation and Handloom and Handicrafts Corporations. For the purpose of human resources development, there is a network of specialised institutes associated with SIDO. At grassroot level, NGOs play an important role for the development of tiny units.

Industry Associations provide support to the SSI sector and offer with a common platform to raise industry-related issues. Government policies, in recent years, have stressed the increasing role of Industry Associations in the setting up of common facilities and other ventures in the area of technology, marketing and other support services.

Women Entrepreneurs

The importance of the economic development of women takes on an added dimension in India when considered in the context of the prevailing social, legal and economic norms. The Government has, therefore, taken several steps to promote women entrepreneurship.

In view of the initiative shown by women in various economic activities, promotional organisations have been organising special programmes for them. This trend indicates a shift towards a gender-specific approach to such programmes in order to enhance the competence of women in the establishment and management of SSIs.

The 1991 Industrial Policy has envisaged special training programmes to support women entrepreneurs. Accordingly, women entrepreneurs are receiving training through Entrepreneurship Development Programmes (EDPs) conducted by various institutions and organisations both at the Central and State levels.

The SIDO, with its field offices all over the country, has been carrying out development programmes for women entrepreneurs and is providing technical schemes for the setting up of SSI units. In view of changing outlook for the promotion of women enterprises, the SSI Board in 1991 revised the definition of women enterprises by omitting the condition of employing 50 per cent of women workers. This provided a boost to women entrepreneurs to take up businesses and avail of facilities/concessions as are applicable to all SSIs.

The SIDBI, has instituted various developmental initiatives towards promoting women enterprises. The Bank has designed programmes, with a focus on women, *viz.,* Mahila Vikas Nidhi, Mahila Udyam Nidhi, Micro Credit Scheme, Women Entrepreneurship Development Programmes, etc. These programmes have been formulated with the twin objectives of: *(i)* providing training and extension services support to women entrepreneurs through a comprehensive package suited to their skills and socio-economic status; and *(ii)* extending financial assistance on liberal terms, to enable them to set up industrial units in the small-scale sector.

Andhra Pradesh has set up an exclusive Industrial Estate for Women Entrepreneurs.

Marketing

The marketing support for SSIs consists of a combination of agencies and incentive schemes.

Marketing is a major problem area of the VSI sector. This sector generally experiences a lack of resources for sales promotion and advertising. Institutional assistance, therefore, is, often, very much essential for marketing of SSI products.

1. *NSIC:* Registers SSI and tiny units under a single point registration and secures orders for the supply of various stores, on preferential terms tendered by the DGS&D.

2. *Sub-contracting Exchanges:* There are 16 such exchanges that operate through the Small Industries Service Institutes (SISIs). These exchanges enlist SSIs and identify items for ancillarisation from various Public Sector Undertakings. These offices promote contacts between large- and medium-scale industries on the one hand and SSI ancillary units on the other to secure sub-contracting jobs.

3. *Quality Certification:* *(a)* The Bureau of Indian Standards (BIS) sets the standards for different manufactured products and it registers SSIs for the adoption of quality standards as a measure of marketing support. *(b)* SIDO has set up 4 Regional Testing Centres, which provide testing facilities to SSI units as per BIS standards. In addition, there are a number of field-testing stations extending testing facilities and assistance to SSIs. *(c)* SIDO is operating a scheme to reimburse (upto 75 per cent subject to a maximum of ₹ 0.075 million) the cost of acquiring ISO 9000 certification.

4. *Marketing Development Assistance (MDA) Scheme:* Ministry of Commerce, Government of India reimburses the expenditure incurred by the SSI delegations that visit foreign countries (60 per cent of the expenditure incurred by the delegation) for the purpose of exploring marketing possibilities. This incentive is extended to admissible items only.

5. *Training Programmes for Export Packaging:* SIDO, in partnership with the Indian Institute of Packaging, organises training programmes for SSI exporters on packaging for exports. Exporters are provided information on the latest packaging standards and techniques in order to boost exports.

6. *Organising Exhibitions and International Trade Fairs:* For promoting exports, STDO annually participates in selected international Trade Fair and Exhibitions held abroad by the India Trade Promotion Organisation (ITPO). All expenses on space hiring, display, shipment, insurance, handling and clearance, publicity etc. are borne by SIDO.

7. *Export Promotion Councils:* The existence of export promotion councils for specific industries provides the SSI member units with a platform for export marketing. A number of Export Promotion Councils are providing marketing infrastructure through procurement of direct orders and distribution of items among member units for production and sale.

These Councils also arrange for quality testing of products, pre-shipment inspection, packaging and sales transactions assistance. These bodies arrange for the participation of member units in various Exhibitions and Trade Fairs.

8. *SIDBI's Marketing Finance and Development Department:* SIDBI established its Marketing Finance and Development Department (MFDD) in January 1996 to focus attention on marketing-related activities undertaken by the SSI sector. The Bank formulated a comprehensive scheme for providing financial assistance to SSIs enabling them to undertake various marketing activities as also to assist institutions/agencies engaged in strengthening the existing marketing channels and infrastructure for the SSI sector. A special Marketing Assistance Development Fund with sub-allocation for women entrepreneurs has been set up. A number of development and support services have also been undertaken by the Department to assist the marketing efforts of the SSI units.

STATE INDUSTRIAL POLICIES

The State/UT Governments pursue the Central Government industrial policies and assistance is obtained under different centrally sponsored schemes/incentives for disbursement among eligible SSIs. This Central policy framework serves as a guiding principle for States, which evolve respective policies for SSI promotion depending upon the specific requirements of the State. The State Governments also design suitable incentives to encourage existing units to expand/diversify products and support entrepreneurs to establish new units.

State Governments provide technical and other support services to SSIs through the Directorate of Industries and DICs.

The main areas of support and facilities extended by State governments are listed below.

1. To develop and manage industrial areas by respective Industrial Development and Investment Corporation.
2. Financial support services by State Financial Corporations (SFCs).
3. Technical guidance by Technical Consultancy Organisations (TCOs).
4. Human resources development by a host of training institutions.
5. Infrastructure development by Infrastructural Development Corporations.

6. Export promotion by Small Industry and Export Corporations.
7. Single Window Assistance by District Industries Centres.

Besides above, State Governments also offer a range of incentive measures for providing an impetus to industrialisation. These incentives to SSIs are mainly by way of providing land and developed plots/sheds on concessional terms, industrial infrastructural facilities, subsidy on investment (in selected areas) and on generating sets, sales tax and stamp duty exemptions, water supply at reduced rates, seed capital assistance for setting up of units etc.

KHADI AND VILLAGE INDUSTRIES

Khadi means any cloth woven on handlooms in India from cotton, silk or woollen yarn handspun in India or from mixture of any two or all such yarns.

Industries coming under the purview of Village Industries include: (1) Bee keeping; (2) Cottage Match, manufacture of fireworks and agarbatties; (3) Cottage Pottery; (4) Cottage Soap; (5) Flaying, curing and tanning of hides and skins and ancillary industries connected with the same and cottage leather industry; (6) Ghani Oil; (7) Handmade paper; (8) Manufacture of cane-gur and khandasari; (9) Palmgur making and other palm products; (10) Processing, packing and marketing of cereals, pulses, spices, condiments, massalas, etc.; (11) Manufacture and use of manure and methane gas from cowdung and other waste products (such as flesh of dead animals, night soil, etc.); (12) Limestone, lime shell and other lime products; (13) Manufacture of shellac; (14) Collection of forest plants and fruits for medicinal purposes; (15) Fruit and vegetable processing, preservation and canning, including pickles; (16) Bamboo and cane-work; (17) Blacksmithy; (18) Carpentry; (19) Fibre other than coir; (20) Manufacture of household utensils in aluminium; (21) Manufacture of Katha; (22) Manufacture of gums and resins; (23) Manufacture of Lokvastra; (24) Manufacture of Polyvastra; (25) Processing of maize and ragi.

KVIC

The Khadi and Village Industries Commission (KVIC) is a statutory organisation engaged in the task of promoting and developing khadi and village industries with a view to creating employment opportunities in the rural areas and thereby strengthening the rural economy. It was established in 1975 by an Act of Parliament. It is an autonomous body which took over from its predecessor, the All-India Khadi and Village Industries Board, set up in 1953.

The broad objectives that the KVIC has set before it are:

1. the social objective of providing employment;
2. the economic objective of producing saleable articles; and
3. the wider objective of creating self-reliance amongst the people and building up a strong rural community spirit.

The functions of the KVIC are generally to plan, organise and implement programmes for the promotion and development of khadi and village industries. In particular, they include:

1. training of persons engaged in production of khadi and village industries;
2. building up reserve of raw materials and implements and supplying them to persons engaged in the production of KVIs at economical rates;
3. to provide for sale and marketing of khadi and products of village industries and handicrafts;

4. to encourage and promote research in the technique of production of khadi and in the development of village industries, and to provide facilities for study of problems relating to KVIs;
5. to maintain or assist in the maintenance of institutions for the development of KVIs;
6. to undertake, assist or encourage production of khadi or development of village industries;
7. to promote and encourage cooperative efforts among manufactures of khadi and persons engaged in village industries; and
8. for ensuring the genuineness of and for granting certificates to producers of or dealers in, khadi or the products of any village industry.

The KVIC have created an organisational base for further development with many State KVI Boards, a large number of registered institutions and industrial cooperatives. KVIC has a very large number of sales outlets in the country. This is a unique national organisation in the country which has its roots in the villages and has wide organisational linkages. Its activities cover numerous villages in the country. A substantial number beneficiaries belong to the scheduled caste and scheduled tribes and inhabitants in hill and border areas. The participation of women in the activities is also very high.

ANCILLARY INDUSTRIES

Integration of small and large industries through ancillarisation is an important feature of industrial development of countries like USA and Japan. In India, the government policy has been one of encouraging ancillarisation.

Though all industries are not amenable to ancillarisation, there are a number of industries with scope for considerable ancillarisation. Large industries may benefit from ancillarisation in different ways. One benefit of ancillarisation is the realisation of economies of scale. If the requirement of any item is less than the economic size of production, it stands to gain by purchasing the item from an outside unit of economic size. Further, a large company can relieve itself from the problem of tying up of capital, managerial time, etc., on minor items which can be efficiently produced by ancillaries. The society also benefits from the economies of scale and other efficiencies associated with ancillarisation. As the impact of energy crisis and credit squeeze is comparatively less on small-scale units, ancillarisation offers further advantages to large units in an era of power shortage and financial problems.

Ancillarisation support the growth of both large and SMEs.

Ancillarisation and sub-contracting, however, have some problems also. The parts or components supplied by these units may not sometimes be of satisfactory quality. The small units usually do not have the resources for carrying out research and development. Hence, parent units will have to help them to update technology and enforce strict quality control.

Industrial machinery, agricultural and earth-moving machinery; machine tools; industrial; scientific and mathematical instruments; locomotives and rolling stock; ships; aircrafts; bicycles; boilers; steam generating plants; steam engine; automotive parts; turbine; internal combustion engine; commercial, office and household equipment; telecommunication equipment; electronics; electrical equipment; packaging items for use in chemicals; some iron and steel industry items are but some fields where there is good scope for ancillarisation.

According to a study conducted some time ago, the extent of ancillarisation possible in different fields in India is as high as 60 to 90 per cent in transportation industry; 50 to 75 per cent in communications industry and 30 to 50 per cent in prime movers and power-based

industry. It is 20 to 40 per cent in industrial machinery and machine tools; 15 to 30 per cent in chemicals and pharmaceuticals industry; 10 to 30 per cent in consumption and consumer durable goods industry; and 5 to 10 per cent in basic industry, such as metals, minerals, cement and petroleum. The lowest range is 2 to 10 per cent in wood, paper fibres, glass, ceramics, leather, rubber, etc.[3]

DRAWBACKS AND PROBLEMS

The number of VSI units have increased remarkably. The role of this sector in the Indian economy cannot be underestimated. However, as the Planning Commission observes, some of the important objectives set for the village and small industries sector are yet to be fully achieved.

The dispersal of small-scale units far away from the metropolitan areas and large cities has not taken place to an appreciable extent. Available data indicate that the industrially developed States account for a very large share of the registered small-scale units. Within the developed States, there has been concentration of units in areas which are either metropolitan or large cities or industrial complexes. Although one may wish a balanced distribution of the units, the small-scale and large-scale linkages, infrastructural and marketing factors and several other reasons contribute to the tendency to concentrate.

Industrial sickness is widespread in the small-scale sector.

A number of promotional measures designed to develop the VSI sector have not produced the expected results. *For example,* the Entrepreneurial Development Programme has not made significant progress except in a few States like Gujarat in widening the entrepreneurial base.

Low levels of technology resulting in poor productivity and inadequate returns continue to characterise the traditional industrial sector.

It has been pointed out that a number of the registered small-scale units are bogus; they have been registered to avail the credit and other facilities offered to this sector. There is deliberate diversion of resources from the genuine use. Units are deliberately made sick after swindling the credit amount.

Though a number of arguments are put forward in favour of the VSI sector, in a number of cases the VSI units are promoted and sustained at a heavy social cost. The enormous subsidies they are granted, like concessional finance, fiscal incentives, price preferences, etc., have to be borne by the society.

The important problems confronting the VSI sector generally encompass, production, finance, marketing and technological factors.

The earning levels of a large number of people employed in the VSI sector, especially in the traditional sector, are very low. Unless productivity in this sector increases, there might not be significant improvement in the earning levels.

Available estimates show that the capacity utilisation in different village and small industries is very low.

The major problems of the small-scale units are the following.

Problem of inputs: Inadequacy or non-availability of inputs of proper quality at responsible price is important problem facing a number of units. It is pointed out that the allotment of raw materials by State supply corporations have been very inadequate.

Financial problems: Many small units face financial crisis. Though there has been an increase in the flow of institutional credit to this sector, large part of this has gone to the relatively large units in this sector. The increased flow of institutional funds in favour of the decentralised

industrial sector has not covered the artisan sector adequately which continues to depend, for a major part of its capital requirements, on non-institutional sources, often, at exorbitant rates of interest.

Marketing problems: Marketing is a major problem area for the small units in general. Small entrepreneurs, generally, do not have resources and expertise to market their products effectively. Financial constraints do not permit them to offer attractive credit terms and the like to the marketing intermediaries. The VSI sector is in a weak bargaining position so much so that the intermediaries take advantage of the situation. Though the governments have taken some steps, marketing arrangements for selling of the products of the small units are still quite inadequate.

Competition from the large units: Productivity in the VSI sector is, by and large, not satisfactory. No much progress could be made in the upgradation of technology particularly in the traditional sector. They also suffer from limitations of finance, marketing capability in competing with large enterprises. The increasing global competition poses a big challenge to the VSI units.

Institutional constraints: Though a number of measures have been taken by the Central and State Governments to assist the VSI sector, they have not come up to the expectations. The small entrepreneurs have to cross many hurdles to obtain assistance from them. The District Industries Centres (DICs) have not come up to the expectations. There are many criticisms about the functioning of the organisations meant to assist the VSI sector.

In short, as the Planning Commission observes, low levels of technology resulting in poor productivity and inadequate returns continue to characterise the village and small industries. Coupled with this, the problem of obtaining raw materials of desirable quality at reasonable prices and lack of marketing arrangements for selling their produce at fair prices have deprived the artisans of a good part of the earnings which should have accrued to them.

BOX 16.2 : RESERVATIONS AGAINST RESERVATION

The Report of the Expert Committee on Small Enterprises, appointed by Government of India in 1997 under the chairmanship of Abid Hussain, has made the following observations on the policy of reservation of items for the exclusive manufacture in the small-scale sector.

In reality, reservation may have played only a limited role in promoting small-scale industries while restricting the entry of large companies into these industries. The existence of reservation policy has also provided an illusion to the government and the country at large that adequate protection/promotion was being provided to small-scale industries. This may have militated against more realistic policies for providing support to small-scale industries for entry and growth. The issue of investment limit is also of greater relevance for the items that are reserved for small-scale industries. In the case of items that are not reserved, small-scale industries are free to grow the only incentive not to grow is the loss of the various facilities and incentives that the units may have availed of as small-scale units. In the case of industrial units manufacturing reserved items they are not permitted to cross the small-scale investment limits and are therefore not able to grow. Instead it is often found that such units merely clone themselves and set up parallel separate units rather than expanding the original unit as would have happened if the items were not reserved. Thus, the reservation policy acts as a powerful barrier to growth.

After considering the issues very carefully and looking to the future of the Indian industry and its place in the world economy, and the imperatives for growth among small-scale industries themselves, the Expert Group has concluded that the changed economic circumstances suggest that the obsolete policies of small-scale reservations should now be abolished. At the same time, we feel that transitional support should be provided to those units which might encounter some difficulty as a result of this abolition. Our judgment is that such units will not be many.

The policy of reservation prevents the successful units from growing. It, therefore, acts as a dampener on entrepreneurship. The biggest psychological incentives for new entrepreneurs is the example of small enterprises which have grown to become large. The policy for promoting small-scale enterprises should be such as to induce new entry by small entrepreneurs, and then to aid them to prosper and grow. The SSI reservations policy prevents this.

Not only is the reservation indefensible on logical grounds, the empirical realities lay bare its patent obsolescence. The policy of reservations has crippled the growth of several industrial sectors, restricted exports and has done little for the promotion of small-scale industries…

It has been found that in the case of many items currently reserved for small-scale industries the manufacture of these items at appropriate quality and efficiency levels requires investments in plant and machinery at a level much higher than the existing investment limits. The existing investment limit on these items, therefore, precludes the quality production of such items in India.

Since the changes in the trade policy instituted since 1991 almost all items except for consumer goods are now freely importable. A careful examination of the import policy has shown that more than 550 items on the list of reserved products are now (in 1996-QR restrictions, were almost completely done away with by April 2001, making almost all the reserved items importable), freely importable. This means that, whereas foreign companies which produce these products could sell them freely in India, large domestic companies are not free to manufacture such items. Some protection however, is provided by the applicable customs tariff. These facts give credence to the view that the government has allowed free competition between the Indian small-scale sector and the multinationals but not with the large Indian companies.

Several labour-intensive industries such as garments, shoes, leather goods, sports goods, hand tools, and the like that have flourished in East Asian economies but have not done so in India due to the exclusion of large companies. The toy industry has prospered in other Asian countries but its growth in India has been unremarkable. Similarly, the light engineering industry, e.g., hand tools, is among the larger industries in East Asia but have not achieved significant progress in India. The food processing industry in India is a potential giant but its growth has been arrested by the reservation policy.

The reservation of products for the small-scale sector has proved to be a barrier to growth of exports in a number of these industries. It is true that despite severe odds, some of these industries such as garments and shoes have contributed tremendously to the country's export effort. These are the sectors where the country exhibits significant comparative advantage. But various studies conducted by the Export Import Bank of India and others show that our export of items such as garments and shoes are limited to a narrow range of goods and exhibit low unit values. They are also not able to supply branded goods in large quantities with consistent quality to large buyers like trading houses and department stores. In the case of garments, for example, *our record of exporting to non-quota countries is poor since we are not able to compete. The dismantling of the Multiple Fibre Agreement (MFA) will mean the existing quota markets will also become increasingly competitive over the next 8 years. It is, therefore, imperative for future export growth to remove such small-scale industry reservations so that adequate new investment and technology upgradation take place in these industries and that existing units are allowed to upgrade. It should be understood that existing units are unlikely to be hurt as they could continue exporting their current composition of products, instead they would be enabled to grow. The experience in South East and East Asian countries suggests that these industries would grow quite spectacularly if they are freed in such a manner. Whereas many large units could come up in sectors such as garments, toys, and shoes, a great amount of outsourcing and subcontracting would take place so that, in fact, even greater growth would take place in the small-scale sector with the attendant employment growth.*

An additional consideration that has a bearing on exports is speedy delivery. The clearest example of this can be found in the garments industry where the exporters need to use computer-aided cutting machines to be able to match the delivery schedules of their competitors. Consequently, large-scale investments are required.

Similarly, the poor quality of inputs manufactured in the small-scale sector has its deleterious influence on the end products. This is, for example, *evident in the automobile sector markets and bicycles. The final product suffers because low quality components over the final quality of the assembled product. The result is that for export of items such as bicycles many components have to be imported.*

We have also been made aware of some of the impacts of reserved items on the large industries which are the suppliers of intermediate goods to the final manufactures of the finished goods which are reserved for small-scale industries. For example, *in the case of the textile industry, where fibre or fabric producers supply to garment producers in the small-scale sectors, domestic industry is handicapped because they do not have large-scale buyers. Large industries would become more competitive if they had more demanding buyers. They would then upgrade in quality as well.*

The experience with reservation tells a story of love's labour lost. Good intentions of the government have manifestly not registered in the business calculations of small enterprises. The second census of small-scale industries provides persuasive evidence of the misplaced importance given the policy of reservation. Out of a total

of 200 products leading in value of output produced by the small-scale sector, it was found that reserved products accounted for only 21 per cent. Only 210,000 small scale sector units, less than half out of a total of 5,82,000 units, manufactured the reserved products at *all. No less than 233 reserved items out of a total of* 1,076 *(when expanded at a lower level of aggregation in the NIC code) were found not be manufactured at all according to the census. Although further inquiries have revealed that many of these products are found to be manufactured by some units, the fact remains that their production is in negligible quantities.*

Conversely, very few of the reserved products attracted significant levels of participation from small-scale units. As many as 90 products were found to be manufactured by just one company each. The sum total of the value of production of all small-scale companies in as many as 692 items was a low of ₹ 10 crore or less. Just 68 reserved items accounted for 81 per cent of the total value of production of reserved products and 83 per cent of the units.

In general, small-scale units do not need protection by reservation and can survive in free markets. Analysis of Korean data showed that small-scale companies (defined as employing between I to 100 employees) accounted for between 17 to 39 per cent of the employment in as many as 373 industries." They survive due to product differentiation. This can take the form of small companies specialising for consumption in different markets. Or small companies survive in niche markets requiring custom designed products. They also do well in new markets where large companies have not made their presence felt. Thus existence of product differentiation means that many SSI firms co-exists with large firms and cater to different consumption needs. In some cases, small firms supply low priced products for mass consumption in local markets where larger firms cannot compete. In other cases, they supply high priced products for the elite market. As the markets grow, small companies also grow in size and retain their dominant petition.

The removal of reservation will also pave the way for greater equity participation from large Indian companies and foreign investors along with greater sub-contracting. Large companies will then have an incentive to establish long-term relationships and transfer proprietary technology for improving the quality of products supplied by small-scale companies. It would then be much easier to establish interdependent relationships between large, medium and small industries as subcontractors, ancillaries, and suppliers of parts and components. The establishment of mother units would then spawn large numbers of small units in clusters.

SUMMARY

Development of village and small-scale industries has been given a lot of emphasis in India because of a number of avowed objectives such as promotion of entrepreneurship, generation of employment opportunities, development of decentralised development, prevention of concentration of economic development, utilisation of local resources, protection of interests of artisans, preservation of craftsmanship and heritage of the country etc.

To support the development of the VSI sector, an elaborate institutional network has been established and several schemes have been introduced to provide infrastructural, financial, technical, operational and marketing assistances. To guard against competition from the large firms, manufacture of a large number of items were exclusively reserved for the SSI sector and SSI units were given preferences in Government purchases. They have also been offered several fiscal and monetary incentives.

There is a strong feeling that the policy of exclusive reservation has not contributed to the healthy development of the SSI sector. The Abid Hussain Committee observed: "...instead of focusing on areas that should be the province of the small scale sector by economic rationale, the SSI policy has traditionally concentrated on exclusive activities for this sector. In this process, it has lost sight of the simple but determining logic of market system that it can make business sense for a large company to do anything that can be done more competitively by a small unit. A policy of exclusive reservation for the small-scale industry, therefore, is at best unnecessary and at worst inefficient."

However, the SSI units suffer from a number of problems which include technological, marketing, financial and operational problems. A large number of them are sick/weak, many of which are unviable. With the liberalisation global dimension, they have come to face increasing competition. This does not mean that the VSI units have no future. Experience of developed economies show that growth of large and small units go hand in hand. Efficiency, dynamism and strategy are needed to survive in a competitive environment.

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Chapter 17

INDUSTRIAL SICKNESS

Structure

Definition

Causes of Sickness

Preventive and Curative Measures

Summary

References

Industrial sickness is a matter of serious national concern because besides affecting the owners, employees, creditors and suppliers. It causes wastage of national resources and social unrest.

Industrial sickness is a universal phenomenon. While the industrial sickness is easily manifested in market economies, it may be concealed in economies where the market mechanism does not operate. In a market economy, the competition tests and exposes the strengths and weaknesses of firms and, therefore, sickness becomes easily visible. There has been a fear that the liberalisation and the concomitant increase in competition, both domestic and foreign, would increase sickness. Although the first several years of liberalisation did not witnessed any significant change in the magnitude of sickness, between 1998 and 1999 there was a substantial increase in industrial sickness.

DEFINITION

There are different perceptions of the symptoms and characteristics of industrial sickness. Sickness is a relative concept. Further, "a given sickness manifests itself in several forms, and at a point of time these forms may not throw unambiguous or clear-cut signals. No wonder, then, that sickness is found being understood, interpreted and measured differently by individuals and even by institutions."[1]

"To a layman, a sick unit is one which is not healthy. To an investor, it is one which skips dividends. To an industrialist, it is a unit which is making losses and tottering on the brink of closure. To a banker, it is a unit which has incurred cash losses in the previous year and is likely to repeat the performance in the current and following years."[2] In terms of the definition evolved by the Reserve Bank of India, an industrial unit is regarded as sick if it has incurred cash loss for one year and in the judgement of the bank, it is likely to continue to incur cash loss in the two following years and it has imbalance in its financial structure such as current ratio being less than 1:1 and worsening debt-equity ratio. The Sick Industrial Companies (Special Provisions) Act, 1985, as amended in 1993, defines a sick industrial company as an industrial company (being a company registered for not less than five years) which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth. The definition is for the purpose of application of the Act which covers only registered companies which have been in existence for at least seven years.

According to the Scheme for Rehabilitation of Small-scale and Non-BIFR Sick Viable Industries, Government of Gujarat, "a unit is considered sick when any of its borrowal accounts has become a *doubtful advance* as defined by the Reserve Bank of India, *i.e.,* principal or interest in respect of any of its borrowal accounts has remained overdue for a period exceeding two-and-a-half years and there is an erosion in the net worth due to accumulated cash losses to the extent of 50 per cent or more of its peak net worth in the preceding two accounting years."

Industrial sickness has several common symptoms.

Common symptoms of industrial sickness include failure to pay statutory liabilities like Provident Funds and ESI contributions, failure to pay timely installment of capital and interest on loans taken from financial institutions and through public deposits, increase in inventories with a large number of slow or non-moving items, high rate of rejection of goods manufactured, low capacity utilisation and frequent industrial disputes.

Weak Units

It is important to detect sickness at the incipient stage and take necessary remedial measures. The Reserve Bank has, therefore, advised the commercial banks to take remedial measures in respective units at the stage of 50 per cent erosion of their net worth. Such units are termed as weak units to distinguish them from sick industrial companies as defined in the Sick Industrial Companies Act.

An Industrial unit is termed as weak if at the end of any accounting year it has: (i) accumulated losses equal to or exceeding 50 per cent of its peak net worth in the immediately preceding five accounting years; (ii) a current debt-equity ratio of less than 1 : 1, and (iii) suffers a cash loss in the immediately preceding accounting year.

Industrial sickness can be caused by internal or external factors.

Magnitude

There is a large number of sick units in the small-scale sector (SSI sick units) and the non-SSI sector. Many of the sick units are non-viable, *i.e.,* they cannot be brought back to healthy existence.

CAUSES OF SICKNESS

Industrial units may become sick at different stages and due to different reasons. Indeed, some industrial units "are born sick, some achieve sickness and some have sickness thrust upon them."[3]

Born Sick: Industrial units born sick are those which are destined for disaster right from their conception due to various causes. A study conducted by the Institute of Economics, Hyderabad, found that 50 per cent of the dead units closed within three years of opening. This proves that these units never had any reasonable survival prospect right from birth.[4]

Any one or more of the following factors may cause the birth of sick units.

Many industrial units are born sick due to faulty project appraisal, time and cost overruns, financial problems, technological factors, locational problems etc.

1. Lack of experience of the promoters, wrong selection of the project, faulty project planning, etc., may give birth to sick units. The mushroom growth of the so-called consultancy firms has been regarded as a factor contributing to these sorts of problems because the primary interest of such consultancy firms is to make money by selling some ideas or project reports to the aspirants who may, thus, be misguided or made overenthusiastic. We must also think that the rosy hopes generated by the high-sounding promises and schemes including the self-employment schemes of the financial institutions and other promotional agencies of the Governments also contribute to this unfortunate situation.

2. Paucity of funds and faulty financial management may also cause the birth of sick units. Many new units have been found to be underutilised and the strains of undercapitalisation become evident when the unit becomes operational. In case of some companies, the heavy investment in non-productive capital assets like staff housing projects even before they commence production distorts the liquidity and causes a lot of problems. Problems also crop up due to inadequate provisions for contingencies, faulty fund flow and cash flow estimate etc.

3. Time and cost overruns sometimes prove to be very disastrous. Particularly in case of large projects, delays in project commissioning due to delay in supply of equipment, both indigenous and imported, slippage in the schedule of civil works, creation of equipment, etc., are not uncommon. Such delays cause cost escalations leading to capital shortage, liquidity problems, hike in the production costs and break-even point etc.

4. Sickness may arise from locational problems also. It has been observed that "high-technology based units are established in areas without skilled labour or supporting infrastructure; industries based on imported raw materials are founded in regions without adequate transport and communication system."[5]

5. Technological factors like selection of obsolete or improper technology or the technology becoming outdated due to innovations while the project is being executed, substandard machinery, wrong collaboration, etc., also cause sickness.

According to the Tiwari Committee, 14 per cent of the large sick units suffered from technical factors and faulty initial planning.

6. Wrong assessment of the market potential or faulty demand forecasting, change in the market conditions, including the change in the consumer tastes and preferences and competitive situation, etc. can also cause birth of sick units.

Achieved Sickness: Industries which achieve sickness are those which fail after becoming operational due to internal causes. Such internal causes which are common are the following.

1. Bad management, which "covers a wide range from inexperience, inefficiency, lack of professional expertise, neglect and internal squabbles to delinquency and dishonesty"[6] is an important cause of industrial sickness. According to the Tiwari Committee Report, 1984, "the factor most often responsible for industrial sickness can be identified as 'management'. This may take the form of poor production management, poor labour management, poor resources management, lack of professionalism, dissensions within the management, or even dishonest management". The Committee found that 65 per cent of the large sick units were affected by this problem.

2. Unwarranted expansion and diversion of resources may also result in sickness. Some concerns tend to expand beyond the resources including managerial capability. Diversion of resources to start new units or to acquire interest in other concerns without due regard to the capability of the unit to provide such funds sometimes lands the unit in trouble.

Personal extravagances and acquisition of unproductive fixed assets like company guest houses etc. also may contribute to sickness.

Inefficient management, labour problems, external factors like infrastructural problems and changes in business environment cause sickness.

3. Poor inventory management in respect of finished goods as well as inputs may land a unit in trouble.

4. Failure to modernise the productive apparatus, change the product mix and other elements of the marketing mix to suit the changing environment is a very important cause of industrial sickness.

5. Poor labour-management relationship and the associated poor worker morale and low productivity, strikes, lock-outs, etc., also may ruin the health of a unit to survive.

External Causes: Sickness may be caused also due to factors beyond the control of an industrial unit. Some of these common external factors are the following:

1. Energy crisis arising out of power cuts or shortage of coal, and oil have been a serious problem for many industrial units in India.

2. In a number of cases, the units are not able to achieve optimum capacity due to shortage of raw materials due to production setbacks in the supply industries, poor agricultural output due to natural reasons, changes in the import conditions etc.

3. Infrastructural problems like transport bottlenecks also sometimes cause serious problems.

4. It is a general complaint of the industrial circles that the credit squeeze very adversely affects the industrial sector. According to the Tiwari Committee, 24 per cent of the large sick units were affected by shortage of working capital/liquidity constraints.

5. Artificial economic constraints also make their contribution to the growing industrial sickness. Government controls on the product mix and prices caused serious problems for certain industries. Sometimes, it is not possible to automate or rationalise due to unfavourable government policy or labour attitude.

There are, thus, many external and internal factors which can cause industrial sickness. In many cases, sickness is caused by a combination of factors.

It may also be noted that sometimes the attitude of labour, financial institutions and government which does not allow a unit to take measures, before it becomes sick, to strengthen itself also may cause sickness. Rehabilitation packages suggested by the BIFR for several sick units include such measures as closing down certain divisions or lines of business, modernisation, rationalisation and redeployment of labour force, sale of assets to generate funds, etc. The pity, however, is that a unit which proposes to take such measures before it becomes sick may have to face opposition from the trade unions and even from government/government agencies. And there will be suggestions to take such measures, offer of concessions and the like after the catastrophe has ushered in. Further, the swiftness with which the administrative machinery responds to a grave problem is indicated by the fact that it took three years to establish the BIFR after the Tiwari Committee recommended such a measure! After many years of functioning of the BIFR without producing the expected benefits, there has been a confusion, for quite some time, as to whether the Sick Industrial Companies Act and the BIFR established under the Act be scrapped or not.

Absence of an appropriate exit policy has significantly contributed to the problem of industrial sickness in India.

PREVENTIVE AND CURATIVE MEASURES

As the Tiwari Committee observes, "Industrial sickness tends to cause loss of production very often leading to unemployment/loss of employment and resulting in blocking of scarce resources of the banks and financial institutions, besides entailing loss of substantial revenue to the exchequer. The magnitude and incidence of industrial sickness are matters of serious concern for the Central and State governments, Reserve Bank of India, banks and financial institutions not merely due to the above factors, but also because such a trend undermines public confidence in the functioning of the organised sector with attendant repercussions on the overall investment climate in the economy of the country. Several measures have, therefore, been taken by the government and financial institutions to detect the symptoms of sickness, and to prevent or cure sickness to the extent possible.

There are some laws which enable the Central Government to monitor and control the functioning of industrial undertakings and to deal with the problem of sickness.

The Companies Act, 1956, empowered the government to collect information from the companies which would enable it to assess the state of affairs of the companies and to take certain measures to prevent mismanagement. The Industries (Development and Regulation) Act, 1951 (IDRA), empowers the government to regulate the management of industrial undertakings, including the takeover of the management or the undertaking. The Sick Industrial Companies (Special Provisions) Act was passed in 1985 to deal with the problem of industrial sickness.

Government endorsed the recommendation of the Chokshi Committee regarding amalgamation of sick units and healthy units and amended Section 72A of the Income Tax Act relaxing the provision relating to carry forward and set off of accumulated business loss and unabsorbed depreciation allowances in case of amalgamation.

In 1981, the government announced certain policy guidelines to deal with industrial sickness. These guidelines required the ministries administratively concerned with various industries to take responsibility for rehabilitation of sick units. Banks and financial institutions were required to strengthen the monitoring arrangement for prevention of sickness.

An important limitation on the ability to tackle sickness arises from the fact that commercial banks may legitimately consider sick units as poor security risks.

Sick Industrial Companies Act

The purpose of SICA was timely detection of sickness and formulation and implementation of turnaround package.

An important piece of legislation dealing with industrial sickness was the Sick Industrial Companies (Special Provisions) Act, 1985. The objectives of the (SICA), were:

1. The timely detection of sick and potentially sick companies owning industrial undertaking.
2. The speedy determination by a Board of experts of the preventive, ameliorative, remedial and other measures which need to be taken with respect to such companies.
3. The expeditions enforcement of the measures so determined and for matters connected therewith or incidental thereto.

According to the SICA, amended in 1993, a sick industrial company meant an *industrial company (being a company registered for not less than five years) which had at the end of any financial year accumulated losses equal to or exceeding its entire net worth.*

An industrial company was regarded as potentially sick, *if the accumulated losses of an industrial company as at the end of any financial year had resulted in the erosion of fifty per cent or more of its peak net worth during the immediately preceding four financial years.*

Under this Act, the Central Government established a Board for Industrial and Financial Reconstruction (BIFR) to exercise the jurisdiction and powers and discharge the function and duties conferred or imposed on the Board by the Act.

The SICA required the Board of Directors of a sick industrial company to make a reference to the BIFR for determination of the measures to be adopted with respect to the company. The BIFR could direct any operating agency like the financial institution to prepare the scheme for revival of the sick unit. The scheme could provide for any one or more of the following measures.

1. The financial reconstruction of the company.
2. The proper management of the sick industrial company by change in or takeover of management of the sick industrial company.
3. The amalgamation of the sick industrial company with any other company, or any other company with the sick industrial company.
4. The sale or lease of a part or whole of industrial undertaking of the sick industrial company.

Where the BIFR was of the opinion that the sick industrial company was not likely to make its net worth exceed its accumulated losses within a reasonable time and that it was not likely to become viable in future and that it was just and equitable that the company should be wound up, it could imitate proceedings with the High Court, for winding up of the company.

There had been all-round criticism against the SICA and the BIFR and it had been felt that they should be scrapped. The SICA was repealed and the powers exercised by the BIFR were transferred to the National Company Law Tribunal (NCLT). *Revival and Rehabilitation of Sick Companies now come under the Companies Act*. For details, see the chapter on *Indian Company Law* (Chapter 19).

SUMMARY

Sickness is a serious problem that has afflicted the small, medium and large industries and it is a matter of serious national concern because besides affecting the owners, employees, creditors and suppliers, it causes wastage of national resources and social unrest.

Industrial units may become sick at different stages and due to different reasons. Indeed, some industrial units "are born sick, some achieve sickness and some have sickness thrust upon them."

Lack of experience of the promoters; wrong selection of the project; faulty project planning; paucity of funds and faulty financial management; time and cost overruns; wrong location of the project; technological factors like selection of obsolete or improper technology or the technology becoming outdated due to innovations while the project is being executed; sub-standard machinery; wrong collaboration; wrong assessment of the market potential or faulty demand forecasting; change in the market conditions; including the change in the consumer tastes and preferences and competitive situation, etc. can cause birth of sick units.

Firms become sick after becoming operational due to internal causes such as bad management; unwarranted expansion or diversion of resources; poor inventory management in respect of finished goods as well as inputs; failure to modernise the productive apparatus, change the product mix and other elements of the marketing mix to suit the changing environment; and poor labour-management relationship and the associated problems.

Sickness may be caused also due to external factors, *i.e.,* factors beyond the control of an industrial unit, such as energy crisis arising out of power cuts or shortage of coal, and oil; failure to achieve optimum capacity due to shortage of raw materials due to production setbacks in the supply industries, poor agricultural output due to natural reasons, changes in the import conditions etc; infrastructural problems like transport bottlenecks; credit squeeze; Government controls on the product mix and impossibility to automate or rationalise due to unfavourable government policy or labour attitude.

Absence of an appropriate exit policy has significantly contributed to the problem of industrial sickness in India.

In the past, the Government took over a large number of sick units, particularly in the textiles industry. Overburdened with their huge financial burden, Government has given up the policy of taking over sick units.

The Sick Industrial Companies (Special Provisions) Act was passed in 1985 with the main objectives of timely detection of sick and potentially sick and the speedy determination by a Board of experts (BIFR) of the preventive, ameliorative, remedial and other measures which need to be taken with respect to such companies. The SICA and the BIFR failed to achieve their objectives. The SICA was repealed and the revival and rehabilitation of sick companies are now dealt with the Companies Act, 2013.

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Chapter 18

PRICE AND DISTRIBUTION CONTROLS

Structure

Objectives of Price and Distribution Controls

Price Policy in India

Price Controls

The Public Distribution System

Summary

Control over price and distribution has been regarded as one of the important means of achieving the socio-economic goals in many planned, especially developing, economies. Even market economies have price and distribution controls.

Price and distribution controls in countries like India are necessitated by short supply of goods and services; an unreasonable level of prices in the free market and the very low levels of income of a large number of people.

OBJECTIVES OF PRICE AND DISTRIBUTION CONTROLS

The objectives of price and distribution controls (PDCs), in general, are to supplement the efforts of other instruments of planning. The specific objectives of the control over price and distribution may be listed as follows.

1. ***Equity or Distributive Justice:*** Growth with social justice has been accepted as a major objective of development. This implies that the fruits of development should be distributed equitably. But it has been generally accepted that inflation distorts income distribution against the poor. Many a time, the scarcity of "wage goods"—the essential consumer items—leads to blackmarketing, making the life of the poor more miserable. One of the prime objectives of price and distribution controls, therefore, is to protect the vulnerable sections against inflation and shortages, and ensure a reasonable level of consumption for them.

2. ***Maintain Quality of Goods and Services:*** Price and distribution controls aim at ensuring the quality of goods and services. For instance, the Industries (Development and Regulation) Act, 1951, the Essential Commodities Act, 1955, etc. empower the Government of India to control the quality of various goods and services.

3. ***Prevention of Monopolistic, Restrictive and Unfair Trade Practices:*** Prevention of certain trade practices that are detrimental to the common interest is another major objective of price and distribution controls. In India, the MRTP Act, 1969, sought to prevent the monopolistic, restrictive and unfair trade practices that are prejudicial to the public interest. The MRTP Act has been replaced by the the Competition Act 2002.

4. ***Augmentation of Supply:*** Increasing the supply of goods and services is of paramount importance to reduce the hardships of the people by making goods available at reasonable prices. And this is one of the objectives of the price and distribution controls. Laws like the Industries (Development and Regulation) Act and the Essential Commodities Act contain provisions to prevent unjustifiable reduction in production by industrial undertakings. The public distribution system of the Government of India envisages a comprehensive production-cum-distribution scheme.

DCs seek to regulate the quality and quantity of production, smoothen supply, influence resource allocation, protect interests of vulnerable sections and control prices.

5. ***Enlargement and Smoothening of the Supply System:*** To remove the imperfections in the supply system in order to ensure the availability of essential goods at reasonable prices to the vulnerable sections in all areas, it is essential to enlarge and strengthen the distribution channels to cover all areas. It is one of the aims of our public distribution system to provide the benefits of its services even to the remote areas and thereby assure social justice.

6. ***Supply of Inputs to Priority Sectors:*** Ensuring supply of essential inputs to the priority sectors at reasonable prices is an important objective of the price and distribution controls. For instance, in India, certain industries are accorded priority in the allocation of certain raw materials and intermediate goods which are in short supply. Small-scale industries, export industries, agriculture and other priority sectors have been given credit at concessional terms.

7. ***Resource Allocation:*** Control over prices and distribution enables the planning authorities to achieve the desired pattern of resource allocation more easily. Apart from distributing the productive resources as mentioned above, the price and distribution controls can be made use of in other ways also to achieve the objective of resource allocation. To encourage investment in a particular field, it is essential to ensure a remunerative price for the output. For this purpose,

sometimes price support schemes will have to be adopted. Considerable supply response to prices is noticed in case of certain agricultural commodities. In such cases, deliberate variations in relative prices may be effected to redistribute the area under different crops to obtain a desirable output mix.

8. ***Prevention of Hoarding and Blackmarketing:*** Hoarding and blackmarketing have almost become by-products of shortage economy. An effective system of control should prevent the creation of artificial scarcity by the unscrupulous businessmen for profiteering. Laws like the Prevention of Blackmarketing and Maintenance of Supplies of Essential Commodities, and Essential Commodities Act, are designed to serve this purpose.

9. ***Control of Inflation and Deflation:*** As it is abundantly clear from the objectives mentioned above, control of inflation is a principal objective of price and distribution controls. In certain cases, however, prevention of fall in the prices is also the task of these controls. As there is a close interrelationship between supply and prices, price and distribution policies should mutually support each other to achieve the desired objective.

PRICE POLICY IN INDIA

The price system can be used as a steering mechanism to secure the desired allocation of consumption and production, and thereby the interpersonal and inter-sectoral distribution of income. Hence, it is essential to have a price policy that is comprehensive enough to help achieve the various socio-economic aims. Today, the price policies of various nations aim, in general, at avoiding wide fluctuations in the price behaviour, mobilisation and optimum utilisation of resources by bringing about their rational allocation, providing price incentives for increasing production and redistribution of income in favour of the poor. The nature of price policy a nation should adopt, however, depends on the nature of the economy, objectives of development, the institutional framework, trade and commercial practices and the overall market behaviour.

Plan priorities and monetary, fiscal and commercial policies have roles in PDCs.

When the First Five-Year Plan of India was formulated, the planners did not appear to have bothered much about the prices. As the First Plan experienced comparative price stability, the issue of prices was not a major concern while formulating the Second Plan also. But, during the Second Plan period, prices exhibited a disturbing trend and this became a matter of major concern. Hence, a separate chapter on Price Policy was incorporated, for the first time, in the Third Plan document.

The chapter on *Price Policy* for the Third Plan mainly dealt with the scope and limitations of price policy and the constituents of the price policy. It stated that the price policy in a developing economy should concentrate on two main objectives: *(a)* it must ensure that the movements of relative prices accorded with priorities and targets that had been set in the Plan; and *(b)* it must prevent any considerable rise in prices of essential goods that entered into the consumption of low income groups.

Fiscal and monetary discipline was conceived as the major constituent of price policy. It pointed out that fiscal policy must be directed to mopping up the excess purchasing power which tended to push up demands above the level of available supplies. The quantum of taxation must, in other words, be adequate to keep down consumption to the limits provided for in the Plan. The requirements of public sector investment programme must be met by the transfer of real resources from the public rather than by creation of fresh purchasing power. In other words, fiscal policy in all its aspects must aim at restraining consumption and mobilising savings more effectively.

It was stressed that monetary policy should go hand in hand with fiscal policy. Just as the latter should avoid the creation of excess purchasing power through government operations, the former should regulate the pace of credit creation through banks.

The policy also recognised the scope and limitations of the commercial policy in imparting stability to the economy.

While stressing that without adequate fiscal and monetary discipline, other regulatory measures would not have the desired effect, the policy recognised that fiscal and monetary policies by themselves might also not suffice to secure the right relationship between various prices or to prevent undue hardship to low and fixed income groups. "It may be necessary, then, to have physical allocations and direct controls in certain sectors. It will be agreed, for instance, that so long as steel is scarce, it should be distributed between competing uses on the basis of agreed priorities. It may, of course, be essential to raise the price of any commodity that is scarce; but it may not be desirable from an overall point of view to get the highest bidder to get the bulk of the available supplies, leaving the rest to their own devices. If, similarly, there is a shortage of an essential drug, control of prices and distribution at a fair price to genuine users would be the appropriate course of action to adopt. The same reasoning applies to essentials of life like food or cloth. The prices of what may be called basic essentials must be held reasonably stable, in regard to commodities that are less essential, or may be classified as comforts or luxuries, a rise in prices may have to be tolerated. In the case of comfort and luxuries, in fact, an important factor in policy is the need to raise more resources, a rise in their prices does not affect the common man. The techniques of price regulation may vary from commodity to commodity; in some cases an increase in production may be the only way to secure a reasonable level of prices. In other cases, buffer stocks, reorganisation of distribution arrangements and some direct controls may be inescapable."

Thus, the Price Policy recognised the importance of fiscal and monetary policies, commercial policy, physical controls, enhancement of supply, etc., in achieving its objectives.

Successive Plans have emphasised the need for achieving price stability and distributive justice. However, the basic objectives and approach enunciated the Price Policy formulated in the Third Plan continued in the successive plans without any remarkable change and more and more measures were taken by the government to realise the objectives. Decontrol of prices and distribution has been a part of the economic reforms ushered in 1991. Price and distribution controls would, however, continue in certain vital areas.

PRICE CONTROLS

A number of measures have been taken to control the prices. These measures include both indirect and direct controls.

INDIRECT CONTROLS

Indirect controls are exercised mainly through the monetary policy, fiscal policy and commercial (foreign trade) policy.

Indirect controls work through macroeconomic policies like monetary, fiscal and commercial policies.

The term monetary policy refers to the policy of the Central Bank of the country in respect of the cost and availability of credit. The rationale of using the monetary policy to control prices is that there is a very strong direct relationship between money supply and prices. *Ceteris paribus*, an increase in money supply results in an increase in prices and *vice versa*. Hence, a price rise is sought to be arrested by monetary contraction and a fall in prices is dealt with by monetary expansion.

The Reserve Bank of India (RBI) has been employing the Bank (Discount) Rate Policy, Open Market Operations and Variable Reserve Ratio Requirements and various methods of Selective (Qualitative) Credit Control. (See the chapter on *Monetary and Fiscal Policies* for details).

A policy that should go hand in hand with the monetary policy to make it effective is the fiscal policy. Fiscal policy refers to the policy of the government in respect of public revenue and public expenditure. Fiscal policy can influence the price level by increasing or reducing the purchasing power of the public. Further, it can affect prices by imposing or removing or varying taxes on commodities or services, and by subsidies. Taxes, like excise duties, sales tax and customs duty, can have a profound impact on the prices of commodities.

Commercial policy has also been used to a certain extent to stabilise the domestic economy. Prices can be kept under control by increasing the supply by importing goods which are in short supply. This has been done for such commodities as edible oils. Further, the government bans the export of certain items the supply position of which is not comfortable within the economy.

To prevent an unwarranted fall in the prices, the government may sometimes resort to the deliberate export of certain items.

There are also some other measures such as buffer stock operations which can help avoid wide fluctuations in prices.

DIRECT CONTROLS

Direct controls work through legislative and administrative measures.

The Central and State Governments in India have armed themselves with a number of Acts to exercise direct control over the functioning of the economy. Laws like the Industries (Development and Regulation) Act, the Essential Commodities Act, the MRTP Act (now the Competition Act), the Foreign Trade Development and Regulation Act [earlier the Imports and Exports (Control) Act], etc., empower the Central Government to control production, supply, distribution and price in a large number of cases.

Administered Prices

Administered price, a term coined by Lord Keynes, refers to the price which is set consciously by a single decision-making body—like a monopoly firm, a cartel, or a government agency—rather than being determined by the free play or market forces. However, the term administered price often refers to the government determined price.

When the market forces of supply and demand are free to interact, the price of a product rises when the supply falls short of the demand and declines when the supply exceeds demand. But under the administered price system, as the price is fixed at a particular level, fluctuations in demand and supply do not cause any price fluctuation. In other words, the administered price is not an equilibrium price. Not only that, the administered price may not reflect the demand and supply conditions; sometimes it may not even absorb the full cost of production.

In India, the price of a number of key commodities were administered by the government. Some key commodities and services such as steel, coal, fertilisers, aluminium and electricity, whose prices were administered, account for about one-fifth of the total weight in the wholesale price index. Thus, in the past, the administered price was an important factor affecting the general price level in India. At one time, over 70 per cent of the goods and services sold by the public sector enterprises were subject to administered prices. This indicates the importance the administered price had in the Indian economy.

Administered prices were generally fixed on the recommendations of an expert body like the Bureau of Industrial Costs and Prices (BICP) or, in the case of certain public enterprises, on those of specially constituted Inter-ministerial Committee or Groups. The BICP was later replaced by Tariff Commission.

While recommending prices, the recommendatory body normally goes by the guidelines for price fixation prescribed by the government and, *inter alia*, takes into account the cost of most efficient firms which account for a large percentage of the total output (to ensure a certain level of efficiency in production), the optimal norms of consumption of raw materials and energy as well as capacity utilisation, and provides a fair rate of return which has generally ranged between

10 and 14 per cent on net worth, depending on the differences with respect to factors such as risk, priority, growth prospects, etc. In order to reconcile the interests of consumers as well as producers, a system of retention prices for different producers on the basis of cost of production on the one hand and uniform sale prices for consumers on the other had been recommended, and had been in operation in several cases such as steel, fertilisers, cement, etc. Price adjustments had been allowed for changes in major cost components from time to time, and a review in depth is undertaken after suitable intervals.

The principle of fair return is relevant to public enterprises as well. However, these enterprises are generally engaged in the provision of infrastructural services or in the manufacture and supply of basic industrial materials such as coal, steel and POL, or agricultural inputs, such as fertilisers; and an increase in their prices generally has a cascading effect. Hence, an attempt had been made to keep down their prices. This, together with managerial deficiencies and other factors, had resulted in inadequate resource generation by the public enterprises, losses in some of them, and a heavy draft on the public exchequer. It also meant the supply of goods and services produced in the public sector at subsidised prices even for non-priority uses, which had the effect of accentuating the imbalances between demand and supply. There was, therefore, a growing realisation that, in the context of continued inflationary pressure at home and abroad, administered prices should not be kept out of tune with other prices without heavy economic cost to the nation.

The principal aim of the administered price system is the protection of the interests of both the producers and consumers. But, in India, in many an instance, the system miserably failed to safeguard the interests of the producer as well as the consumer. Price controls retarded the growth of the concerned industries and increased market imperfections, resulting in persistent commodity shortages and rampant and flourishing blackmarkets.

Industry circles argued that many a time the price was fixed on unrealistic capacity utilisation norms, and that there was a delay in granting price increases to cover cost escalations.

Take the case of the cement industry, for instance. The unrealistic price policy has retarded the growth of the cement industry and the resultant widening of the demand supply gap "has raised the price of cement in the blackmarket to about four times the official price. Government must also recognise that even imported cement costs twice as much as the indigenous product".

In short, the unrealistic price control policy in India, administered by inefficient and corrupt men at various administrative levels, has resulted in growing shortages and rampant blackmarketing, generating enormous black money.

With the advent of the economic reforms, there has been a phasing out of the administered prices, i.e., fixing prices by government.

Dual Pricing

Some commodities like sugar, cotton textiles, paper and aluminium were subject to dual pricing in India in the past.

The system of dual pricing has been designed to allow the weaker sections of the people or the privileged buyers like the government to get the commodity at a lower price. Under dual pricing, a part of the output of an industry may be acquired by the government at a price fixed by it, which is usually lower than the market price, and the remaining part of the output may be sold by the industry at the market price. For instance, under the dual pricing policy for sugar, a part of the total production of sugar was to be sold to the government as levy at the price fixed by the government. The non-levy sugar (the remaining part) was allowed to be sold at the free market price. Sometimes the free market price went up to three times, the levy price.

The dual pricing system in our country was severely criticised. It was argued that such controls affected capital formation and production in such industries. It is said that the dual pricing system does not always permit the industry to make up for the loss on the levy sales by sales in the free market.

The objective of subsidisation and dual pricing is to protect weaker sections/priority sectors.

Another criticism is that the system encourages malpractices, blackmarketing, tax evasion, corruption and the generation of black money.

Subsidisation

Prices of certain commodities are directly affected by the policy of subsidisation. Important commodities the prices of which were deliberately kept low by the government subsidies were foodgrains, fertilisers and controlled cloth. Certain export goods also enjoyed the benefit of subsidies.

The principal objective of subsidies is the protection of weaker sections and priority sectors. For instance, foodgrains are subsidised to increase the consumption levels of the vulnerable sections. Certain export goods were subsidised to increase their price competitiveness in the international market so as to increase our foreign exchange earnings.

The steep increase in the outflow from the exchequer by way of subsidies has given rise to the demand for their reduction and even the abolition of certain subsidies. There are two principal arguments for reduction/abolition of subsidies, *viz.,* subsidies eat into the resources for development, and subsidies, as they exist today, cannot be justified on ground of economic equity and social justice.

The Essential Commodities Act

The main purpose of the Essential Commodities Act, 1955, was to provide, in the interest of the general public, for the control of the production, supply and distribution of, and trade and commerce in, certain commodities.

The government has listed a number of commodities as essential commodities. For the purpose of this Act, the Central Government may, by a notified order, declare any class of commodity to be an essential commodity.

This Act empowers the Central Government to regulate or prohibit the production, supply and distribution of, and trade and commerce in, any essential commodity for securing any of the following purposes.

(i) Maintaining or increasing their supplies.

(ii) Equitable distribution and availability at fair prices of the commodities concerned.

(iii) Securing any essential commodity for the defence of India or the efficient conduct of military operations.

Where an offence under this Act has been committed by a company and it is proved that the offence has been committed with the consent or connivance of, or is attributable to any neglect on the part of, any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of that offence and shall be liable to be proceeded against and punished accordingly.

The State governments have issued a large number of orders under this Act inhibiting the free movement of some foodgrains and other agricultural products. In the Budget Speech, 2001-02, the Union Finance Minister observed that in the changed situation this is undesirable and the Act and therefore, the Government proposed to review the operation of this Act and to remove many of the restrictions on the free inter-state movement of foodgrains and other agricultural products and to prune down the list of essential commodities to the minimum required.

Other Laws to Control Production, Distribution and Prices

Apart from the Essential Commodities Act, there are several Acts which empower the government to control the production, supply, distribution and price of a large number of commodities.

For the purpose of securing the equitable distribution and availability at fair prices of any article or class of articles relatable to any scheduled industry, the Central Government can, under the Industries (Development and Regulation) Act, regulate their production, supply, distribution, trade and price.

The Essential Commodities Act and the Industries (Development and Regulation) Act are supplemented by the Monopolies and Restrictive Trade Practices Act, 1969, (now the Competition Act) the Prevention of Blackmarketing and Maintenance of Supplies of Essential Commodities Act, 1980; the Conservation of Foreign Exchange and Prevention of Smuggling Act, 1947, etc.

THE PUBLIC DISTRIBUTION SYSTEM

A rapid increase in money supply and population and the slow growth in output usually create an imbalance between the demand for, and the supply of, essential consumer items. When the purchasing power of a vast segment of the population is very low, even a slight increase in the prices of wage goods seriously erodes the consumption power of the vulnerable sections. Hence, in a Welfare State, there should be some system to insulate them against such happenings. An important device we have in our country for this purpose is the Public Distribution System (PDS), under which the government makes available essential mass consumption goods at reasonable prices, especially to the poor.

Evolution of the PDS in India

Public Distribution System existed in India even before Independence. During the pre-Independence era, the PDS was used as a short-term strategy to meet the war-time needs and famine conditions. With the dawn of planning, it assumed importance as one of the instruments for achieving the objectives of planning.

The main objective of the PDS is to make essential consumption goods to the weaker sections at reasonable prices.

In the initial stages, the PDS has been pressed into 'off and on' operations, depending upon plentiful and depleted stocks of foodgrains in the country. Since 1956, the supplies of foodgrains under PL 480 programmes compelled the government to evolve a permanent system of a steady outlet for distribution.

In 1957, the Foodgrains Enquiry Committee, under the chairmanship of Mr. Ashok Mehta, recommended the setting up of an organisation for foodgrains' price stabilisation to counteract the fluctuations in their prices by buffer stock operations. The persistent food crisis during the Second and Third Plan periods made the demand for an effective public distribution system more strong. In April 1959, a maiden decision of "State Trading in Foodgrains" was taken by the government. Though the decision seemed to be a remarkable one, it could not be successfully implemented. However, concrete steps for partial state trading were taken after 1963-64, when the country felt an acute shortage of foodgrains.

The emergence of serious inflationary pressures in the early 1970s made a strong demand for an effective civil supplies arrangement. The Department of Civil Supplies was set up in April 1974; in October 1974, this department was converted into the Department of Civil Supplies and Cooperation. As a model department, its function was to assist multi-pronged fiscal, monetary and administrative action on the part of concerned Ministers and Departments of the Central and State Governments of control inflation and to augment the production and distribution of essential commodities. The bringing together of the Civil Supplies and Cooperation highlighted the government's policy to involve the cooperatives more actively in the public distribution system even while taking steps to strengthen the cooperative organisations, more particularly in the productive sectors.

The cooperative sector has a major role in the PDS.

Since 1974, State Governments have also set up their own Civil Supplies Departments to look after the distribution of essential commodities in their respective jurisdiction.

In August 1976, the Department of Civil Supplies and Cooperation was converted into a separate Ministry. The functions of the Ministry of Civil Supplies and Cooperation are twofold:

(i) Those relating to civil supplies and allied matters, which include: *(a)* monitoring prices, the public distribution system, consumer protection, integrated management of the supply,

prices and distribution of certain essential commodities; *(b)* regulating weights and measures; and *(c)* control of forward trading.

(ii) Those pertaining to cooperation. These include general policy in the field of cooperation, matters relating to national cooperative organisations, cooperative training, education, marketing, processing and consumer cooperation.

On July 1, 1979, the Union Government inaugurated the production-cum-distribution system. The main features of this system are:

(i) Every village or a group of villages having a population of 2,000 and above will have a fair price shop. In remote areas, the population coverage would be even less – about 1,000.

(ii) Commodity coverage will be extended with a view to strengthening the system.

(iii) For the successful implementation of the scheme, effective arrangement will be made for the procurement, including import wherever necessary, and buffer stocking of the commodities for distribution.

(iv) In regard to certain manufactured articles, the Central Government would assist in establishing direct links between the manufacturers and the States and their approved agencies, including cooperatives, for the distribution of such items.

(v) Special care will be taken in the production and distribution of the items of basic consumption by the vulnerable sections of society.

In early 1980, the government decided to make the PDS a permanent feature of the economy and an integral part of its price stabilisation policy.

The cooperative sector is assigned an important role in the PDS in India. Besides consumer cooperatives in urban areas, there are very large number of village cooperative societies. At the secondary level, in semi-urban areas, there are several thousands of Agricultural Marketing Societies. Most of these are engaged in the distribution of consumer articles. At the central level, the National Agricultural Cooperative Marketing Federation (NAFED) and the National Cooperative Consumers' Federation (NCCF) carry out support price operations, maintenance of reasonable prices of essential items, creation of buffer stocks of surplus production, etc. Thus, the cooperatives have a large base and a great potential to contribute to the successful running of the PDS. But, the cooperatives, too, have their own organisational weaknesses. They have to streamline and strengthen the existing consumer cooperative structure to take up the gigantic task of supplying essential commodities to masses in rural, semi-urban and hilly and tribal areas.

The Indian Public Distribution System (PDS) is probably the largest distribution network of its type in the world. The system is designed to help both the producers and consumers of foodgrains by linking procurement to support prices and ensuring their distribution along with other essential commodities at affordable prices throughout the country. PDS continues to be a major instrument of Government's economic policy for ensuring food security for the poor.

The network of fair price shops has been expanding over the years.

Under the PDS, the Central government has assumed responsibility for procurement and supply of essential commodities, *viz.*, wheat, rice, levy sugar, imported edible oils and kerosene, to the State governments and the Union Territories for distribution at affordable prices to the public. These commodities are made available to the States/UTs at fixed Central Issue Prices (CIP) which are determined by the Central government and which generally involve subsidies borne by the Central government. The Central Issue Prices of foodgrains are fixed by the Ministry of Food after taking into account the Minimum Support Price of foodgrains, statutory charges/taxes

payable on the Minimum Support Prices and interest charged at the prescribed rate of interest. In the case of other items like sugar, kerosene and imported edible oils, the cost of procurement/ production, margins to dealers, transportation incidentals, etc., are included while working out the Central Issue Prices. Some States/UTs also distribute additional items of mass consumption through the PDS outlets.

Several states have established State Civil Supplies Corporations to handle the distribution of essential commodities under the Public Distribution System.

Targeted Public Distribution System: In June 1997, the Government launched the Targeted Public Distribution System (TPDS) by streamlining the PDS by issuing special cards to the families below the poverty line (BPL) and selling essential articles under PDS to them at specially subsidised prices. The thrust is to include only the really poor and vulnerable sections of the society such as landless agricultural labourers, marginal farmers, rural artisans/craftsmen such as potters, tappers, weavers, blacksmiths, carpenters, etc., in the rural areas, and slum-dwellers and persons earning their livelihood on a daily basis in the informal sector, like porters, rickshawpullers and hand-cart pullers, fruit and flower-sellers on the pavements, etc. in urban areas.

The TPDS is now in operation in all States/UTs except in Delhi and Lakshadweep.

The PDS, as it operates in our country, has been severely criticised. The major criticism is that the system is inefficient, the supply is not smooth, prompt and sufficient, and the quality of goods supplied is poor. There is a serious allegation that some of the goods of good quality are sold secretly to private traders and low quality goods are sold to the public by the PDS. This needs to be probed into by a competent authority.

BOX 18.1 : PERFORMANCE APPRAISAL OF PDS

In the Performance Appraisal Report (Civil), the Comptroller and Auditor General of India (CAG), has disclosed that the benefits of the public distribution system (PDS) in terms of food availability, income transfer, coverage of the needy and nutrition support did not accrue to the intended sections of society.

The report has pointed out several shortcomings relating to targeting of the beneficiaries, adequacy of food and nutritional security, meagre income transfer to the targeted group, high cost of operations, higher prices charged from the consumers, poor quality and non-existent vigilance system, which adversely affected fulfilment of the envisaged objectives of the PDS.

According to the CAG report, while the objective of remunerative minimum support prices every year for sustained foodgrains production had been achieved to a large extent, the other objectives of supply and distribution to the consumers, particularly to the weaker sections at subsidised rates had not been achieved.

The report noted that inefficient targeting had affected even targeted PDS, under which 10 kg foodgrains per month per family was to be provided to the households below the poverty line (BPL) at about half the normal PDS price.

Many State Governments failed to translate this objective into action. Surveys for identification of the BPL families were not completed in 18 out of 31 States and the Union Territories.

Even in States where identification was completed, ration cards were not provided to a significant number of BPL families.

What is more, in a large number of cases, the BPL families did not get the prescribed quantity of 10kg ration at the special subsidised rates and were charged higher rates. The State Governments did not absorb the cost, over and above that provided by the Centre towards handling, transportation and passed on the higher cost to the consumers, thereby defeating the main objective of TPDS.

Stating that significant inter-state variations in the allocations of rice and wheat were detected, the report said performance of States with large population of poor, such as Bihar, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh and West Bengal, whose aggregate BPL population was 60 per cent of the total BPL population in the country, was relatively low.

The review of the scheme also revealed significant number of cases of diversion of PDS commodities including kerosene oil, undue benefit to millers in some States particularly in Assam, losses in transit and storage, existence

of large number of bogus ration cards, excess charging from the customers than the maximum price fixed by the Central Government and, poor quality of foodgrains supplied through PDS which reduced the efficacy of the PDS.

Though the Centre released ₹ 58.73 crore and ₹ 62.96 crore for construction of godowns and purchase of mobile vans, respectively during 1983-99 to provide infrastructure for distribution and storage of the foodgrains and doorstep delivery to the fair price shops, the responses of the State Governments were, however, lukewarm. The vigilance and monitoring mechanism either did not function at all or did not function as per the design at all tiers, i.e., State, district and fair price shop levels.

SUMMARY

Scarcity, market imperfections and social concerns made price and distribution controls as one of the important means of achieving the socio-economic goals in many planned, especially developing, economies. Even market economies have price and distribution controls.

The important factors that call for price and distribution controls in countries like India are short supply of goods and services; an unreasonable level of prices in the free market and the very low levels of income of a large number of people.

The objectives of price and distribution controls, in general, are to protect the interests of the vulnerable sections and to supplement the efforts of other instruments of planning. The price and distribution controls aim at any one or more of the following: promotion of equity or distributive justice; ensuring the quality of goods and services; prevention of monopolistic, restrictive and unfair trade practices that are prejudicial to the public interest; augmentation of the supply; ensuring the availability of essential goods at reasonable prices to the vulnerable sections in all areas; ensuring supply of essential inputs to the priority sectors at reasonable prices, helping the planning authorities to achieve the desired pattern of resource allocation; prevention of hoarding and blackmarketing; control of inflation and deflation; etc.

The Planning Commission has proposed that the price policy in India, as in developing economies in general, should concentrate on two main objectives: *(a)* it must ensure that the movements of relative prices accorded with priorities and targets that had been set in the Plan; and *(b)* it must prevent any considerable rise in prices of essential goods that entered into the consumption of low income groups. Fiscal and monetary discipline has conceived as the major constituent of price policy. Fiscal discipline in India, however, has been conspicuous by its failure.

The important instruments of price and distribution controls are depicted in *Fig. 18.1*.

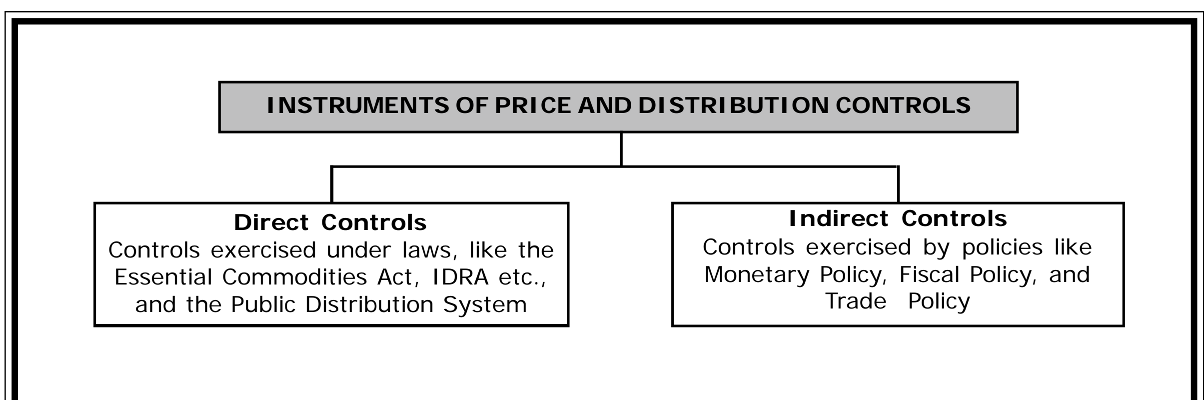

Fig. 18.1 : Instruments of Price and Distribution Controls

Ensuring supply of essential commodities at reasonable prices, particularly to the weaker sections and vulnerable areas, is mainly the responsibility of the Ministry of Civil Supplies and Cooperation. The responsibilities of the Ministry relating to civil supplies and allied matters include: *(a)* monitoring prices, the public distribution system, consumer protection, integrated management of the supply, prices and distribution of certain essential commodities; *(b)* regulating weights and measures; and *(c)* control of forward trading.

The Indian Public Distribution System (PDS), which is probably the largest distribution network of its type in the world, is designed to help both the producers and consumers of foodgrains by linking procurement to support prices and ensuring their distribution along with other essential commodities at affordable prices throughout the country. PDS continues to be a major instrument of Government's economic policy for ensuring food security for the poor.

Several states have also established State Civil Supplies Corporations to handle the distribution of essential commodities under the Public Distribution System.

The cooperative sector is assigned an important role in the PDS in India. Besides consumer cooperatives in urban areas, there are very large number of village cooperative societies. At the secondary level, in semi-urban areas, there are several thousands of Agricultural Marketing Societies. Most of these, are engaged in the distribution of consumer articles. At the central level, the National Agricultural Cooperative Marketing Federation (NAFED) and the National Cooperative Consumers' Federation (NCCF) carry out support price operations, maintenance of reasonable prices of essential items, creation of buffer stocks of surplus production, etc.

The PDS was streamlined and in June 1997, the Government launched the Targeted Public Distribution System by issuing special cards to the families below the poverty line (BPL) and selling essential articles under PDS to them at specially subsidised prices. The thrust is to include only the really poor and vulnerable sections of the society such as landless agricultural labourers, marginal farmers, rural artisans/craftsmen such as potters, tappers, weavers, blacksmiths, carpenters, etc., in the rural areas, and slum-dwellers and persons earning their livelihood on a daily basis in the informal sector, like porters, rickshawpullers and hand-cart pullers, fruit and flower-sellers on the pavements, etc., in urban areas. The TPDS is now in operation in all States/UTs except in Delhi and Lakshadweep.

The administration of the PDS has been far from satisfactory, as it operates in our country, has been severely criticised. The major criticism is that the system is inefficient, the supply is not smooth, prompt and sufficient, and the quality of goods supplied is poor. There is a serious allegation that some of the goods of good quality are sold secretly to private traders and low quality goods are sold to the public by the PDS. The Performance Appraisal Report (Civil), by the Comptroller and Auditor General of India (CAG), has disclosed that the benefits of the public distribution system (PDS) in terms of food availability, income transfer, coverage of the needy and nutrition support did not accrue to the intended sections of society.

Decontrol of prices and distribution has been a part of the economic reforms ushered in 1991. Price and distribution controls would, however, continue in certain vital areas.

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Chapter 19

INDIAN COMPANY LAW

Structure

Companies Act, 2013 — A Synoptic Note
Objectives of Companies Act
Classification of Companies
Incorporation of Company
Management and Administration
Board of Directors
Winding Up of Companies
National Company Law Tribunal and Appellate Tribunal
Miscellaneous
Summary
Reference

BRIEF HISTORY OF COMPANY LAW IN INDIA[1]

Indian Company Law has a long history. The Companies Act, 1956, is the successor to the Indian Companies Act of 1913 and is a consolidation of many successive Amendment Acts, statutory rules and principles laid down in decisions of the courts in India and in England. Several Acts were passed from 1850 onwards. The first Act, passed in 1850, was known as the Joint Stock Companies Act. This was followed by two Acts of 1857 and 1860; but the Act of 1866, which followed soon after, repealed all the previous enactments; and this Act itself was repealed in turn by the Act of 1882. This last mentioned Act remained on the statute book up to 1913, though, in the meantime, it was amended several times to meet the demands of the commercial world. The Indian Companies Act of 1913 was passed with the object of consolidating and amending the law relating to trading companies, and was mainly based upon the English Companies Act of 1908, with certain additional provisions to meet the peculiar business conditions obtaining in this country. Since the Indian Act closely followed the English Company Law, the decisions of the English courts under the latter were also generally followed by the courts in India. This Act of 1913, however, did not provide for certain peculiarities of the Indian commercial world, such as the managing agency, and was, therefore, found to be highly unsatisfactory in several respects in the course of its working. Eventually, extensive amendments were introduced in the Act by the Indian Companies (Amendment) Act of 1935, which came into operation on 15th January, 1937. The vast number of amendments introduced by this Act of 1937, however, involved a few omissions; but they were sought to be removed by frequent amendments in the subsequent years.

The Act of l913 was, however, repealed by the Companies Act of 1956 which was brought into force from 1st April 1956. This Act, while adopting the scheme and most of the provisions of the UK Companies Act of 1948, marked a distinct improvement on the Act of 1913 in several respects and sought to ensure an efficient and honest management of companies governed by the Act.

The Companies Act, 1956, was amended several times, including very significantly sometimes. There was, however, a strong general feeling that the Act needed a thorough overhaul and reformulation, taking into account, in particular, the need to strengthen the corporate governance structure, investor protection and streamlining of procedures. Years of efforts in this direction resulted in the Companies Bill, 2012, which was assented by the President of India on 29th August, 2013, resulting in the Companies Bill, 2012, becoming the Companies Act, 2013.

The Companies Act, 1956, was replaced by the Companies Act, 2013, which is more comprehensive and contemporary than the previous Act. It has introduced several new concepts and regulations.

COMPANIES ACT, 2013 — A SYNOPTIC NOTE

[It may please be noted that this chapter gives only a brief description of what is thought to be important facets of the Act. A bird's eye view of the Act can be obtained from the following three sections of this chapter: *Main Provisions of the Act, Miscellaneous* and *Summary*.]

The Companies Act, 2013, which has replaced the 56 years old Companies Act, 1956, substantially differs from the previous Act in many respects. This landmark law is both more concise and comprehensive compared to the 1956 Act.

The Companies Act, 2013 (CA 2013), has substantially modified the company law in India, reflecting, *inter alia,* a response to the changing business environment. It has 470 Sections and 7 Schedules (compared to 658 Sections and 15 Schedules in the 1956 Act). The current Act has delinked the procedural aspects from the substantive law and provides greater flexibility in rule making *vis-à-vis* the changing business environment. Many facets of the Act are to be explained in the rules prescribed by the Central Government. Interestingly, 74 per cent of the Act provides for delegated legislation as a means of operationalising the provisions as opposed to 16 per cent in the 1956 Act.

The CA 2013 seeks to provide more transparency in corporate governance, enjoins more responsibility and accountability on the Directors of the company, make small companies also to comply with accounting disciplines, protect the interests of small investors and depositors, etc.

It has introduced new provisions or brought about significant changes in the provisions in a number of areas of corporate management and governance. It is claimed that the CA 2013 marks a shift to a more business-friendly corporate regulations and that it would improve corporate governance norms; encourage e-governance; enhance accountability, disclosure norms, compliance and enforcement; raise levels of transparency and protect interests of investors, particularly small investors, and creditors. It is claimed that the Act has ushered in a new era of corporate democracy making a "titanic shift from government control to self-governance."

The CA 2013 has introduced new entities/concepts such as one person company, small company, dormant company, class action suits, registered valuers, serious fraud investigation office etc.

With the CA 2013, India became the first country in the world which has made corporate social responsibility mandatory.

APPLICATION OF THE ACT

The Companies Act 2013 applies to the whole of India and to almost all types of companies – it applies not only to companies incorporated under the Companies Act but also to companies incorporated under other Acts, like insurance companies, banking companies, companies engaged in the generation or supply of electricity, except insofar as the provisions of the Companies Act 2013 are inconsistent with the provisions of the respective Act/Acts under which the company was incorporated or has been governed.

Main Provisions of the Act

The main provisions of the Act describe regulations pertaining to the following broad areas.

1. Types of companies and their formation.
2. Public offer and private placement of securities.
3. Issue of different kinds of share capital and debentures.
4. Acceptance of deposits by companies.
5. Management and administration of companies.
6. Declaration and payment of dividend.
7. Accounts of companies.
8. Audit and auditors.
9. Composition of Board of Directors, qualifications and disqualification of Directors, vacation of office by Directors, removal of Directors, duties of Directors etc.
10. Meetings of Board of Directors, powers of Directors and restrictions on powers of directors, Audit Committee etc.
11. Appointment and remuneration of managerial persons.
12. Inspection, inquiry and investigation pertaining to affairs of companies.
13. Compromises, arrangements and amalgamations.

14. Prevention of oppressions and mismanagement.
15. Removal of names of companies from the register of companies.
16. Revival and rehabilitation of sick companies.
17. Winding up of companies.
18. Companies incorporated outside India.

OBJECTIVES OF COMPANIES ACT

The main objective of the Companies Act is to empower the Central Government to regulate the formation of companies in accordance with certain standards and norms and to control the management of companies by laying down a legal and procedural framework to be adhered to by the companies.

The main objective of the Companies Act is to empower the Central Government to regulate the formation of companies by laying down proper norms and compliance requirements and to exercise control over the management of companies to promote healthy development of the corporate sector.

A look at the provisions of the Companies Act indicates that the principal objectives of the Act are to provide:

1. Certain standards and norms and a clear procedure for formation of companies.
2. A comprehensive regulatory framework to provide for honest administration of companies.
3. Norms for adequate, fair and true disclosure of the affairs of companies.
4. Authority to the government to establish various authorities required for the administration of the company law, such as the Registrar of Companies, National Company Law Tribunal and National Company Law Tribunal, Serious Fraud Investigation Office etc.
5. Mechanism for effective investigation into the affairs of any company in respect of which any mismanagement or objectionable practice is suspected.
6. Proper standard of accounting and auditing.
7. Qualifications and norms in respect of appointment of Directors of the Board, powers and responsibilities of the Board, norms regarding Board meetings etc.
8. Protection of interests and rights of shareholders, creditors etc.
9. Prevent insider trading.
10. Regulation of related party transactions.
11. Restrictions on acceptance of deposits by companies.
12. Regulation of compromises, arrangements, amalgamations etc.
13. Prevention of oppression and mismanagement.
14. Norms regarding declaration and payment of dividend.
15. Revival and rehabilitation of sick units.
16. Procedures for winding up of companies.
17. Regulation of issue and transfer of shares and debentures.
18. Enforcement of corporate social responsibility.

CLASSIFICATION OF COMPANIES

Definition of Company

In the words of Lord Justice Lindley, "a company is an association of many persons who contribute money or money's worth to a common stock and employ it in some trade or business, and who share the profit and loss arising therefrom. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute to it or to whom it belongs are members. The proportion of capital to which each member is entitled is his share. The shares are always transferable although the right to transfer is often more or less restricted". According to Chief Justice Marshall, "a corporation is an artificial being, invisible, intangible, existing only in contemplation of the law. Being a mere creation of law, it possesses only the properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence." Hahlo's *Case Book on Company Law* says that "like any juristic person, a company is legally an entity apart from its members, capable of rights and duties of its own, and endowed with the potential of perpetual succession."

According to the CA 2013, "a company means a company incorporated under this Act or under any previous company law". The Act says that a company formed under the Act may be either a company limited by shares; or a company limited by guarantee; or an unlimited company.

The CA 2013 deals with the following classes of companies.

- Companies limited by shares (subdivided into public, deemed public and private companies)
- Companies limited by guarantee (either with or without share capital)
- Companies with unlimited liability (either with or without share capital)

The Companies Act 2013 also refers to certain special types of companies such as:

- One person company
- Small company
- Dormant company
- Holding and subsidiary companies
- Associate company
- Government company
- Foreign company

According to the Companies Act, there are basically three classes of companies, viz., limited companies, unlimited companies and guarantee companies.

Unlimited Company

A company not having any limit on the liability of its members is termed as unlimited company. The members of an unlimited company are liable, like the partners of a firm, for all its trade debts without any limit.

An unlimited company must have Articles of Association, stating the number of members with which the company is to be registered. An unlimited company may or may not have share capital. As on March 31, 2015, there were 395 unlimited companies.

The High-powered Expert Committee on Companies and MRTP Act, popularly known as the Sachar Committee, observed that "although the present Act provides for the formation of unlimited companies, the latter have hardly had any useful career in the growth and development of the corporate sector. We feel that the concept of a company with unlimited liability of its members does not conform to the corporate concept which necessarily postulates a limited liability. We, therefore, suggest that this type of companies should be abolished from the statue book....It is also suggested that the existing unlimited companies should be compulsorily required to convert themselves into limited companies." However, even after the significant Amendment Act of 2000 and the replacement of the Companies Act 1956 by the Companies Act 2013, unlimited company continues to have its place in the Indian law.

As on 31st March, 2015, there were 395 companies in India with unlimited liabilities.

Guarantee Company

The liability of the members of a guarantee company is limited by a fixed sum which is specified in the memorandum and beyond which they cannot be called upon to contribute.

The memorandum of a company limited by guarantee shall state the amount up to which each member undertakes to contribute to the assets of the company, in the event of its being wound up, for the payment of the debts and liabilities of a company.

The Sachar Committee observed that "although guarantee companies constitute a very negligible fraction of less than three per cent of the total companies at work in India, they still do have a useful role to play as companies for furthering the objects of commerce, art, science, religion, charity or some other useful objects and usually such a company does not apply its profits or rather income except for these desirable objectives. It is, however, inherent in the very nature of these objectives that such companies be formed as public limited companies, limited by guarantee only and for the purpose enumerated in the present Section 25 of the Act." (Section 25 of the Companies Act 1956 referred to charitable/social purposes)

As on 31st March, 2015, the number of companies limited by guarantees was 6015.

Limited Company

In case of a limited company, the liability of its members is restricted to the amount of share capital subscribed by them or standing in their names, if at any time the company is wound up and the value of its assets is insufficient to meet its liabilities.

There are two important kinds of limited companies, *viz.,*

- Private limited company
- Public limited company.

Private Company

Important features of a private company according to the Companies Act 2013 are the following.

1. The Companies (Amendment) Act 2015 deleted the stipulation of a minimum paid-up capital of one lakh rupees for a private company.
2. The number of members is not more than two hundred (excluding employees and former employees who continue to be members after the employment ceased). Before the coming into effect of the Companies Act, 2013, the maximum permissible number of members of a private company was fifty. Further, earlier there had to be a minimum

of two members for a private company. However, the 2013 Act introduced a special category of private company, *viz., one person company*.

3. Its articles restricts the right to transfer its shares.
4. It is prohibited by its articles any invitation to the public to subscribe for any securities of the company;
5. The name of a private limited company shall end with the words "private limited".

At the end of March 2015, there were a total of 952,490 private limited companies in India. 363 of them were government companies.

Private companies include both private sector companies and public sector companies. Similarly, public companies include both private sector and public sector companies. About 98 per cent of the public limited companies in India are non-government companies.

Public Company

According to the CA 2013, a public company means a company:

1. Which is not a private company
2. Companies Amendment Act deleted the stipulation of a minimum paid-up capital of five lakh rupees capital, for a public company.
3. Which has a minimum of seven members (no upper limit).
4. A private company which is a subsidiary of a company which is not a private company shall be deemed to be public company even where such subsidiary company continues to be a private company in its articles.
5. The name of a public limited company shall end with the word "limited".

As on 31st March 2015, there were 63,111 public limited companies in India. 1,054 (less than two per cent of the total) were government companies and the rest non-government companies.

TABLE 19.1 : PRIVATE COMPANY AND PUBLIC COMPANY: A COMPARISON

Requirements/Conditions	Private Company	Public Company
Minimum members	Two (One for OPC)	Seven
Maximum members	200	No limit
Minimum paid-up capital	Not compulsory	Not compulsory
Minimum directors	Two (One for OPC)	Three
Maximum directors	15 (May be increased by Special Resolution)	15 (May be increased by Special Resolution)
Public issue of shares	Not permitted	Permitted
Right to transfer of shares	Restricted by Articles of Association	Permitted
Acceptance of public deposits	Not permitted	Not permitted since Companies Act, 2013

Government Company

According to the CA 2013, Government company means any company in which not less than fifty-one per cent of the paid-up share capital is held by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.

Though the number of Government companies is comparatively small when compared to the number of non-Government companies, they account for a large share of the paid-up capital of all the companies operating in India.

At the end of March 2013, there were 1,381 Government companies in India. 342 of them were private limited companies.

Holding and Subsidiary Companies

According to the Companies Act, "holding company", in relation to one or more other companies, means a company of which such companies are subsidiary companies.

In very simple terms, a company which has control (either managerial or ownership) over another is known as a holding company, and the company so controlled is regarded as a subsidiary company.

A company shall be deemed to be a holding company of another if, but only if, the other is its subsidiary.

A company shall be deemed to be a subsidiary company in any one or more of the following cases:

(*i*) Where one company controls the composition of the Board of Directors of another, the latter becomes a subsidiary of the former.

(*ii*) Where one company holds a majority of the shares in another company, the latter becomes a subsidiary of the former.

(*iii*) Where one company is a subsidiary of another, which is itself a subsidiary of some other company, the first-mentioned company shall also become the subsidiary of the last-mentioned company.

Foreign Company

According to the CA 2013, foreign company means any company or body corporate incorporated outside India which:

(*a*) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and

(*b*) conducts any business activity in India in any other manner.

Chapter XXII of the CA 2013, applies to companies incorporated outside India. If not less than 50 per cent of the paid-up share capital, whether preference or equity, is in Indian hands (individuals or body corporates), the provisions of this Chapter and such other provisions of this Act as may be prescribed shall apply to these companies with regard to the business carried on by it in India as if it were a company incorporated in India.

As on 31-12-2014, there were 4,170 foreign companies in India.

One Person Company

One Person Company (OPC) means a company which has only one person as a member.

The memorandum of One Person Company shall indicate the name of the other person, who shall, in the event of the subscriber's death or his incapacity to contract become the member of the company. 2,238 OPCs were registered until March 2015.

For this, the written consent of this person shall also be filed with the Registrar at the time of incorporation of the One Person Company along with its memorandum and articles. However, this person can withdraw his consent, if he so desires, in such manner as prescribed in the Act. Similarly, member of One Person Company may at any time change the name of such other person by giving notice.

OPC is required to specifically mention the word "one person company" below the name wherever it is used.

The Companies Act provides certain flexibilities to OPC. Some of the relaxations provided to OPC are as under:

- OPC should have minimum one director.
- Where an OPC has only 1 director, the date on which the resolution is signed and dated by such director is considered as the date of the board meeting.
- Provisions of board meeting, quorum and interested director shall not apply to OPC.
- OPC need not hold an AGM.
- Provisions relating to notice, explanatory statement, EGM, quorum, voting, chairman, poll, proxies and postal ballot.
- National Company Law Tribunal's power of calling for EGM does not apply to OPC.
- Financial Statements can be signed by only one director.
- Financial Statements are to be filed with ROC within 180 days from the end of FY.
- OPC can contract with the sole member who is a director.

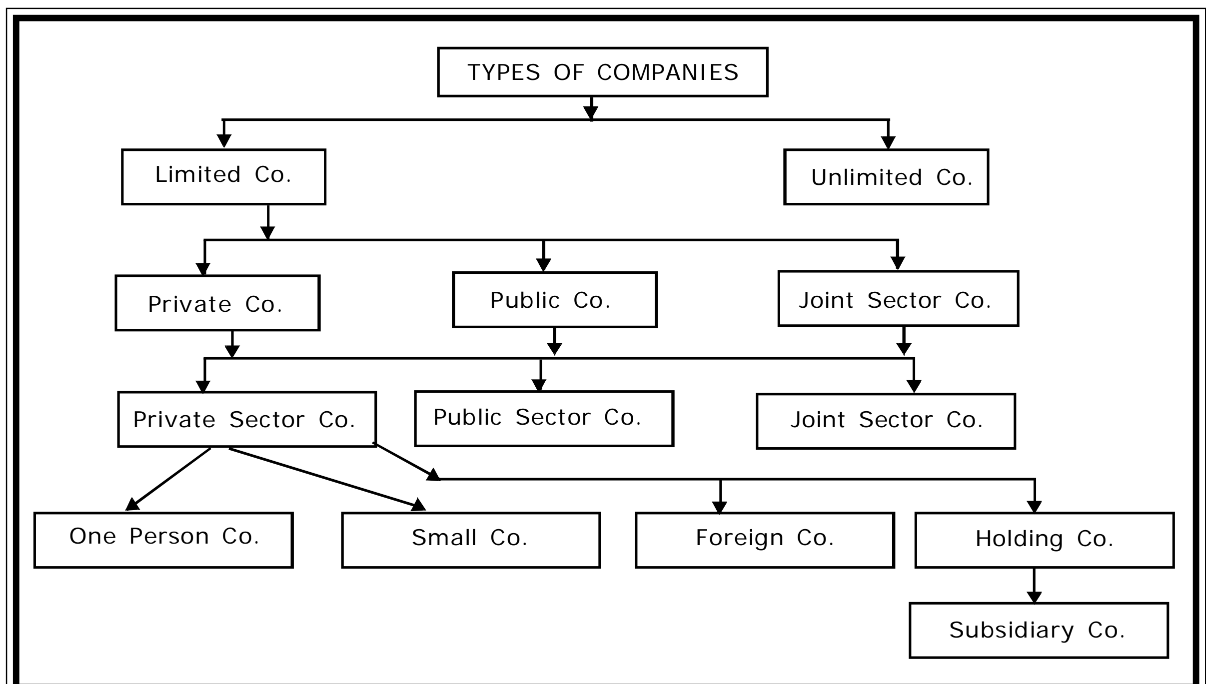

Fig. 19.1: **Classification of Companies**

Small Company

A small company means a company, other than a public company:

(*i*) paid-up share capital of which does not exceed fifty lakh rupees or such higher amount as may be prescribed which shall not be more than five crore rupees; or

(*ii*) turnover of which as per its last profit and loss account does not exceed two crore rupees or such higher amount as may be prescribed which shall not be more than twenty crore rupees.

Small Company cannot be a holding or a subsidiary company.

The Companies Act provides exemptions to Small Companies from certain requirements relating to board meeting, presentation of cash flow statement and certain merger process.

One person company, small company and dormant company are new terms introduced by the Companies Act, 2013.

Dormant Company

According to the CA 2013, the following types of companies may make an application to the Registrar of Companies in prescribed manner for obtaining the status of a dormant company:

A company formed and registered for a future projector to hold an asset or intellectual property and has no significant accounting transaction.

An inactive company (*i.e.,* a company which has not been carrying on any business or operation, or has not made any significant accounting transaction, or has not filed financial statements and annual returns during the last two financial years.)

In case of a company which has not filed financial statements or annual returns for two financial years consecutively, the Registrar shall issue a notice to that company and enter the name of such company in the register maintained for dormant companies.

A dormant company shall have such minimum number of directors, file such documents and pay such annual fee as may be prescribed to the Registrar to retain its dormant status in the register and may become an active company on an application made in this behalf accompanied by such documents and fee as may be prescribed.

The Registrar shall strike off the name of a dormant company from the register of dormant companies, which has failed to comply with the requirements of this section.

Associate Company

According to the CA 2013, associate company, in relation to another company, means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company. "Significant influence" means control of at least twenty per cent of total share capital, or of business decisions under an agreement.

INCORPORATION OF COMPANY

According to the Companies Act, 2013, a company may be formed for any lawful purpose by the number of persons specified below by subscribing their names/name to a memorandum and complying with the requirements of this Act in respect of registration:

(*a*) seven or more persons, where the company to be formed is to be a public company;

(*b*) two or more persons, where the company to be formed is to be a private company; or

(*c*) one person, where the company to be formed is to be One Person Company (that is to say, a private company),

For incorporation of a company, the promoters of the proposed company shall file with the Registrar of Companies certain specified documents containing the details sought to be provided in the documents. The two most important documents are the Memorandum of Association and the Articles of Association.

Memorandum of Association

The Memorandum of Association is regarded as the *fundamental* document of the company because it contains "the fundamental conditions upon which alone the company is allowed to be incorporated." It is the charter of the company, defining the object of its formation and its operations, and its purpose is to inform its stakeholders its permitted range of enterprise. It is *ultravires* for a company to act beyond the scope of its memorandum, and any departure is invalid and cannot be validated even if assented to by all the members of the company. This indicates that the memorandum should be drawn up with utmost seriousness and care.

The promoters of the company shall subscribe their names to the Memorandum. If a private company is to be formed, at least two persons (one person in respect of a One Person Company) shall, and if a public company is to be formed at least seven persons shall subscribe to the memorandum.

The memorandum of a company shall be in respective forms specified in the Companies Act, 2013. The important information that shall be incorporated in the memorandum includes the following:

(*a*) the name of the company with the last word "Limited" in the case of a public limited company, or the last words "Private Limited" in the case of a private limited company;

(*b*) the State in which the registered office of the company is to be situated;

(*c*) the objects for which the company is proposed to be incorporated and any matter considered necessary in furtherance thereof;

(*d*) the liability of members of the company, whether limited or unlimited.

Memorandum of Association and the Articles of Association are very important documents to be produced for registration of a company.

In the case of a company having a share capital, the memorandum shall provide the following additional information:

(*i*) the amount of share capital with which the company is to be registered and the division thereof into shares of a fixed amount and the number of shares which the subscribers to the memorandum agree to subscribe which shall not be less than one share; and

(*ii*) the number of shares each subscriber to the memorandum intends to take, indicated opposite his name.

The Memorandum of a company limited by guarantee shall state, the amount up to which each member undertakes to contribute to the assets of the company in the event of its being wound up and to the costs, charges and expenses of winding up etc.

The memorandum of One Person Company shall indicate the name of the other person, who shall, in the event of the subscriber's death or his incapacity to contract become the member of the company. (See the subsection *One Person Company* under *Types of Companies* given in an earlier part of this chapter for more information).

The two most important documents are the Memorandum of Association and the Articles of Association.

Conditions regarding the name of the company The name stated in the memorandum shall not be identical with or resemble too nearly to the name of an existing registered company. Further, the use of this name by the company shall not constitute an offence under any law for the time being in force or is undesirable in the opinion of the Central Government.

The Act also makes it clear that a company shall not be registered with a name which contains: (*a*) any word or expression which is likely to give the impression that the company is in any way connected with, or having the patronage of, the Central Government, any State Government, or any local authority, corporation or body constituted by the Central Government or any State Government under any law for the time being in force; or (*b*) such word or expression, as may be prescribed, unless the previous approval of the Central Government has been obtained for the use of any such word or expression.

Articles of Association

The Articles of Association are the rules, regulations and bye-laws for the *internal* management of the affairs of a company. They are framed with the object of carrying out the aims and objects as set out in the Memorandum of Association.

The Articles usually contain provisions relating to such matters as share capital; rights of shareholders and variation of these rights; lien on shares; calls on shares; transfer of shares; conversion of shares into stock; alteration of capital; general meetings and proceedings thereat; voting rights of members, voting and poll, proxies; directors, their appointments, remuneration, qualifications, powers and proceedings; Board of Directors; and so on.

The provisions of the Articles must be in conformity with the Memorandum and the provisions of the Companies Act. The Articles shall be in respective forms specified in the Companies Act, as may be applicable to such company. A company may adopt all or any of the regulations contained in the model articles applicable to such company. In case of any company, which is registered after the commencement of this Act, insofar as the registered articles of such company do not exclude or modify the regulations contained in the model articles applicable to such company, those regulations shall, so far as applicable, be the regulations of that company in the same manner and to the extent as if they were contained in the duly registered articles of the company.

The Articles of a company shall contain the regulations for management of the company. The articles shall also contain such matters, as may be prescribed by law/regulation. However, a company is free to include such additional matters in its articles as may be considered necessary for its management.

The CA 2013 permits companies to incorporate in the articles provisions for entrenchment as specified in the Act. The articles may be altered only if conditions or procedures as that are more restrictive than those applicable in the case of a special resolution, are met or complied with.

Registration

For the incorporation of the company, there shall be filed with the Registrar within whose jurisdiction the registered office of a company is proposed to be situated, the memorandum and articles with other documents specified in the Act, and fulfilling all the requirement mentioned in the Act. The Registrar on the basis of the documents and information filed shall register all the documents and information and issue a certificate of incorporation in the prescribed form to the effect that the proposed company is incorporated under this Act.

On and from the date mentioned in the certificate of incorporation, the Registrar shall allot to the company a corporate identity number, which shall be a distinct identity for the company and which shall also be included in the certificate. The company shall maintain and preserve at its registered office copies of all documents and information as originally filed.

PROSPECTUS AND ALLOTMENT OF SECURITIES

Issue of Securities by Public Companies

A public company may issue securities, as per the provisions of the Companies Act 2013:

(*a*) to public through prospectus,

(*b*) through private placement, or

(*c*) through a rights issue or a bonus issue.

Only public companies can issue securities to the public. Both public and private companies can raise capital by rights or bonus issues and through private placement.

Issue of Securities by Private Companies

A private company may issue securities, as per the provisions of the Companies Act:

(*a*) by way of rights issue or bonus issue,

(*b*) through private placement.

Public offer includes initial public offer or further public offer of securities to the public by a company through issue of a prospectus, or an offer for sale of securities to the public by an existing shareholder, through issue of a prospectus.

Prospectus

According to the Companies Act, prospectus means any document described or issued as a prospectus and includes a red herring prospectus or shelf prospectus or any notice, circular, advertisement or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate.

Red herring prospectus means a prospectus which does not include complete particulars of the quantum or price of the securities included therein. A company proposing to make an offer of securities may issue a red herring prospectus prior to the issue of a prospectus.

Shelf prospectus means a prospectus in respect of which the securities or class of securities included therein are issued for subscription in one or more issues over a certain period without the issue of a further prospectus.

Matters to be stated in prospectus Prospectus of a public company shall state the following information:

(*i*) details about the company (names and addresses of the registered office of the company, company secretary, Chief Financial Officer, auditors, legal advisers, bankers, trustees, if any, underwriters and such other persons as may be prescribed);

(*ii*) dates of the opening and closing of the issue, and declaration about the issue of allotment letters and refunds within the prescribed time;

(*iii*) a statement by the Board of Directors about the separate bank account where all monies received out of the issue are to be transferred and disclosure of details of all monies including utilised and unutilised monies out of the previous issue in the prescribed manner;

(*iv*) details about underwriting of the issue;

(*v*) consent of the directors, auditors, bankers to the issue, expert's opinion, if any, and of such other persons, as may be prescribed;

(*vi*) the authority for the issue and the details of the resolution passed therefor;

(*vii*) procedure and time schedule for allotment and issue of securities;

(*viii*) capital structure of the company in the prescribed manner;

(*ix*) main objects of public offer, terms of the present issue and such other particulars as may be prescribed;

(*x*) main objects and present business of the company and its location, schedule of implementation of the project;

(*xi*) particulars relating to management perception of risk factors specific to the project; gestation period of the project; extent of progress made in the project; deadlines for completion of the project; and any litigation or legal action pending or taken by a Government Department or a statutory body during the last five years immediately preceding the year of the issue of prospectus against the promoter of the company;

(*xii*) minimum subscription, amount payable by way of premium, issue of shares otherwise than on cash;

(*xiii*) details of directors including their appointments and remuneration, and such particulars of the nature and extent of their interests in the company as may be prescribed; and

(*xiv*) disclosures in such manner as may be prescribed about sources of promoter's contribution.

The Prospectus shall provide specified particulars about the company and public issue.

Reports to be provided with prospectus The prospectus shall also set out the following reports for the purposes of the financial information:

(*i*) reports by the auditors of the company with respect to its profits and losses and assets and liabilities and such other matters as may be prescribed;

(*ii*) reports relating to profits and losses for each of the five financial years immediately preceding the financial year of the issue of prospectus including such reports of its subsidiaries and in such manner as may be prescribed;

(*iii*) reports made in the prescribed manner by the auditors upon the profits and losses of the business of the company for each of the five financial years immediately preceding issue and assets and liabilities of its business on the last date to which the accounts of the business were made up, being a date not more than one hundred and eighty days before the issue of the prospectus;

(*iv*) reports about the business or transaction to which the proceeds of the securities are to be applied directly or indirectly;

Public Offer of Securities to be in Dematerialised Form

According to the CA 2013, every company making public offer; and such other class or classes of public companies as may be prescribed, shall issue the securities only in dematerialised form. Any company, other than those mentioned above, may convert its securities into dematerialised form or issue its securities in physical form in accordance with the provisions of this Act or in dematerialised form.

Every company making public offer shall do the needful for the securities to be dealt with in one or more recognised stock exchanges.

Allotment of Securities

The Companies Act stipulate certain conditions regarding allotment of securities by companies:

(*a*) the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on application have been received by the company;

(*b*) the amount payable on application on every security shall not be less than five per cent of the nominal amount of the security or such other percentage or amount, as may be specified by the Securities and Exchange Board by making regulations in this behalf;

(*c*) if the stated minimum amount has not been subscribed and the sum payable on application is not received within a period of thirty days from the date of issue of the prospectus, or such other period as may be specified by the Securities and Exchange Board (SEBI), the amount received shall be returned within such time and manner as may be prescribed.

Listing of Securities in Stock Exchanges

The Companies Act lays down every company making public offer shall, before making such offer, make an application to one or more recognised stock exchange or exchanges and obtain permission for the securities to be dealt with in such stock exchange or exchanges. The prospectus shall also state the name or names of the stock exchange in which the securities shall be dealt with.

Further, whenever a company makes any allotment of securities, it shall file with the Registrar of Companies a return of allotment in such manner as may be prescribed.

Private Placement of Securities

Private placement means any offer of securities or invitation to subscribe securities to a select group of persons by a company (other than by way of public offer) through issue of a private placement offer letter.

The offer of securities or invitation to subscribe securities, shall be made to such number of persons not exceeding fifty or such higher number as may be prescribed, [excluding qualified institutional buyers and employees of the company] being offered securities under a scheme of employees stock option as per provisions of the Companies Act, in a financial year and on such conditions (including the form and manner of private placement) as may be prescribed.

SHARE CAPITAL AND DEBENTURES

Kinds of Share Capital

According to CA 2013, the share capital of a company limited by shares shall be of two kinds, namely:

(*a*) equity share capital:

(*i*) with voting rights; or

(*ii*) with differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed;

(*b*) preference share capital.

Equity share capital means all share capital which is not preference share capital.

Preference share capital means that part of the issued share capital of the company which carries or would carry a preferential right with respect to:

(*a*) payment of dividend, either as a fixed amount or an amount calculated at a fixed rate; and

(*b*) repayment, in the case of a winding up or repayment of capital, of the amount of the share capital paid up or deemed to have been paid up.

The Companies Act prohibits issue of preference shares which are irredeemable. Preference shares are normally liable to be redeemed within a twenty years. However, a company may issue preference shares for more than twenty years for infrastructure projects subject to the provisions of the Companies Act.

A company may raise capital by issue of shares (equity or preference) and debentures.

Voting Rights

Every equity shareholder shall have a right to vote on every resolution placed before the company. The voting right shall be in proportion to his share in the paid-up equity share capital of the company.

A preference shareholder shall, have a right to vote only on resolutions placed before the company which directly affect the rights attached to his preference shares and, any resolution for the winding up of the company or for the repayment or reduction of its equity or preference share capital. The voting right shall be in proportion to the share in the paid-up preference share capital of the company.

However, if the dividend in respect of a class of preference shares has not been paid for a period of two years or more, such class of preference shareholders shall have a right to vote on all the resolutions placed before the company.

Issue of Sweat Equity Shares

The Companies Act permits the issue of sweat equity shares to directors or employees subject to the conditions specified in the Act. Sweat equity shares is an exception to the prohibition on issue of shares at discount.

Issue of Bonus Shares

A company may issue fully paid-up bonus shares to its members, subject to conditions laid down in the Companies Act, out of:

(*i*) its free reserves;

(*ii*) the securities premium account; or

(*iii*) the capital redemption reserve account:

No issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

Alteration of Share Capital

A limited company having a share capital may, if so authorised by its articles, alter its memorandum in its general meeting to:

(*a*) increase its authorised share capital by such amount as it thinks expedient;

(*b*) consolidate and divide all or any of its share capital into shares of a larger amount than its existing shares:

(*c*) convert all or any of its fully paid-up shares into stock, and reconvert that stock into fully paid-up shares of any denomination;

(*d*) subdivide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum, so, however, that in the subdivision the proportion between the amount paid and the amount, if any, unpaid on each reduced share shall be the same as it was in the case of the share from which the reduced share is derived;

(*e*) cancel shares which have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled. Such cancellation of shares shall not be deemed to be a reduction of share capital.

Buyback of Shares

Subject to the provisions of the Companies Act, a company may purchase its own shares or other specified securities out of:

(*a*) its free reserves;

(*b*) the securities premium account; or

(*c*) the proceeds of the issue of any shares or other specified securities.

No buyback shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

Issue of Debentures

Debenture is debt instrument issued by companies to raise capital. Following are some of the important provisions of the Companies Act pertaining to issue of debentures.

1. A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption.
2. Companies are prohibited to issue any debentures carrying any voting rights.
3. Secured debentures may be issued by a company subject to such terms and conditions as may be prescribed.
4. A company issuing debentures shall create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account shall not be utilised by the company except for the redemption of debentures.

MANAGEMENT AND ADMINISTRATION

Some of the important provisions of the Companies Act, regarding Management and Administration of companies are given below.

The Companies Act specifies the records to be maintained by companies, particulars to be provided in annual returns and norms for holding general meetings.

Register of Members

Every company shall keep and maintain the following registers as specified in the ACT:

(*a*) Separate registers of members holding each class of equity and preference shares.

(*b*) register of debenture-holders; and

(*c*) register of any other security holders.

Annual Returns

Every company shall prepare an annual return in the prescribed form containing the particulars as on the close of the financial year. The particulars to be furnished are:

(*a*) its registered office, principal business activities, particulars of its holding, subsidiary and associate companies;

(*b*) its shares, debentures and other securities and shareholding pattern;

(*c*) its indebtedness;

(*d*) its members and debenture-holders along with changes therein since the close of the previous financial year;

(*e*) its promoters, directors, key managerial personnel along with changes therein since the close of the previous financial year;

(*f*) meetings of members or a class thereof, Board and its various committees along with attendance details;

(*g*) remuneration of directors and key managerial personnel;

(*h*) penalty or punishment imposed on the company, its directors or officers and details of compounding of offences and appeals made against such penalty or punishment;

(*i*) matters relating to certification of compliances, disclosures as may be prescribed;

(*j*) details, as may be prescribed, in respect of shares held by or on behalf of the Foreign Institutional Investors indicating their names, addresses, countries of incorporation, registration and percentage of shareholding held by them; and

(*k*) such other matters as may be prescribed.

It is also required that every listed company shall file a return in the prescribed form with the Registrar of Companies with respect to change in the number of shares held by promoters and top ten shareholders of such company, within fifteen days of such change.

Annual General Meeting

Every company, other than a One Person Company, shall hold its annual general meeting every year. Not more than fifteen months shall elapse between the date of one annual general meeting and that of the next. In case of the first annual general meeting, it shall be held within a period of nine months from the date of closing of the first financial year of the company and in other cases, within a period of six months from the date of closing of the financial year.

For a company which has held its first annual general meeting as aforesaid, it is not necessary to hold any annual general meeting in the year of its incorporation.

The annual general meeting shall be called during business hours (between 9 a.m. and 6 p.m.) on any day that is not a National Holiday and shall be held either at the registered office

of the company or at some other place within the city, town or village in which the registered office of the company is situated.

If any default is made in holding the annual general meeting of a company, as specified in the Companies Act, the Tribunal is empowered by the Act to call, or direct the calling of, an annual general meeting of the company.

Extraordinary General Meeting

The Board may, whenever it deems fit, call an extraordinary general meeting of the company.

The Companies Act also lays down that the Board shall call an extraordinary general meeting at the requisition made by certain minimum specified members of the company subject to the conditions laid down in the Act. The important conditions are that: In the case of a company having a share capital, the requisition is made by not less than one-tenth of such of the paid-up share capital of the company. In the case of a company not having a share capital, the requisition is made by such number of members who have not less than one-tenth of the total voting power of all the members.

The requisition shall set out the matters for the consideration of which the meeting is to be called and shall be signed by the requisitionists and sent to the registered office of the company.

If the Board does not take adequate measures to hold the meeting so requisitioned within forty-five days from the date of receipt of such requisition, the meeting may be called and held by the requisitionists themselves within a period of three months from the date of the requisition, subject to the provisions of the Act.

The Act specifies how the notice of the general meeting shall be given and the items of information to be annexed to the notice.

Quorum for General Meetings

The Companies Act lays down that the quorum for a general meeting, shall be as follows (unless the articles of the company provide for a larger number):

(*a*) in case of a public company: (*i*) five members personally present if the number of members of the company as on the date of meeting is not more than one thousand; (*ii*) fifteen members personally present if the number of members as on the date of meeting is more than one thousand but up to five thousand; (*iii*) thirty members personally present if the number of members as on the date of the meeting exceeds five thousand;

(*b*) in the case of a private company, two members personally present shall be the quorum for a meeting of the company.

If the quorum is not present within half-an-hour from the time appointed for holding a meeting of the company:

(*a*) the meeting shall stand adjourned to the same day in the next week at the same time and place, or to such other date and such other time and place as the Board may determine. If at the adjourned meeting also, a quorum is not present within half-an-hour from the time appointed for holding meeting, the members present shall be the quorum.

In the case of the meeting called by requisitionists, it shall stand cancelled if there is no quorum.

A shareholder may vote in person attending the annual general meeting, by proxy, postal ballot or by electronic means.

Proxy

Any member of a company entitled to attend and vote at a meeting of the company shall be entitled to appoint another person as a proxy to attend and vote at the meeting on his behalf. However, the proxy shall not have the right to speak at such meeting and shall not be entitled to vote except on a poll, subject to the conditions prescribed by the Central Government.

Vote by Electronic Means

The Central Government may prescribe the class or classes of companies and manner in which a member may exercise his right to vote by the electronic means.

Postal Ballot

The Act also lays down the norms regarding postal ballot.

Report on AGM

Every listed public company shall prepare in the prescribed manner a report on each annual general meeting including the confirmation to the effect that the meeting was convened, held and conducted as per the provisions of this Act and the rules made thereunder.

The company shall file with the Registrar of Companies a copy of this report within thirty days of the conclusion of the annual general meeting as prescribed in the Act.

DECLARATION AND PAYMENT OF DIVIDEND

A company may declare and pay dividends out of its profits for the year, previous years or free reserves.

According to the CA 2013, a company shall declare dividends only out of:

(a) (1) the profits of the company for that year after providing for depreciation as specified in the Act, (2) or out of the profits of the company for any previous financial year or years after providing for depreciation.

(*b*) the money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.

(c) free reserves, when profits are inadequacy or in any financial year for payment of dividends.

A company may, before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company.

The Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year, subject to certain conditions.

The amount of the dividend, including interim dividend, shall be deposited in a scheduled bank in a separate account within five days from the date of declaration of such dividend.

The Companies Act permits the capitalisation of profits or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company.

The dividend declared shall be paid or the warrant in respect thereof shall be posted within thirty days from the date of declaration to all shareholders entitled to the payment of the dividend.

According to Companies (Amendment) Act 2015, no company shall declare dividend unless carried over past losses and depreciation in previous year or years are set off against profit for the current year.

Failure to comply with the provisions of the Act pertaining to payment of dividend is punishable.

BOARD OF DIRECTORS

Every company, including one person company, shall have a Board of Directors. At least one-third of the Directors of a listed public company shall be Independent Directors and specified class of companies shall have at least one Woman Director.

A company being an artificial person, its activities have to be carried out by persons authorised for that purpose. It may be said that the ultimate power rests with the shareholders. However, the responsibility for formulation of strategies for the development of the company and their implementation primarily rests with the Board of Directors, most the Directors being normally elected by the shareholder. The executive authority is usually exercised by the Board of Directors through the various levels of executives appointed by the Board.

According to the Companies Act, every company shall have a Board of Directors consisting of individuals as directors. Some important provisions of the Act related to the Board are as follows.

Number of Directors

The number of directors of different categories of companies according to the Companies Act 2013 are as follows:

One Person Company: Minimum one director.

Private Company: A minimum of two and a maximum of fifteen directors.

Public company: A minimum of three and a maximum of fifteen directors.

A private/public company may appoint more than fifteen directors after passing a special resolution.

Woman Director

The CA 2013, for the first time, made it mandatory that certain specified class or classes of companies shall have at least one woman director. Accordingly, every Listed Company/Public Company with paid-up capital of ₹ 100 crore or more/Public Company with turnover of ₹ 300 crore or more shall have at least one Woman Director.

Independent Directors

According to the CA 2013, at least one-third of the total number of directors of a listed public company shall be independent directors (ID) and the Central Government may prescribe the minimum number of independent directors in case of any class or classes of public companies.

An independent director means a director other than a managing director or a whole-time director or a nominee director. Some of the important qualification pertaining to the independent Director are the following: An ID shall be a person: (1) of integrity, possessing relevant expertise and experience; (2) who has not ever been associated with the company or its holding, subsidiary or associate company as a promoter; (3) who is not related to promoters or directors in the company, its holding, subsidiary or associate company; (4) who had or has no pecuniary relationship

with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year.

Resident Director

The Companies Act 2013 lays down that every company shall have at least one director who has stayed in India for a total period of not less than one hundred and eighty-two days in the previous calendar year.

Director Elected by Small Shareholders

A listed company may have one director elected by small shareholders in such manner and with such terms and conditions as prescribed. In this context, "small shareholder" means a shareholder holding shares of nominal value of not more than twenty thousand rupees or such other sum as may be prescribed.

Additional, Alternate and Nominee Directors

The articles of a company may confer on its Board of Directors the power to appoint any person, other than a person who fails to get appointed as a director in a general meeting, as an additional director at any time who shall hold office up to the date of the next annual general meeting or the last date on which the annual general meeting should have been held, whichever is earlier.

The Board of a company shall meet at least four times a year and the interval between two meetings shall not be more than four months.

Meetings of Board

Number of meetings A new company shall hold the first meeting of the Board of Directors within thirty days of the date of its incorporation.

A company is required to hold a minimum of four meetings of its Board of Directors every year. Not more than one hundred and twenty days shall intervene between two consecutive meetings of the Board.

There is relaxation in the number of meetings in respect of One Person Company, Small Company and Dormant Company. The stipulation in their case is that at least one meeting of the Board of Directors is held in each half of a calendar year and the gap between the two meetings is not less than ninety days.

The conditions regarding the Board meetings is not applicable to One Person Company in which there is only one director on its Board.

Participation of directors in meetings The participation of directors in a meeting of the Board may be either in person or through video conferencing or other audio-visual means, as may be prescribed, which are capable of recording and recognising the participation of the directors and of recording and storing the proceedings of such meetings along with date and time. However, the Central Government may, by notification, specify such matters which shall not be dealt with in a meeting through video conferencing or other audio-visual means.

Notice of meeting A meeting of the Board shall be called by giving not less than seven days' notice in writing to every director at his address registered with the company and such notice shall be sent by hand delivery or by post or by electronic means. However, a meeting of the Board may be called at shorter notice to transact urgent business subject to the condition that at least one independent director, if any, shall be present at the meeting. In case of absence of independent directors from such a meeting of the Board, decisions taken at such a meeting shall be circulated to all the directors and shall be final only on ratification thereof by at least one independent director, if any.

Quorum for meeting The quorum for a meeting of the Board of Directors of a company shall be one-third of its total strength or two directors, whichever is higher. The participation of the directors by video conferencing or by other audio-visual means shall also be counted for the purposes of quorum.

Where a meeting of the Board could not be held for want of quorum, then, unless the articles of the company otherwise provide, the meeting shall automatically stand adjourned to the same day at the same time and place in the next week or if that day is a national holiday, till the next succeeding day, which is not a national holiday, at the same time and place.

Number of Directorship

According to the Companies Act 2013, the maximum number of companies a person can hold office as a director, including any alternate directorship, at the same time is twenty. It is also laid down that the maximum number of public companies in which a person can be appointed as a director shall not exceed ten. For reckoning the limit of public companies in which a person can be appointed as director, directorship in private companies that are either holding or subsidiary company of a public company shall be included.

However, the members of a company may, by special resolution, specify any lesser number of companies in which a director of the company may act as directors.

The Board can exercise all powers and do all acts and things as the company is authorised to do except those powers which can be exercised by the company only in general meeting.

Powers of Board

The powers of the Board of Directors of a company are derived from the relevant provisions of the Companies Act, the Memorandum or Articles of Association of the company or any valid regulations, including regulations made by the company in general meeting.

Powers to be exercised in general meeting Powers which are specified to be exercised or done by the company in general meeting shall be exercised only so. However, no regulation made by the company in general meeting shall invalidate any prior act of the Board which would have been valid if that regulation had not been made.

Powers to be exercised by resolutions passed at meetings of the Board The Board of Directors of a company shall exercise the following powers by means of resolutions passed at meetings of the Board, namely:

(*a*) to make calls on shareholders in respect of money unpaid on their shares;

(*b*) to authorise buyback of securities under section 68;

(*c*) to issue securities, including debentures, whether in or outside India;

(*d*) to borrow monies;

(*e*) to invest the funds of the company;

(*f*) to grant loans or give guarantee or provide security in respect of loans;

(*g*) to approve financial statement and the Board's report;

(*h*) to diversify the business of the company;

(*i*) to approve amalgamation, merger or reconstruction;

(*j*) to take over a company or acquire a controlling or substantial stake in another company;

(*k*) any other matter which may be prescribed.

The Board may delegate any of the powers mentioned above to any committee of directors, the managing director, the manager or any other principal officer of the company or the principal officer of the branch office.

Duties of Directors

1. Subject to the provisions of the CA 2013, a director of a company shall act in accordance with the articles of the company.
2. A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment.
3. A director of a company shall exercise his duties with due and reasonable care, skill and diligence and shall exercise independent judgement.
4. A director of a company shall not involve in a situation in which he may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company.
5. A director of a company shall not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates and if such director is found guilty of making any undue gain, he shall be liable to pay an amount equal to that gain to the company.
6. A director of a company shall not assign his office and any assignment so made shall be void.

If a director of the company contravenes the provisions of the Act pertaining to the duties of directors, such director shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

Vacation of Office of Director

The office of a director shall become vacant in case:

(*a*) he incurs any of the disqualifications specified in the Act;

(*b*) he absents himself from all the meetings of the Board of Directors held during a period of twelve months with or without seeking leave of absence of the Board;

(*c*) he acts in contravention of the provisions of the Act relating to entering into contracts or arrangements in which he is directly or indirectly interested;

(*d*) he fails to disclose his interest in any contract or arrangement in which he is directly or indirectly interested, in contravention of the provisions of the Act;

(*e*) he becomes disqualified by an order of a court or the Tribunal;

(*f*) he is convicted by a court of any offence, whether involving moral turpitude or otherwise and sentenced in respect thereof to imprisonment for not less than six months:

(*g*) he is removed in pursuance of the provisions of this Act;

(*h*) he, having been appointed a director by virtue of his holding any office or other employment in the holding, subsidiary or associate company, ceases to hold such office or other employment in that company.

If a person, functions as a director even when he knows that the office of director held by him has become vacant on account of any of the disqualifications mentioned above, he shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

Where all the directors of a company vacate their offices under any of the disqualifications specified above, the promoter or, in his absence, the Central Government shall appoint the required number of directors who shall hold office till the directors are appointed by the company in the general meeting.

According to the Companies Act, a private company may, by its articles, provide any other ground for the vacation of the office of a director in addition to those specified in the Act.

Vacation of office of a director may also occur due to resignation.

DISQUALIFICATIONS FOR APPOINTMENT OF DIRECTOR

A person shall not be capable of being appointed director of a company, if:

(*a*) he has been found to be of unsound mind by a court of competent jurisdiction and the finding is in force.

(*b*) he is an undischarged insolvent.

(*c*) he has applied to be adjudicated as an insolvent and his application is pending.

(*d*) he has been convicted by a court of any offence involving moral turpitude and sentenced in respect thereof to imprisonment for not less than six months, and a period of five years has not elapsed from the date of expiry of the sentence.

(*e*) he has not paid any call in respect of the company shares held by him, whether alone or jointly with others, and six months have elapsed from the last day fixed for the payment of the call.

(*f*) an order disqualifying him for appointment as director has been passed by a court in pursuance of the provisions of the Act and is in force, unless the leave of the court has been obtained for his appointment in pursuance of that section.

(*g*) He is already a director of a public company which has not filed the annual accounts and annual returns for continuous three financial years or has failed to repay its deposit or interest thereon on due date or pay dividend and such failure continues for one year or more.

A private company, which is not a subsidiary of a public company, may, by its articles, provide that a person shall be disqualified for appointment as a director on any grounds in addition to those specified above.

The Audit Committee monitors the appointment and performance of the auditors, evaluates reports of auditors, oversees financial transactions of the company and evaluates internal financial controls and risk management system.

Board Committees

The Companies Act provides for the constitution of four committees by the Board: Audit Committee, Nomination and Remuneration Committee, Corporate Social Responsibility Committee and Stakeholder Relationship Committee.

Audit Committee

The Companies Amendment Act, 2000, has incorporated the mandatory recommendation of the Birla Committee on Corporate Governance for an Audit Committee for company to act as a catalyst for effective financial reporting, with powers to investigate any activity within its terms

of reference and to seek information from any employee. According to this, the major role of the Audit Committee appointed by the Board of Directors is the oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.

According to the Companies Act, 2013, the Board of Directors of every listed company or any other as may be prescribed, shall constitute an Audit Committee. Important provisions of the Act related to the Audit Committee are the following.

- The Audit Committee shall consist of a minimum of three directors with independent directors forming a majority.
- Majority of members of Audit Committee including its Chairperson shall be persons with ability to read and understand, the financial statement.

Every Audit Committee shall act in accordance with the terms of reference specified by the Board which shall, *inter alia,* include:

(*i*) the recommendation for appointment, remuneration and terms of appointment of auditors of the company;

(*ii*) review and monitor the auditor's independence and performance, and effectiveness of audit process;

(*iii*) examination of the financial statement and the auditors' report thereon;

(*iv*) approval or any subsequent modification of transactions of the company with related parties;

(*v*) scrutiny of inter-corporate loans and investments;

(*vi*) valuation of undertakings or assets of the company, wherever it is necessary;

(*vii*) evaluation of internal financial controls and risk management systems;

(*viii*) monitoring the end use of funds raised through public offers and related matters.

The Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.

The Audit Committee shall have authority to investigate into any matter in relation to the items specified in the Act or referred to it by the Board and for this purpose shall have power to obtain professional advice from external sources and have full access to information contained in the records of the company.

Nomination and Remuneration Committee

The Board of Directors of every listed company and such other class or classes of companies, as may be prescribed, shall constitute the Nomination and Remuneration Committee (NRC) consisting of three or more non-executive directors out of which not less than one-half shall be independent directors. The Chairperson of the company (whether executive or non-executive) may be appointed as a member of this Committee but shall not chair the Committee.

Role of NRC

The NRC shall: (*a*) identify persons who are qualified to become directors and who may be appointed in senior management and recommend to the Board their appointment and removal

Prescribed classes of companies shall have a Nomination and Remuneration Committee to identify qualified persons for key managerial positions and recommend policy relating to their remuneration and Stakeholders Relationship Committee to deal with the grievances of security holders of the company.

and shall carry out evaluation of every director's performance; and (*b*) formulate the criteria for determining qualifications, positive attributes and independence of a director and recommend to the Board a policy relating to the remuneration for the directors, key managerial personnel and other employees.

(Key managerial personnel means, (*i*) the Chief Executive Officer or the managing director or the manager; (*ii*) the company secretary; (*iii*) the whole-time director; (*iv*) the Chief Financial Officer; and (*v*) such other officer as may be prescribed.)

While formulating the remuneration policy, the Committee shall ensure that: (*a*) the level and composition of remuneration is reasonable and sufficient to attract, retain and motivate directors of the quality required to run the company successfully; (*b*) relationship of remuneration to performance is clear and meets appropriate performance benchmarks; and (*c*) remuneration to directors, key managerial personnel and senior management involves a balance between fixed and incentive pay reflecting short- and long-term performance objectives appropriate to the working of the company and its goals.

Stakeholders Relationship Committee

The Board of Directors of a company which consists of more than one thousand shareholders, debenture-holders, deposit-holders and any other security holders shall constitute a Stakeholders Relationship Committee consisting of a chairperson who shall be a non-executive director and such other members as may be decided by the Board.

The purpose of this Committee is to consider and resolve the grievances of security holders of the company.

(*Corporate Social Responsibility Committee* is described in Chapter 9.)

Prohibition of Insider Trading

The Companies Act prohibits insider trading.

Insider trading means: (*i*) an act of subscribing, buying, selling, or dealing in any security or agreeing to do any of these by any director or key managerial personnel or any other officer of the company either as principal or agent if such a person is reasonably expected to have access to any non-public price-sensitive information in respect of securities of the company.

Communicating any non-public price-sensitive information to any person or counselling about dealing in securities based on such information too is regarded as insider trading.

Price-sensitive information means any information which relates, directly or indirectly, to a company and which if published is likely to materially affect the price of securities of the company.

If any person contravenes the provisions of this section, he shall be punishable with imprisonment for a term which may extend to five years or with fine which shall not be less than five lakh rupees but which may extend to twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher, or with both.

INSPECTION, INQUIRY AND INVESTIGATION

The Companies Act specifies many do's and don'ts for the companies to serve the purpose of the Act for ensuring proper management of companies and healthy development of the corporate sector. It is, therefore, natural that the Companies Act has provisions for the required scrutiny of the affairs of the companies.

Under the Companies Act, the Registrar of Companies is given the power to seek any relevant information or explanation from a company to ascertain facts. He can ask the company to produce any relevant document for his examination and scrutiny. If the registrar is not satisfied with the information or explanation so received, or on a scrutiny of the documents furnished, he is of the opinion that an unsatisfactory state of affairs exists in the company he may call on the company to produce for his inspection such further books of account, books, papers and explanations.

The Registrar can seek any relevant information or explanation from a company to ascertain facts and the Central Government may order an investigation into the affairs of a company if it is felt that an unsatisfactory state of affairs exists in the company which needs to be probed.

If the Registrar or Inspector appointed to conduct an inquiry feels that any relevant documents are likely to be destroyed, mutilated, altered, falsified or secreted, he may, after obtaining an order from the Special Court for the seizure of such books and papers, enter, with such assistance as may be required, and search, the place or places where such books or papers are kept; and conduct of inspection and inquiry. The provisions of the Code of Criminal Procedure, 1973 relating to searches or seizures shall apply, *mutatis mutandis,* to every search and seizure so made.

The Registrar or inspector shall, after the inspection of the records books of account or an inquiry, submit a report to the Central Government and such report may, if necessary, include a recommendation that further investigation into the affairs of the company is necessary giving his reasons in support.

Central Government may order an investigation into the affairs of a company if it is of the opinion that such an investigation is necessary:

(*a*) on the receipt of a report of the Registrar or inspector;

(*b*) on intimation of a special resolution passed by a company that the affairs of the company ought to be investigated; or

(*c*) in public interest,

If an order is passed by a court or the Tribunal in any proceedings before it that the affairs of a company ought to be investigated, the Central Government shall order an investigation into the affairs of that company. For the purposes of an investigation in respect of the references made above, the Central Government may appoint one or more persons as inspectors to investigate into the affairs of the company and to report thereon in such manner as the Central Government may direct.

Serious Fraud Investigation Office

According to the Companies Act 2013, the Central Government shall, by notification, establish an office to be called the Serious Fraud Investigation Office to investigate frauds relating to a company.

Investigation into affairs of Company by Serious Fraud Investigation Office may be initiated (a) on receipt of a report of the Registrar or inspector as specified in the Companies Act, (b) on intimation of a special resolution passed by a company that its affairs are required to be investigated; (*c*) in the public interest; or (*d*) on request from any Department of the Central Government or a State Government.

REVIVAL AND REHABILITATION OF SICK COMPANIES

Under the Sick Industrial Companies Act (SICA), 1985, an industrial company was regarded as sick if its net worth was completely eroded. This definition of industrial sickness was generally followed until the coming into effect of the Companies Act 2013.

The Companies Act 2013 takes a different view of sickness. Accordingly, a sick company is one which fails to pay the debt. Further, while the Sick Industrial Companies Act dealt with only industrial companies, the current Companies Act is applicable to all types of companies.

Initiation of Reporting of and Determination of Sickness

The authority which deals with sick companies under the Companies Act 2013 is the National Company Law Tribunal.

The tribunal initiates measures for determination whether a company is a sick company on a reference to made by it by any of the following parties who has sufficient reasons to believe that any company has become a sick company:

(*a*) secured creditors of the company representing fifty per cent or more of its outstanding amount of debt;

(*b*) the company itself;

(*c*) the Central Government

(*d*) the Reserve Bank of India;

(*e*) the Government of a State in which all or any of the undertakings belonging to such company are situated;

(*f*) a public financial institution or a State level institution or a scheduled bank which has a financial exposure in the company.

It is laid down in the Act that where a reference of sickness has been made to the Tribunal, (1) the company shall not dispose of or otherwise enter into any obligation with regard to its properties or assets except as required in the normal course of business and (2) the Board of Directors shall not take any steps likely to prejudice the interests of the creditors.

The Tribunal shall determine whether the company is a sick company or not, within a period of sixty days of the receipt of an application regarding sickness.

The authority to deal with sick companies is the NCLT. Sickness may be referred to the Tribunal by secured creditors, Central or relevant State governments, RBI or financiers of the company.

Revival and Rehabilitation

If the Tribunal is satisfied that a company has become a sick company, the Tribunal shall decide, as soon as may be, whether it is practicable for the company to make the repayment of its debts within a reasonable time.

If the Tribunal deems fit that it is practicable for a sick company to pay the debts within a reasonable time, the Tribunal shall, subject to such restrictions or conditions as may be specified, give such time to the company as it may deem fit to make repayment of the debt.

On the determination of a company as a sick company by the Tribunal, any secured creditor of that company or the company may make an application to the Tribunal for the determination of the measures that may be adopted with respect to the revival and rehabilitation of such company.

On the receipt of such an application, the Tribunal shall appoint an interim administrator to convene a meeting of creditors of the company in accordance with the relevant provisions of the Act to consider whether it is possible to revive and rehabilitate the sick company and such other matters, which the interim administrator may consider necessary.

The interim administrator shall appoint a committee of creditors with such number of members as he may determine, but not exceeding seven, and as far as possible a representative

each of every class of creditors should be represented in that committee. The interim administrator may direct any promoter, director or any key managerial personnel to attend any meeting of the committee of creditors and to furnish such information as may be considered necessary by the interim administrator.

On consideration of the report of the interim administrator, if the Tribunal is satisfied that the creditors representing three-fourths in value of the amount outstanding against the sick company present and voting have resolved that it is not possible to revive and rehabilitate such company, the Tribunal shall take any one of the following courses of action:

1. Order that the proceedings for the winding up of the company be initiated, or
2. Appoint a company administrator for the company and cause such administrator to prepare a scheme of revival and rehabilitation of the sick company if the Tribunal is of the opinion that by adopting certain measures the sick company may be revived and rehabilitated. (The Tribunal may, if it thinks fit, appoint an interim administrator as the company administrator.)

The scheme prepared by the company administrator shall be placed before the meeting of the creditors of the sick company for their approval. If the scheme is approved by the unsecured creditors representing one-fourth in value of the amount owed by the company to such creditors and the secured creditors, representing three-fourths in value of the amount outstanding against financial assistance disbursed by such creditors to the sick company, the company administrator shall submit the scheme before the Tribunal for sanctioning the scheme:

Where the scheme relates to amalgamation of the sick company with any other company, such scheme shall, in addition to the approval of the creditors of the sick company under this sub-section, be laid before the general meeting of both the companies for approval by their respective shareholders and no such scheme shall be proceeded with unless it has been approved, with or without modification, by a special resolution passed by the shareholders of that company.

The scheme prepared by the company administrator shall be examined by the Tribunal and a copy of the scheme with modification, if any, made by the Tribunal shall be sent, in draft, to the sick company and the company administrator and in the case of amalgamation, also to any other company concerned, and the Tribunal may publish or cause to be published the draft scheme in brief in such daily newspapers as the Tribunal may consider necessary, for suggestions and objections, if any, within such period as the Tribunal may specify.

The Tribunal may make such modifications, if any, in the draft scheme as it may consider necessary in the light of the suggestions and objections received from the sick company and the company administrator and also from the transferee company and any other company concerned in the amalgamation and from any shareholder or any creditors or employees of such companies. The Tribunal shall within sixty days therefrom, after satisfying that the scheme had been validly approved in accordance with this section, pass an order sanctioning such scheme.

WINDING UP OF COMPANIES

Exit of Companies

A company registered under the Companies Act can cease to exist by any one of the following legal methods:

- If a company transfers its undertaking(s) to another company under a scheme of reconstruction or amalgamation, it may be dissolved without winding up, if the court so directs.
- The name of a defunct company may be removed from the Register of Companies by the Registrar.
- A company may be wound up as per the provisions of the Companies Act, 2013.

The Registrar may initiate measures to remove the name of a company from the Register if has reasonable cause to believe that:

(*a*) the company has failed to commence its business within one year of its incorporation;

(*b*) the subscribers to the memorandum have not paid the subscription which they had undertaken to pay and a declaration to this effect has not been filed within the specified period (one hundred and eighty days from the date of incorporation of a company)

(*c*) the company is not carrying on any business or operation for a period of two immediately preceding financial years and has not made any application within such period for obtaining the status of a dormant company under the Companies Act 2013.

Meaning of Winding Up Pennington defines winding up as a process by which the management of a company's affairs is taken out of its directors' hands, its assets are realised by a liquidator, and its debts are paid out of the proceeds of realisation, and any balance remaining returned to its members. At the end of the winding up, the company will have no assets or liabilities. It will, therefore, be only a formal step to have it dissolved, and bring to an end its legal personality as a corporation.

Modes of Winding Up

According to the Companies Act 2013, there are two modes of winding up, *viz.*,

- Winding up by the National Company Law Tribunal
- Voluntary winding up

Winding up by the Tribunal

Circumstances in which a company may be wound up by the Tribunal on petition received under the Companies Act are the following:

(*a*) the company is unable to pay its debts;

(*b*) the company has, by special resolution, resolved that the company be wound up by the Tribunal;

(*c*) the company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality;

(*d*) the Tribunal has ordered the winding up of a sick company;

(*e*) fraudulence, misfeasance or misconduct;

(*f*) the company has made a default in filing with the Registrar its financial statements or annual returns for immediately preceding five consecutive financial years; or

(*g*) the Tribunal is of the opinion that it is just and equitable that the company should be wound up.

A petition to the Tribunal for the winding up of a company may be presented by: (*a*) the company; (*b*) any creditor or creditors; (*c*) any contributory or contributories; (*d*) all or any of the persons specified above together; (*e*) the Registrar; (*f*) any person authorised by the Central Government in that behalf; or (*g*) the Central Government or a State Government in specified cases.

A company may be wound up by the Tribunal on grounds such as inability to pay debts, sickness, anti-national activities, illegitimate and unfair conduct and mismanagement, special resolution to wind up the company etc.

Voluntary Winding Up

The circumstances in which a company may be wound up voluntarily are the following:

(*a*) the company in general meeting passes a resolution requiring the company to be wound up;

(*b*) the company passes a special resolution that the company be wound up voluntarily.

The company in general meeting may pass a resolution requiring the company to be wound up voluntarily as a result of the expiry of the period for its duration, if any, fixed by its articles or on the occurrence of any event in respect of which the articles provide that the company should be dissolved.

NATIONAL COMPANY LAW TRIBUNAL AND APPELLATE TRIBUNAL

The Companies Act 2013 has required the Central Government to constitute a tribunal known as National Company Law Tribunal (NCLT) and an Appellate Tribunal known as the National Company Law Appellate Tribunal for hearing appeals against the orders of the Tribunal. The National Company Law Tribunal is often referred to as the Tribunal and the National Company Law Appellate Tribunal is often referred to as the Appellate Tribunal.

With the establishment of these two authorities, the Company Law Board and Board for Industrial and Financial Reconstruction (BIFR) ceased to exist. They would relieve the Courts of their burden while simultaneously providing specialised justice.

The National Company Law Tribunal shall have a President, who shall be a person who is or has been a Judge of a High Court for five years, and the Appellate Tribunal shall have a Chairperson who shall be a person who is or has been a Judge of the Supreme Court or the Chief Justice of a High Court. Both these authorities shall consist of Judicial Members of prescribed qualifications and Technical Members who shall be persons of proven ability, integrity and standing having special knowledge and experience in law, industrial finance, industrial management or administration, industrial reconstruction, investment, accountancy, labour matters, or such other disciplines related to management, conduct of affairs, revival, rehabilitation and winding up of companies.

Cases under the Companies Act are dealt with by the Tribunal and appeals against orders of the Tribunal can be made to the Appellate Tribunal. Appeals against orders of Appellate Tribunal may be filed to Supreme Court.

According to the Act, there shall be constituted such number of Benches of the Tribunal, as may be specified by the Central Government. The Principal Bench of the Tribunal shall be at New Delhi which shall be presided over by the President of the Tribunal.

For the purposes of discharging their functions, the Tribunal and the Appellate Tribunal have the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 while trying a suit in respect of the following matters, namely:

(*a*) summoning and enforcing the attendance of any person and examining him on oath;

(*b*) requiring the discovery and production of documents;

(*c*) receiving evidence on affidavits;

(*d*) subject to the provisions of sections 123 and 124 of the Indian Evidence Act, 1872, requisitioning any public record or document or a copy of such record or document from any office;

(*e*) issuing commissions for the examination of witnesses or documents;

(*f*) dismissing a representation for default or deciding it *ex-parte;*

(*g*) setting aside any order of dismissal of any representation for default or any order passed by it *ex-parte;* and

(*h*) any other matter which may be prescribed.

Any order made by the Tribunal or the Appellate Tribunal may be enforced by that Tribunal in the same manner as if it were a decree made by a court in a suit pending therein. All proceedings before the Tribunal or the Appellate Tribunal shall be deemed to be judicial proceedings. The Tribunal and the Appellate Tribunal shall have the same jurisdiction, powers and authority in respect of contempt of themselves as the High Court has and may exercise, for this purpose, the powers under the provisions of the Contempt of Courts Act, 1971, subject to certain conditions.

Any person aggrieved by any order of the Tribunal may file an appeal to the Appellate Tribunal and any person aggrieved by any order of the Appellate Tribunal may file an appeal to the Supreme Court.

MISCELLANEOUS

Following are some of the important points of the Act not covered above.

Corporate Social Responsibility

With the CA 2013, India became the first country to make spending towards corporate social responsibility mandatory. Accordingly, at least two per cent of the average net profits of the preceding three financial years shall be spent on projects beneficial to the society by companies having:

- net worth of ₹ 500 crore or more; or
- turnover of ₹ 100 crore or more; or
- net profit of ₹ 5 crore or more

Details of the provisions of the Companies Act pertaining to CSR are given in Chapter 9 (*Social Responsibility of Business*) of this book.

Mergers and Acquisitions

The CA 2013 has introduced a fast track and simplified procedure for mergers and amalgamations of certain class of companies such as holding and subsidiary, and small companies after obtaining approval of the Indian government.

The Act permits cross-border mergers, both ways – a foreign company merging with an India company and *vice versa* – with prior permission of RBI.

Class Action Suits

The CA 2013 permits pursuing class action suits (*i.e.,* suits by a group of persons) by members, debenture-holders or depositors. This is an important step towards protecting interests of stakeholders, particularly small investors.

Restrictions on Non-audit Services

The CA 2013 imposes restrictions on auditors on performing non-audit services to the company where they are auditors to ensure independence and accountability of auditor.

Prohibition of Loans to Directors

The CA 2013 prohibits companies from extending, directly or indirectly, any kind of loan/ guarantee/security to any of its directors or to any other person in whom the director is interested.

Uniform Financial Year

The CA 2013 has made the financial year uniform for all accompanies (*i.e.,* 1st April – 31st March).

National Financial Reporting Authority

The CA 2013 provides for constitution of a National Financial Reporting Authority (NFRA) by Central Government for dealing with matters relating to accounting and auditing policies and standards to be followed by companies and their auditors.

Companies with Charitable Objects

The CA 2013 increased the scope of companies that may be formed with charitable objectives to include sports, education, research, social welfare, protection of environment in addition to the promotion of commerce, arts, science, religion and charity.

Related Party Transactions

The CA 2013 made approval of related party transactions by Audit Committee/Board of Directors at Board meeting mandatory; but Central Government approval for related party transactions is not required now. Related party transactions also require prior shareholder's approval by special resolution for companies having prescribed paid-up capital or transactions exceeding prescribed amounts. Related party transactions shall be disclosed in the Director's Report along with justification thereof.

Prohibition of Acceptance of Public Deposits

Regulations pertaining to public deposits have been significantly amended. After the coming into effect of the CA 2013, no company (other than banking and non-banking financial companies) can accept deposits from the public or renew deposits accepted earlier.

Acceptance of Deposits from Members

However, a company can accept deposits from its members subject to the conditions laid down in the Act. The conditions include passing of a resolution to this effect in general meeting, issuance of a circular to its members indicating the financial position of the company, the credit rating obtained, the total number of depositors and the amount due towards deposits in respect of any previous deposits accepted by the company and such other particulars in such form and

in such manner as may be prescribed; depositing not less than fifteen per cent of the amount of its deposits maturing during a financial year and the next year in a scheduled bank in a separate bank account to be called as deposit repayment reserve account; providing deposit insurance as may be prescribed, etc.

Vigil Mechanism

Every listed company or such class or classes of companies, as may be prescribed, shall establish a vigil mechanism for directors and employees to report genuine concerns in such manner as may be prescribed.

The vigil mechanism shall provide for adequate safeguards against victimisation of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases. The details of establishment of such mechanism shall be disclosed by the company on its website, if any, and in the Board's report.

E-governance

The CA 2013 permits move towards e-governance. The Act permits maintenance of books of account, deeds, vouchers, writings, documents, minutes and registers maintained on paper or in electronic form. It also permits holding of Board meetings through video conferencing/other electronic mode and voting by shareholders through electronic mode. Serving of documents to companies by electronic mode and filing of documents with the Registrar in electronic mode are permitted. Financial statements are to be placed on company's website.

Secretarial Audit

Secretarial Audit by Company Secretary in practice for listed and prescribed class of companies is now mandatory under the Companies Act. The report of such Secretarial Audit has to be annexed to the Director's report presented in annual general meeting.

The functions of the company secretary include:

(*a*) to report to the Board about compliance with the provisions of this Act, the rules made thereunder and other laws applicable to the company;

(*b*) to ensure that the company complies with the applicable secretarial standards;

(*c*) to discharge such other duties as may be prescribed.

Secretarial standards refers to secretarial standards issued by the Institute of Company Secretaries of India.

National Financial Reporting Authority

The CA 2013 provides for constitution of a National Financial Reporting Authority (NFRA) by Central Government for dealing with matters relating to accounting and auditing policies and standards to be followed by companies and their auditors.

Consolidation of Financial Statements

Consolidation of financial statements is made mandatory for all companies with one or more subsidiaries, whether Indian or foreign. For the purposes of consolidation of financial statements, the expression subsidiary includes associate company and joint venture.

Appointment of Key Managerial Personnel

According to the CA 2013, prescribed class of companies to have whole-time Key Managerial Personnel (KMP). Key managerial personnel refers to:

(*i*) the chief executive officer or the managing director or the manager;

(*ii*) the company secretary;

(*iii*) the whole-time director;

(*iv*) the Chief Financial Officer; and

(*v*) such other officer as may be prescribed.

SUMMARY

The Companies Act, 2013, which has replaced the 56 years old Companies Act of 1956, substantially differs from the previous Act in many respects. The current Act contains many provisions of the previous Act and includes a number of newly incorporated provisions and amended matter.

Some important highlights of the Companies Act, 2013 are given below. A number of important aspects of the Act are given in a summary form in the section *Miscellaneous* above.

Application of the Act

The CA 2013 applies to the whole of India and to almost all types of companies – it applies not only to companies incorporated under the Companies Act but also to companies incorporated under other Acts, like insurance companies, banking companies and electricity companies.

Objective of the Act

The main objective of the Companies Act is to empower the Central Government to regulate the formation of companies in accordance with certain standards and norms and to control the management of companies by laying down a legal and procedural framework to be adhered to by the companies.

Types of Companies

According to the Companies Act, there are basically three classes of companies, *viz.,* limited companies, unlimited companies and guarantee companies.

The CA 2013 introduced some new entities, *viz.,* one person company, small company and dormant company. The first two of these are private companies and last may be public or private.

There are two important kinds of limited companies, *viz.,* private limited company and public limited company.

A private company shall have a minimum paid-up capital of one lakh rupees and the number of members shall not be more than two hundred (excluding employees and former employees who continue to be members after the employment ceased).

A public company shall have a minimum paid-up capital of five lakh rupees and a minimum seven members (no upper limit).

Taking a total view, the CA 2013 deals with the following classes of companies.

- Companies limited by shares (subdivided into public, deemed public and private companies)
- Companies limited by guarantee (either with or without share capital)
- Companies with unlimited liability (either with or without share capital)

The Companies Act 2013 also refers to certain special types of companies such as:

- One person company
- Small company
- Dormant company
- Holding and subsidiary companies
- Associate company
- Government company
- Foreign company

Incorporation of Company

For any lawful purpose, a public company may be formed by seven or more persons, a private company by two or more persons, one person company (which is essentially a private company) by one person.

For incorporation of a company, the promoters of the proposed company shall file with the Registrar of Companies certain specified documents containing the details sought to be provided in the documents. The two most important documents are the Memorandum of Association and the Articles of Association. The Memorandum of Association is regarded as the *fundamental* document of the company which defines the object of its formation and operations. The Articles of Association are the rules, regulations and bye-laws for the *internal* management of the affairs of a company. They are framed with the object of carrying out the aims and objects as set out in the Memorandum of Association.

Corporate Governance

The CA 2013 provides an elaborate legal framework to foster healthy corporate governance. These include:

(*a*) Norms and standards pertaining to the composition of the board of directors, including the stipulations regarding independent director, qualifications and disqualifications for appointment as director, powers of the Board and duties of directors, stipulations regarding Board meetings etc.

(*b*) Provisions regarding norms for accounting, auditors and auditing, preparation and submission of various documents etc.

(*c*) Measures aimed at imparting required transparency about the operations and affairs of the company, including provisions regarding disclosure of information.

(*d*) Regulations regarding related party transactions, inter-corporate investments and loans to directors.

(*e*) Compliance requirements.

Powers to Oversee and Control Management of Companies

The Companies Act has a number of provisions aimed at preventing mismanagement or objectionable activities by companies.

The Act gives powers to the Registrar of Companies to call for information, inspect records books and conduct inquiries into the affairs of companies, conduct inspection and inquiry, search and seize records etc. Further, the Central Government is entitled to investigate into the affairs of any company as per the provisions of the Act.

The Act also provides for the establishment of Serious Fraud Investigation Office by the Central Government. The Central Government may order an investigation into the affairs of any company by the Serious Fraud Investigation Office if the Government is of the opinion that it is necessary to do so.

Winding Up of Companies

There are two modes of winding up, *viz.,* voluntary winding up and winding up by National Company Law Tribunal.

Tribunal and Appellate Tribunal

Cases under the Companies Act is dealt with by National Company Law Tribunal (NCLT), which has replaced the role of High Court in company law matters. The Tribunal, consisting of judicial and technical members, exercise and discharge the powers and functions conferred on it by the Central Government including approval of merger, corporate reorganisation, capital reduction etc. The Tribunal can have such number of Benches as decided by the Central Government.

Appeals against the orders of the Tribunal may be made to the National Company Law Appellate Tribunal and Supreme Court is the authority to consider appeals against orders of the Appellate Tribunal.

Revival and Rehabilitation of Sick Companies

The authority to deal with sick companies under the CA 2013 is the National Company Law Tribunal, which has replaced the role played by the Board for Industrial and Financial Reconstruction (BIFR) established under the Sick Industrial Companies Act (SICA) of 1985 which was repealed in 2003. The CA 2013 covers all types of sick companies whereas the SICA covered only sick industrial companies. While erosion of net worth was the important criterion to decide sickness under the SICA, a company which fails to pay the debt is regarded sick under the CA 2013.

Issue of Securities by Companies

Both public and private companies can raise capital by rights or bonus issues and through private placement. Only public companies can issue securities to the public.

According to the CA 2013, the share capital of a company limited by shares can be of two kinds, namely: (*a*) equity share capital and (*b*) preference share capital.

Prohibition of Insider Trading

The Companies Act bans insider trading (*i.e.,* dealing in securities by any director or key managerial personnel or any other officer of the company having, or reasonably expected to have, non-public price-sensitive information in respect of securities the company). Price-sensitive information is information which is likely to affect the price of securities.

REFERENCE

1. **The first two paragraphs of this section are adapted from the *Report of High-powered Expert Committee on Companies and MRTP Acts* (Government of India, 1978).**

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Chapter 20

PATENTS AND TRADE MARKS

Structure

Patents

Trade Marks

Summary

References

Annexure 20.1: Falsifying and Falsely Applying Trade Marks

Protection of intellectual property rights has become an issue of wide and serious discussion with the formation of the General Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs) under the Uruguay Round (UR) Agreement of the GATT (now the WTO).

Intellectual property rights may be defined as "information with commercial value". IPRs have been characterised as a composite of "ideas, inventions and creative expression" plus the "public willingness to bestow the status of property" on them and give their owners the right to exclude others from access to or use of protected subject matter".

IPRs may be legally protected by patents, copyrights, industrial designs, geographical indications, and trade marks. Special *(sui generis)* forms of protection have also emerged to address specific needs of knowledge-producers as in the case of plant breeder's rights and the protection of layout designs of integrated circuits. A number of countries also have trade secret laws to protect undisclosed information that gives a competitive advantage to its owner.

Intellectual property right refers to the right over creations of mind.

The UR Agreement on TRIPs covers seven intellectual properties, *viz.,*

1. Copyright and related rights
2. Trade mark
3. Geographical indications
4. Industrial designs
5. Patents
6. Layout designs (topographies) of integrated circuits
7. Undisclosed information, including trade secrets

On copyrights and related rights, the Agreement requires compliance with the provisions of *Bern Convention to* which India is a signatory and the new Copyright Act of India already meets the requirements of the TRIPs Agreement. Trade and Merchandise Marks Act of 1958 was replaced by a new Act, namely, The Trade Marks Act, 1999, so as to provide for the protection of service marks also.

PATENTS

A patent is a legal protection granted for an invention that is new, non-obvious and useful. The patent grants the patent holder the exclusive right to make use or sell the patented products or process. The main purpose of the patent system is to benefit the society. Patents, by providing an opportunity to recoup the cost of invention (which is quite substantial in many cases) and to make profit out of the invention, encourage research and development and thereby contribute to the well-being of the society.

Patent is a monopoly right granted by law for the exclusive use of an intellectual property.

An invention, to be patentable, must satisfy the following three conditions.

- It is new.
- It is useful to the society.
- It is non-obvious to a person possessed of average skill in the art.

PATENT PROTECTION IN INDIA

Patent protection in India has a long history. Patent protection was introduced in India in the 18th century. Formal patent protection was ushered in by the Patents Act, 1911. The Patents Act, 1970 amended and consolidated the law related to patents.

Some very significant amendments to India's patent law was, however, necessitated by the Agreement on Intellectual Property Rights that emerged from the Uruguay Round of multilateral trade negotiations that brought into being the WTO. Being a member of the WTO, India was obliged to align its patent law with the stipulations under the WTO with effect from January 1, 2005. Accordingly, the Indian Patents Act, 1970 and the Patent Rules 1972 were amended.

The Indian Patents Act, 1970, as amended and effective from January 1, 2005, lays down:

- The eligibility, procedures and conditions for grant of patents
- Inventions and other subjects not patentable
- Rights and obligations of patentee
- Grounds for revocation of patents
- Matters related to working of the patent and compulsory licensing
- Rights of government regarding patented products

The Patents Act lays down the eligibility, procedures and conditions for grant of patents and grounds for revocation of patent.

1. *Grant of Revocation of Patents:* Under the Act, a patent may be granted to an invention, subject to the provisions of the Act. According to the Act, an "invention" means a new product or process involving an inventive step and capable of industrial application. An "inventive step" means a feature of an invention that involves technical advance as compared to the existing knowledge or having economic significance or both and that makes the invention not obvious to a person skilled in the art.

There is also provision for the grant of patents of addition to the patentee (*i.e.,* granting of patent in respect of any improvement in or modification of an invention which is patented. The grant of patent of addition shall be for a term equivalent to that of the patent for the main invention.

The Act also provides for revocation of patents on certain grounds such as any claim made for the grant of patent has been found invalid, or the Central government feels that a patent or the mode in which it is exercised is mischievous to the state or generally prejudicial to the public interest.

2. *Items not Patentable:* A list of inventions and other subjects not patentable is provided in the Patents Act. Some examples of those which are not patentable: Inventions which are frivolous or contrary to public interest; method of agriculture or horticulture; any process of treatment of human beings or animals; plants and animals (other than microorganisms but including seeds, varieties and species and essentially biological processes for production or propagation of plants and animals); a mathematical or business method or a computer program *per se* or algorithms; the mere discovery of a scientific principles or the formulation of an abstract theory or discovery of any living thing or non-living substance occurring in nature; a mere scheme or rule or method of performing mental act or method of playing game; a presentation of information; topography of integrated circuits; an invention which, in effect, is traditional knowledge or which is an aggregation or duplication of known properties of traditionally known component or components.

3. *Product Patent:* The amended Act provides for grant of product patent. Previously, for food, pharmaceutical and chemical products, only process patent was granted. This meant that any body was free to manufacture the same or similar product by a process different from the patented one. This is no more allowed because of the adoption of the product patent.

4. *Patent Period:* For food, pharmaceutical and chemical products, previously the patent period was 14 years. Now, patents are granted for all products for a period of 20 years from the date of application.

5. Rights and Obligations of Patentee: The Act lays down the rights and obligations of patentee. A Patent granted under this Act confers on the patentee the exclusive right to use, make, sell or import the patented process/product. The Act normally prevents third parties from using, making, selling or importing the patented process/product without the consent of the patentee.

The Patents Act makes it clear that patents are not granted merely to enable patentees to enjoy a monopoly but to encourage inventions and to secure that the inventions are worked in India on a commercial scale and to the fullest extent that is reasonably practicable without undue delay; and to make the benefit of the patented invention available at reasonably affordable prices to the public.

6. *Working of the Patent:* As pointed out above, a patent is granted subject to certain considerations which ensure that it is properly worked in the country to serve the interests of the society. Working of patent means that the patented product is produced in India and made available sufficiently at reasonable prices within reasonable time.

The Act makes it clear that a patent is granted to encourage inventions and to secure that the inventions are worked in India on a commercial scale and to the fullest extent that is reasonably practicable without undue delay; the patent shall not be deemed a monopoly right to import the patented article in to the country. It is also expected that a patent contributes to the promotion of technological innovation and to the transfer and dissemination of technology to the mutual advantage of the producers and users of the technological knowledge.

7. *Compulsory Licensing:* The Act provides for compulsory licensing of the patent and revocation of the patent if it is not worked in the country.

A serious concern in India and elsewhere has been that product patents will result in exorbitant prices for drugs, seriously impairing the health and nutritional requirements of the large majority of the population. The considerations regarding the working of patents, laid down in the Act seek to safeguard the public interest in this respect. To protect the interests of the public, Indian Patents Act provides for grant of compulsory licence on ground such as failure to work the patent in the country. Compulsory licencing means grant of licence to third party to work the patent in the country.

8. *Exceptions:* The Patents Act also lays down certain exceptions to the rights of the patentee.

Any patented product or process may by made, imported or used by or on behalf of the government for its own use or purpose. The Central Government may also acquire a patent for public purpose, if necessary.

Any patented medicine or drug may be imported by the Government for the purpose merely of its own use or for distribution in any dispensary, hospital or other medical institution maintained by or on behalf of the Government or any other dispensary, hospital or other medical institution specified by the government in public interest.

Any patented process or product may be used or made by any person, for the purpose merely of experiment or research including the imparting of instructions to pupils.

Evaluation

The amendments to the Patents Act has come in for scathing criticism in India. The 1970 Act was regarded as a skillfully drafted piece of legislation which sought to protect the infant drugs and pharmaceuticals and chemicals industries from foreign monopolies in these fields. The critics fear that the adoption of product patent will enable the multinational drug firms to exploit the Indian consumers. While it is true that patent confers monopoly power on the patentee, in

the absence of product patent the patentee does not get sufficient protection. It may also be noted that patented drugs account for only about 15 per cent of the drugs market and patented drugs without alternatives account for about eight per cent of the market. However, the fact that patented drugs, by and large, are vital ones makes the situation very serious. If the government does not make effective use of the safeguards in the Act to protect the interests of the consumers, their plight could become miserable.

TRADE MARKS

Brands and *trade marks,* used very extensively in modern marketing to maintain product identity and to help product promotion, have become very popular terms.

The definitions of some the important terms given in *Marketing Definitions: A Glossary of Marketing Terms,* published by the American Marketing Association, and the Indian Trade Marks Act, 1999, are given below.

Brand: A brand is a name, term, sign, symbol, or design or a combination of them, intended to identify the goods or services of one seller or group of sellers and to differentiate them from those of competitors.

Brand Name: Brand name is that part of the brand which can be vocalised — the utterable.

Brand Mark: Brand mark is that part of a brand which can be recognised but is not a utterable, such as symbol, design or distinctive colouring or lettering.

Trade Mark: A trade mark is a brand or part of a brand that is given legal protection because it is capable of exclusive appropriation. A trade mark protects the seller's exclusive rights to use the brand name and/or brand mark.

Trade mark is an exclusive mark intended to distinguish the products of one seller from those of others.

According to the Trade Marks Act, 1999, trade mark means a mark capable of being represented graphically and which is capable of distinguishing the goods or services of one person from those of others and may include shape of goods, their packaging and combination of colours; and

(i) in relation to Chapter XII (other than Sec. 107), a registered trade mark or a mark used in relation to goods or services for the purpose of indicating or as to indicate a connection in the course of trade between the goods or services, as the case may be, and some person having the right as proprietor to use the mark; (Chapter XII deals with offences and penalties) and

(ii) in relation to other provisions of this Act, a mark used or proposed to be used in relation to goods or services for the purpose of indicating or so as to indicate a connection in the course of trade between the goods or services, as the case may be, and some person having the right, either as proprietor or by way of permitted user, to use the mark whether with or without any indication of the identity of that person, and includes a certification trade mark or collective mark.

According to the Trade Marks Act, certification trade mark means a mark capable of distinguishing the goods or services in connection with which it is used in the course of trade which are certified by the proprietor of the mark in respect of origin, material, mode of manufacture of goods or performance of services, quality, accuracy or other characteristics from goods or services not so certified and registrable as such under Chapter IX (which deals with Certification Trade Marks) in respect of those goods or services in the name, as proprietor of the certification trade mark, of that person.

Collective Mark: According to the Trade Marks Act, collective mark means a trade mark distinguishing the goods or services of members of an association of persons, not being a partnership within the meaning of the Indian Partnership Act, 1932 (9 of 1932), which is the proprietor of the mark from those of others.

THE TRADE MARKS ACT, 1999

The Indian law relating to trade marks has been amended and consolidated and Trade and Merchandise Marks Act, 1958 has been replaced by The Trade Marks Act 1999.

Registration gives legal protection against misappropriation or misuse of the trade mark by others.

Objectives

The objectives of The Trade Marks Act, 1999, are to provide for:

- The registration and better protection of trade marks for goods and services
- The prevention of the use of fraudulent marks

Registrar and Trade Marks Registry

The Controller-General of Patents, Designs and Trade Marks, appointed by the Central Government, is the Registrar of Trade Marks for the purpose of the Trade Marks Act. Further, the Central Government may appoint other officers with such designations as it thinks fit for the purpose of discharging, under the superintendence and direction of the Registrar, such functions of the Registrar under this Act as he may authorise them to discharge.

For the purposes of this Act, there shall be a Trade Marks Registry with its head office at such place as the Central Government may specify. For the purpose of facilitating the registration of trade marks, there may be branch offices of the Trade Marks Registry established at such places as the Central Government may think fit.

The Act also lays down that a Register of Trade Marks shall be kept at the head office of the Trade Marks Registry, wherein shall be entered all details regarding the registered trade marks. (*i.e.,* the names, addresses and description of the proprietors, notifications of assignment and transmissions, the names, addresses and descriptions of registered users; conditions, limitations and such other matter relating to registered trade marks as may be prescribed).

A copy of the register and the other relevant documents shall be kept at each branch office of the Trade Marks Registry.

Registration of Trade Marks

Any person claiming to be the proprietor of a trade mark used or proposed to be used by him, who is desirous of registering it, shall apply to the Registrar in the prescribed manner for the registration of his trade mark.

A single application is enough for registration of a trade mark for different classes of goods and services.

The application shall be filed in the office of the Trade Marks Registry within whose territorial limits the principal place of business in India of the applicant is situated. In the case of joint applicants, it shall be filed in the office of the Trade Marks Registry within whose territorial limits the principal place of business in India of the applicant whose name is first mentioned in the application as having a place of business in India is situated.

Where the applicant or any of the joint applicants does not carry on business in India, the application shall be filed in the office of the Trade Marks Registry within whose territorial

limits the place mentioned in the address for service in India as disclosed in the application is situated.

Subject to the provisions of this Act, the Registrar may accept the application absolutely or subject to such amendments, modifications, conditions or limitations, if any, as he may think fit, or refuse the application.

In the case of a refusal or conditional acceptance of an application, the Registrar shall record in writing the grounds for such refusal or conditional acceptance and the materials used by him in arriving at his decision.

When an application for registration of a trade mark has been accepted, the Registrar shall cause the application as accepted together with the conditions or limitations, if any, subject to which it has been accepted, to be advertised in the prescribed manner. In certain cases, such advertisement may be made before the acceptance of the application. The purpose of the advertisement is to allow any person who has any opposition to the registration of the proposed trade mark to give proper notice to the Registrar, of opposition to the registration.

If any proper notice of opposition is received, the Registrar shall serve a copy of the notice on the applicant for registration and, within two months from the receipt by the applicant of such copy of the notice of opposition, the applicant shall send to the Registrar in the prescribed manner in counter-statement of the grounds on which he relies for his application. If he does not do so, he shall be deemed to have abandoned his application.

If the applicant sends such counter-statement, the Registrar shall serve a copy thereof on the person giving notice of opposition. The Registrar shall take an appropriate decision after hearing the parties, if so required, and considering the evidence.

On the registration of a trade mark, the Registrar shall issue to the applicant a certificate in the prescribed form of the registration thereof, sealed with the seal of the Trade Marks Registry.

Where registration of a trade mark is not completed within twelve months from the date of the application by reason of default on the part of the applicant, the Registrar may, after giving notice to the applicant in the prescribed manner, treat the application as abandoned unless it is completed within the time specified in that behalf in the notice.

The Registrar may amend the register or a certificate to registration for the purpose of correcting a clerical error or an obvious mistake.

The duration of the registration of a trade mark is ten years, but may be renewed from time to time in accordance with the provisions of the Act. The failure to renew the registration may result in the removal of the trade mark from the register.

Where the proprietor of a trade mark claims to be entitled to the exclusive use of any part thereof separately, he may apply to register the whole and the part as separate trade marks. Each such separate trade mark shall satisfy all the conditions applying to and have all the incidents of, an independent trade mark.

The Act also provides for registration of several trade marks as a series in one registration, in respect of the same or similar goods or services or description of goods or description of services, which differ in respect of: *(a)* statement of the goods or services in relation to which they are respectively used or proposed to be used; or *(b)* statement of number, price, quality or names of places; or *(c)* other matter of a non-distinctive character which does not substantially affect the identity of the trade mark; or *(d)* colour.

The Act also has provisions regarding registration of collective marks and certification trade marks.

Grounds for Refusal of Registration

The Act lists a number of absolute grounds or refusal of registration of trade marks: the trade mark is devoid of distinctive characteristics, it is of such nature as to deceive the public or cause confusion; it is likely to hurt the religious susceptibilities of any class or section; it comprises or contains scandalous or obscene matter; which consists exclusively of marks or indications which have become customary in the current language or in the *bona fide* and established practices of the trade; etc. and relative grounds for refusal (such as identity or similarity with other trade marks) of registration.

Certain common names or names with certain connotations cannot be registered as trade marks.

The Act also prohibits the registration of names of commonly used and accepted name of any single chemical element or any single chemical compound or international non-proprietary names declared by the WHO.

The Registrar may refuse registration to a trade mark which falsely suggests a connection with any living person, or a person whose death took place within twenty years prior to the date of application for registration of the trade mark, if the applicant does not furnish the consent of such living person or, as the case may be, of the legal representative of the deceased person.

Effect of Registration

The registration of a trade mark gives the registered proprietor of the trade mark:

- The exclusive right to the use of the trade mark in relation to the goods or services in respect of which the trade mark is registered, subject to any conditions and limitations to which the registration is subject.
- The right to obtain relief in respect of infringement of the trade mark in the manner provided by this Act.

No person shall be entitled to institute any proceeding to prevent, or to recover damages, for the infringement of an unregistered trade mark.

Assignment and Transmission

The Trade Marks Act allows the proprietor of a trade mark to assign the trade mark, and to give effectual receipts for any consideration for such assignment. A registered trade mark is assignable and transmissible, whether with or without the goodwill of the business concerned. It may be done in respect either of all the goods or services in respect of which the trade mark is registered or of only some of those goods or services.

An unregistered trade mark may be assigned or transmitted with or without the goodwill of the business concerned.

Associated trade marks shall be assignable and transmissible only as a whole and not separately.

A certification trade mark shall not be assignable or transmissible otherwise than with the consent of the Registrar.

Where a person becomes entitled by assignment or transmission to a registered trade mark, he is entitled to get himself registered as the proprietor of the trade mark, as per the provisions of the Act.

Appellate Board

The Trade Marks Act provides for the establishment of an Appellate Board to be known as the Intellectual Property Appellate Board by the Central Government to exercise the jurisdiction, powers and authority conferred on it by or under this Act.

The Appellate Board shall consist of a Chairman, Vice-Chairman and such number of other Members, as the Central Government may, deem fit. The jurisdiction, powers and authority of the Appellate Board may be exercised by Benches thereof. A Bench shall consist of one Judicial Member and one Technical Member and shall sit at such place as the Central Government may specify.

Any person aggrieved by an order or decision of the Registrar under this Act, or the rules made thereunder may prefer an appeal to the Appellate Board in the prescribed manner within three months from the date on which the order or decision sought to be appealed against is communicated to such person preferring the appeal.

Offences and Penalties

Offences under the Act are punishable by imprisonment and fine. Such offences include falsifying and falsely applying trade marks, applying false trade marks and trade descriptions etc., selling goods or providing services to which false trade marks or false trade description is applied.

SUMMARY

Legal protection of intellectual property rights provide the owners of them the exclusive right to their commercial use so that they are rewarded for their innovative or marketing ingenuity.

Patent

A patent is a legal protection granted for an invention that is new, non-obvious and useful. The main purpose of the patent system is to benefit the society. Patents, by providing an opportunity to recoup the cost of invention and to make profit out of the invention, encourages research and development and thereby contributes to the well-being of the society.

The Indian Patent Act of 1970 has significant differences from the patent regulation stipulated by the GATT/WTO. The Uruguay Round Agreement imposes more stringent regulations than stipulates more stringent conditions for compulsory licensing of patents, when compared to the Indian law.

It is argued that the acceptance of product patents will strangle the growth of the Indian pharmaceutical industry and the monopolisation of the vital areas of this industry by multinationals will result in sharp increase in drug prices. This fear, however, seems to be exaggerated. Patented drugs account for only a small share of the Indian pharmaceutical market and within the patented drugs segment, more than half of the drugs have other therapeutic equivalents.

While there are strong criticisms against the WTO patent regime on the one hand, there are many who argue that it will be beneficial to India in several ways. This has made several Indian pharmaceutical firms to pay more attention to R&D.

Trade Mark

According to the Trade Marks Act, 1999, trade mark means a mark capable of being represented graphically and which is capable of distinguishing the goods or services of one person from those of others and may include shape of goods, their packaging and combination of colours.

The Indian law relating to trade marks has been amended and consolidated and Trade and Merchandise Marks Act, 1958 has been replaced by The Trade Marks Act 1999. This Act provides

for the registration and better protection of trade marks for goods and services, and the prevention of the use of fraudulent marks.

A registered trade mark is assignable and transmissible, whether with or without the goodwill of the business concerned. It may be done in respect either of all the goods or services in respect of which the trade mark is registered or of only some of those goods or services.

The registration of a trade mark gives the registered proprietor of the trade mark the exclusive right to the use of the trade mark in relation to the goods or services in respect of which the trade mark is registered. This also entitles him to relief in respect of infringement of the trade mark. No person is entitled to institute any proceeding to prevent, or to recover damages, for the infringement of an unregistered trade mark.

The Registrar of Trade Marks for the purposes of this Act is known as the Controller-General of Patents, Designs and Trade Marks.

There is a Trade Marks Registry with its head office at such place as the Central Government may specify. For the purpose of facilitating the registration of trade marks, there may be branch offices of the Trade Marks Registry established at such places as the Central Government may think fit.

Under the Trade Marks Act, an Appellate Board to be known as the Intellectual Property Appellate Board is established by the Central Government to exercise the jurisdiction, powers and authority conferred on it by or under this Act.

Any person aggrieved by an order or decision of the Registrar under this Act, or the rules made thereunder may prefer an appeal to the Appellate Board.

Offences such as falsifying and falsely applying trade marks, applying false trade marks and trade descriptions etc., and selling goods or providing services to which false trade marks or false trade description is applied are punishable under the Act by imprisonment and fine.

REFERENCES

1. **Jayshree Wattal, "The Sunny Side", *The Economic Times,* December 27, 1993, p. 7.**
2. **P.S. Jha, "Dunkel Draft: The Brighter Side", *The Economic Times,* December 25, 1993, p. 4.**

ANNEXURE 20.1

Falsifying and Falsely Applying Trade Marks

1. A person shall be deemed to falsify a trade mark who, either–
   (a) without the assent of the proprietor of the trade mark makes that trade mark or a deceptively similar mark; or
   (b) falsifies any genuine trade mark whether by alteration, addition, effacement or otherwise.
2. A person shall be deemed to falsely apply to goods or services a trade mark who, without the assent of proprietor of the trade mark–
   (a) applies such trade mark or a deceptively similar mark to goods or services or any package containing goods;
   (b) uses any package bearing a mark which is identical with or deceptively similar to the trade mark of such proprietor, for the purpose of packing, filling or wrapping therein any goods other than the genuine goods of the proprietor of the trade mark.
3. Any trade mark falsified as mentioned in sub-section (1) or falsely applied as mentioned in sub-section (2) is in this Act referred to as a false trade mark.
4. In any prosecution for falsifying a trade mark or falsely applying a trade mark to goods or services, the burden of proving the assent of the proprietor shall lie on the accused.

Falsely Representing a Trade Mark as Registered

Falsely representing a trade mark as registered means making any representation–

(a) with respect to mark, not being a registered trade mark, to the effect that it is a registered trade mark; or

(b) with respect to a part of a registered trade mark, not being a part separately registered as a trade mark, to the effect that it is separately registered as a trade mark; or

(c) to the effect that a registered trade mark is registered in respect of any goods or services in respect of which it is not in fact registered; or

(d) to the effect that registration of a trade mark gives an exclusive right to the use thereof in any circumstances in which, having regard to limitation entered on the register, the registration does not in fact give that right.

If any person contravenes any of the provisions pertaining to falsely representing a trade mark as registered shall be punishable with imprisonment for a term which may extend to three years, or with fine, or with both.

Registration of Trade Marks as Associated Trade Marks

1. Where a trade mark — which is registered, or is the subject of an application for registration, in respect of any goods or services is identical with another trade mark which is registered, or is the object of an application for registration, in the name of the same proprietor in respect of the same goods or description of goods or same services or description of services or so nearly resembles it as to be likely to deceive or cause

confusion if used by a person other than the proprietor, the Registrar may, at any time, require that the trade marks shall be entered on the register's associated trade marks.

2. Where there is an identity or near resemblance of marks that are registered, or are the subject of applications for registration in the name of the same proprietor, in respect of goods and in respect of services which are associated with those goods or goods of that description and with those services or services of that description, sub-section (1) shall apply as if applies as where there is an identity or near resemblance of marks that are registered, or are the subject of applications for registration, in the name of the same proprietor in respect of the same goods or description of goods or same services or description of services.

3. Where a trade mark and any part thereof are registered as separate trademarks in the name of the same proprietor, they shall be deemed to be, and shall be registered as, associated trade marks.

4. All trade marks as a series in one registration shall be deemed to be, and shall be registered as, associated trade marks.

5. On application made in the prescribed manner by the registered proprietor of two or more trade marks registered as associated trademarks, the Registrar may dissolve the association in respect of any of them if he is satisfied that there would be no likelihood of deception or confusion being caused if that trade mark were used by any other person in relation to any of the goods or services or both in respect of which it is registered, and may amend the register accordingly.

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Chapter 21

COMPETITION POLICY AND LAW

Structure

Competition Policy and Law – Nature and Scope
Government Policies and Distortions to Competition
Interface of FDI and Competition Law
Prerequisites for a Competition Policy
Contours of Competition Policy
Competition Act, 2002
Summary
References
Annexure 21.1: MRTP Act

Competition policy refers to the government policy designed to ensure contestability and fair competition by removing/preventing factors and forces that tend to distort fair competition.

The economic liberalisation has increased the relevance of competition policy. In 1980, less than 40 countries had competition laws; the number has increased to over 100 today. The pace of adoption increased rapidly after 1989, when former centrally planned economies in Central and Eastern Europe introduced comprehensive programmes of investment liberalisation, deregulation, privatisation and competition-law enforcement, and a number of developing countries also adopted competition laws. Moreover, many of these laws have been strengthened over the years, in terms of stricter and broader rules and higher penalties.[1]

The main purpose of competition policy and law is to ensure fair competition in the market economy including prevention of abuse of market dominance.

Fair competition is the hallmark of a free enterprise economy. Economic liberalisation unleashes competitive forces. In the absence of safeguards, this may, however, also provide scope for unfair competition, like powerful competitors crushing small firms through unfair means, collusion, and mergers and acquisitions (M&As) detrimental to competition. Further, there may still be some government policies like reservation for small business, trade restrictions, cross subsidisation, preferences in government procurements etc. which hamper competition. These call for a competition policy and law.

COMPETITION POLICY AND LAW — NATURE AND SCOPE

As Dr. S Chakravarthy, who was a member of the MRTP Commission and the High Level Committee on Competition Policy and Law puts it, competition policy is essentially understood to refer to governmental measures that directly affect the behaviour of enterprises and the structure of industry. A coherent and pragmatic competition policy should be capable of enhancing competition in local and national markets. It is an instrument to achieve efficient allocation of resources, technical progress and consumer welfare and to regulate concentration of economic power detriment to competition with flexibility to adjust to the changing international economic milleu. On a broad note, a well-designed competition policy should govern policies relating to globalisation, liberalisation and deregulation as may have an impact on competition. Of particular importance is the trade policy, which impacts competition on the market significantly – whether positively or adversely – and thus has to be subservient to competition policy.[2]

Chakravarthy has succinctly drawn up the distinction and relation between policy and law as follows.[3] Competition policy can be regarded as a genus, of which competition law is a specie. The former covers a whole array of executive policies and even approaches, whereas the latter is a piece of legislative enactment having the character of enforceability in a court of law. Government made decisions by way of executive policies and executive guidelines are pronounced in trade policy areas, in terms of which trade is regulated or even liberalised without the promulgation of a law or without the requirement of having to secure the approval of die legislature before applying the same. In policies which are not having the cover of law, there is always the danger of discrimination, abuse of discretion and non-rule based decisions. While one can easily appreciate the difficulties involved in covering and supporting every executive made competition policy by a legislative enactment, it is desirable that there is a codification of the principles the competition law which should act as an umbrella framework for making executive policies. Furthermore, such a competition law should have necessary provisions and teeth, to review any executive policy on the touchstone of competition and also have the power to require the executive to amend its policies, as may be necessary. This will ensure the spirit of competition in the executive policies relating to trade and market.[3]

As an UNCTAD report observes, the main objective of competition laws is to preserve and promote competition as a means to ensure the efficient allocation of resources in an economy,

resulting in the best possible choice of quality, the lowest prices and adequate supplies for consumers. In addition to promoting efficiency, many competition laws make reference to other objectives, such as the control of concentration of economic power, promoting the competitiveness of domestic industries, encouraging innovation, supporting small and medium-size enterprises and encouraging regional integration. Some of these additional objectives may sometimes be in conflict with the efficiency objective. The manner in which efforts are made to reconcile these conflicting objectives can be relevant to domestic firms and to the way TNCs are allowed to enter and operate in domestic markets.[4]

Competition laws prohibit restrictive business practices and monitor/control changes in the market structures.

Most competition laws deal with enterprise *behaviour* by prohibiting such restrictive business practices as competition-restricting horizontal agreements, acquisitions and abuses of dominant positions, as well as substantially restrictive vertical distribution agreements. In addition, an increasing number of competition laws deals with alterations to the *structure* of markets, through the control of M&As, as well as joint ventures aimed at avoiding the creation of dominant firms, monopolies, or even oligopolies. In some laws, the divestment of parts of monopolies is also authorised, to change the structure of markets.[5]

Most competition laws contain exceptions (basically sectoral) and exemptions (in most cases adopted in respect to categories of practices) to the application of their provisions. These can cover, among others, labour, regulated industries (e.g., telecommunications, defence, agriculture), small and medium-size enterprises, and certain types of cooperative arrangements, including R&D joint ventures. The rationales behind exemptions vary. In some cases (market failures, for example), competition and market forces are not viewed as the best tools leading to the maximisation of economic efficiency; rather, direct regulation of prices or entry is used. A number of countries, however, are reviewing the soundness and validity of those across-the-board exemptions. The emphasis is increasingly on applying competition law to all business practices not explicitly imposed on firms by statutory provisions. It is then the task of the competition authority or courts to consider business practices, and focus on those that have the highest probability of anti-competitive effects and the least justification based on efficiency. Usually, such cartel practices as price fixing, collusive tendering and market allocation are prohibited without need for market analysis, while distribution, joint ventures and merger agreements are assessed in a market context and increasingly under a rule-of-reason standard taking into account the efficiencies likely to be achieved and passed on to consumers.[6]

BOX 21.1 : SELECTED RESTRICTIVE BUSINESS PRACTICES ADDRESSED BY COMPETITIVE LAW

There are four main types of business practices that can have anticompetitive effects: practices undertaken by a single firm (when a firm enjoys a dominant position); anti-competitive mergers and acquisitions; horizontal restraints (i.e., arrangements between competitors to restrain competition) and vertical restraints (anti-competitive arrangements between firms along the production-distribution chain). Horizontal and vertical restraints include the following arrangements, which can be undertaken individually or in combination.

HORIZONTAL RESTRAINTS[A]

Price fixing	*Competing suppliers enter into cooperative agreements regarding prices and sales conditions.*
Restraint of output	*Competing suppliers enter into agreements regarding output and product quality.*
Market allocation	*Competing suppliers allocate customers amongst themselves, who therefore cannot benefit from competition by other suppliers.*
Exclusionary practices	*Competing suppliers employ practices that inhibit or preclude the ability of other actual or potential suppliers to compete in the market for a product.*
Collusive tendering	*Competing suppliers exchange commercially sensitive information on bids and agree to take turns as to who will make the most competitive offer.*

Conscious parallelism	*Competing suppliers generally set the same prices, but without an explicit agreement.*
Other restraints on	*Generally characterized by suppliers entering into cooperative agreements not to undertake certain actions of competitive value (e.g., advertising).*
	VERTICAL RESTRAINTS
Exclusive dealing	*A producer supplies distributors and guarantees not to supply other distributors in a given region.*
Reciprocal exclusivity	*A producer supplies on the condition that the distributor does not carry anybody else `s products.*
Refusal to deal	*A supplier refuses to sell to parties wishing to buy.*
Resale price maintenance	*A producer supplies distributors only on the condition that the distributor sells at a minimum price set by the supplier.*
Territorial restraint	*A supplier sells to distributors only on the condition that the distributor does not market the product outside a specified territory.*
Discriminatory pricing	*A supplier charges different parties different prices under similar circumstances.*
Predatory pricing	*Suppliers sell at a very low price (or supply intermediate inputs to competitors at excessive prices) in order to drive competitors out of business.*
Premium offers or	*A dominant supplier offers discounts or other inducements only to certain parties on the condition they do not sell someone else `s products.*
Tied selling	*Producers force purchasers to buy goods they do not want as condition to sell them those they do want, or force resalers or wholesalers to hold more goods than they wish or need.*
Full-line forcing	*A supplier requires distributors, for access to any product, to carry all of the supplier `s products.*
Transfer pricing	*May involve over-invoicing or under-invoicing of intermediate inputs between foreign affiliates. Under-invoicing can be used to facilitate predatory pricing.*

[a] *These may take the form of domestic cartels, import cartels, export cartels and international cartels.*

[Reproduced in World Investment Report 1997 from Boner, Roger Alan and Reinold Krueger, The Basics of Antitrust Policy : A Review of Ten Nations and the European Communities, World Bank Technical Papers Series No. 160, 1991]

GOVERNMENT POLICIES AND DISTORTIONS TO COMPETITION

Several government policies and regulations distort competition.

Many government polices and regulations designed to serve certain social and economic objectives tend to distort competition. Swaminathan S. Aiyar, has made a pointed reference to the plethora of law and rules in India that explicitly protect favoured players, reduce competition and give discretion in decision-making to politicians and bureaucrats in the name of public interest. He has observed that public interest is frequently and unabashedly invoked to protect one specific interest group (unionized labour, small-scale industries, handloom weavers) with no explanation of how or why the interest of this group transcends all others. He has provided the illustration of restrictive policies which impede competition like reservation of industries for the public sector (Coal, Railways, Postal services, Insurance, Petroleum etc.), canalisation of exports and imports through the public sector (Petroleum and some agricultural products), the jute packaging, order (compelling fertiliser and cement producers to use jute rather than plastic sacks resulting in leakage of material), reservation of items for the small-scale sector and reservation of items for the handloom sector in support of his contention that many Governmental policies are anti-competitive in character. He has also referred to the Industrial Disputes Act which makes it impossible to retrench labour or close units without government permission, even if the units are unviable and to the Urban Land Ceiling Act which inhibits competition in using urban land. In

the name of public interest, runs his further argument, protecting job leads to sacrifice of efficiency, raises potential costs and risks and discourages new investment. All Governmental policies will have to be viewed through the competition lens to ensure that consumer interest and welfare and economic efficiencies and development dimensions are not pejorated.[7]

It may be noted that the High Level Committee on Competition Policy and Law, appointed by Government of India, recommended removal of several such policy induced distortions as a precondition for competition policy.

Even policy measures aimed at promoting competition may have conflicting impacts. As an UNCTAD Report[8] observes, governments rely on several policy tools to ensure that their markets remain contestable and that competition in markets is maintained as far as possible, so that economic growth and welfare are not adversely affected by the inefficient allocation or use of resources. The tools of such policy include trade policy, FDI policy, regulatory policy with respect to domestic economic activity, and competition policy. While the first three comprise rules and regulations that serve several purposes and not only that of maintaining competition with a view to fostering efficiency, the last relates specifically to the rules and regulations – implemented by competition authorities — with respect to arrangements among firms/suppliers and the conduct of individual firm/suppliers, generally but not exclusively, in national markets. It is increasingly recognised that consistency and coherence between the different policies – some of which, as mentioned above, could serve competing objectives – are important. This is reflected in the fact that, in many developing countries, trade liberalisation, FDI liberalisation and domestic deregulation are currently taking place simultaneously. This ensures that the contestability and competition introduced by one set of policies are not undermined by another; but it also makes the pain of adjustment to competition, especially for hitherto protected domestic firms, a problem requiring attention and action by governments.

INTERFACE OF FDI AND COMPETITION LAW

As an UNCTAD Report points out, investment liberalisation and the adoption of competition laws have received impetus from the growth of regional free trade and integration agreements. The European Union, *for example,* includes the institution of a system for ensuring that competition is not distorted in the internal market as one of the means of attaining the basic goals of the Union. When NAFTA was created, Mexico introduced important reforms in its investment legislation and adopted a competition law comparable to that of its NAFTA partners. This process may receive further impetus in the future.

M&As, particularly international, can distort market structure and competition.

Cross-border M&As can pose severe threats to competition, both at the time of entry and subsequently. Indeed, the threat of monopoly or tight monopoly is potentially the single most important negative effect of cross-border M&As and therefore poses the single most important policy challenge. The challenge, more precisely, is to ensure that policies are in place to deal with those M&As that raise competitive concerns, and they are implemented effectively.[9] It may be noted that in the light of the growing M&As, countries like the United States have further strengthened their competition control system.

PREREQUISITES FOR A COMPETITION POLICY

Competition process is likely to run smoothly and thus lead to desirable results, only if several prerequisites are met. Micro-industrial Governmental policies that may support or adversely impinge on the application of competition policy, according to the High Level Committee on

Competition Policy and Law, would include the industrial policy; reservation for the small-scale industrial sector; privatisation and regulatory reforms; trade policy, including tariffs, quotas, subsidies, anti-dumping action etc.; state monopolies policy; and labour policy.

There could be serious conflicts between trade policy and competition policy. In this context, therefore, in respect of the above policies, the Committee held the view that the essence and spirit of competition should be preserved while positing the Competition Policy and seeking to harmonise the conflicts between Competition Policy and Governmental Policy. According to the Committee, the Industries (Development and Regulation) Act, 1951 may no longer be relevant except for a matter like regulation of location and environmental protection; there should be no reservation for the small-scale sector of products which are on Open General License (OGL) for imports and there should be a progressive reduction and ultimate elimination of reservation of products for the small-scale industrial and handloom sectors; the economic reforms of liberalisation, deregulation and privatisation need to be further progressed and should be so designed that they strengthen the Competition Policy and *vice versa*; all trade policies should be open, on-discriminatory and rule-bound and they should fall within the contours of the competition principles; all physical and fiscal controls on the movement of goods throughout the country should be abolished; Government should divest its shares and assets in State monopolies and public enterprises and privatise them in all sectors other than those subserving defence and security needs and sovereign functions; all State monopolies and public enterprises will be under the surveillance of Competition Policy to prevent monopolistic, restrictive and unfair trade practices on their part; any form of discrimination in favour of the public sector and Government commercial enterprises except where they relate to security concerns must be removed, while at the same time taking care not to create private monopolies out of public monopolies; the Industrial Disputes Act, 1947 and the connected statutes need to be amended to provide for an easy exit to the non-viable, ill-managed and inefficient units subject to their legal obligations in respect of their liabilities; structures like BIPR and the Sick Industrial Companies Act itself may be scrapped; concerns relating to trade dimensions *vis-à-vis* WTO agreements and principles need to be squarely addressed; Urban Land Ceiling Act should be repealed.

All the recommendations of the Committee apply to all industrial and professional enterprises including those in public and private sector.

The Committee suggested that the Government while enacting an appropriate Competition Law for the country needs to address the prerequisites as recommended above and that the pre-requisites will constitute a foundation over which the edifice of Competition Policy and Competition Law needs to be built.

CONTOURS OF COMPETITION POLICY

Noting that the focus for most Competition Laws today in the world is in the following three areas, the Committee centered its recommendations on the same.

- Agreement among enterprises
- Abuse of dominance
- Mergers or, more generally, Combinations among enterprises

Collusion and dominance (including M&As) have potential for unfair competition.

Agreement among Enterprises: Horizontal and Vertical agreements between firms have the potential of restricting competition. Horizontal agreements refer to agreements among competitors and vertical agreements to an actual or potential relationship of buying or selling to each other.

The Committee recommended that both these types of agreements should be covered by the Competition Law, if it is established that they prejudice competition. Horizontal agreements

relating to prices, quantities, bids (collusive tendering) and market sharing are particularly anti-competitive. Vertical agreements like tie-in arrangements, exclusive supply/distribution agreements and refusal to deal are also generally anti-competitive. Agreements that contribute to the improvement of production and distribution and promote technical and economic progress, while allowing consumers a fair share of the benefits should be dealt with leniently. Blatant price, quantity, bid and territory sharing agreements and cartels should be presumed to be illegal.

Abuse of Dominance: Dominance needs to be appropriately defined in the Competition Law in terms of "the position of strength enjoyed by an undertaking which enables it to operate independently of competitive pressure in the relevant market and also to appreciably affect the relevant market, competitors and consumers by its actions". The definition needs to be also in terms of "substantial impact on the market including creating barriers to new entrants". The Committee did not consider it desirable to prescribe any arithmetical figure like percentage of market share to define dominance, as a firm with a high market share may conduct business ethically if there is a strong and effective rival in the relevant market and likewise, a firm with a small market share may abuse its market power if its competitors diffusedly hold the remaining market share.

Abuse of dominance rather than dominance should be the key for Competition Policy/Law. Abuse of dominance will include practices like restriction of quantities, markets and technical development. Abuse of dominance which prevents, restricts or distorts competition needs to be frowned upon by Competition Law. Relevant market needs to be an important factor in determining abuse of dominance.

Predatory pricing which is defined as the situation where a firm with market power prices below costs so as to drive competitors out of the market is generally prejudicial to consumer interest in the long run. Instead of always taking an adverse view, it is desirable in the Committee's view that predatory pricing may be treated as an abuse, only if it is indulged in by a dominant undertaking.

By and large, abuse of dominance and exclusionary practices will need to be dealt with by the adjudicating Authority on the rule of reason basis.

Mergers: Mergers need to be discouraged, if they reduce or harm competition. The Committee, however, cautions against monitoring of all mergers by the adjudicating Authority, for the reason that very few Indian companies are of international size and that in the light of continuing economic reforms, opening up of trade and foreign investment, a great deal of corporate restructuring is taking place in the country and that there is a need for mergers, amalgamations etc. as part of the growing economic process before India can be on an equal footing to compete with global giants, as long as the mergers are not prejudicial to consumer interest.

It is in this context that the Committee recommended that mergers beyond a threshold limit in terms of assets should require pre-notification. The threshold limit suggested is the value of assets of the merged identity at ₹ 100 crore or more and of the group to which merged entity belongs at ₹ 2000 crore or more, both linked to Wholesale Price Index.

The Competition Law needs to be designed and implemented in terms of the contours enunciated above.

Competition Policy/Law needs to have necessary provisions and teeth to examine and adjudicate upon anti-competition practices that may accompany or follow developments arising out of the implementation of *WTO* Agreements. In particular, agreements relating to foreign investment, intellectual property rights, subsidies, countervailing duties, anti-dumping measures, sanitary and phytosanitary measures, technical barriers to trade and Government procurement need to be reckoned in the Competition Policy/Law with a view to dealing with anti-competition practices.

State monopolies, government's business policies and operations and the functioning of Regulatory Authorities should be scrutinised by competition law.

Furthermore, the Committee recommended as follows regarding State Monopolies, Regulatory Authorities, Government procurement, Foreign companies, Professions and Standards.

- The State Monopolies, Government procurement and foreign companies should be subject to the Competition Law. The Law should cover all consumers who purchase goods or services, regardless of the purpose for which the purchase is made.
- All decisions of the Regulatory Authorities can be examined under the touchstone of Competition Law by the Competition Commission.
- Bodies administering the various professions should use their autonomy and privileges for regulating the standard and quality of the profession and not to limit competition. In the competitive and globalised environment, there is need to encourage size, growth and international affiliation of professional firms. This should be encouraged and restraints should be removed.
- If quality and safety standards for goods and services are designed to prevent market access, such practices will constitute abuse of dominance/exclusionary practices.

COMPETITION ACT

The Competition Act, 2002, enacted in 2003, following the recommendation of the High Level Committee on Competition Policy and Law, is a landmark legislation that aims at promoting competition through prohibition of anti-competitive practices, abuse of dominance and regulation of combinations beyond certain sizes. Certain amendments to this Act were made in 2007 and 2009.

With the coming into effect of the Competition Act, 2002 from September 1, 2009, the Monopolies and Restrictive Trade Practices (MRTP) Act, 1969, was repealed and later the Monopolies and Restrictive Trade Practices Commission was replaced by Competition Commission of India (CCI). (See *Annexure 21.1* for a short description of the MRTP Act)

BOX 21.2: WHY A NEW LAW?

In early nineties, when Government of India undertook widespread economic reforms, Indian enterprises started facing the heat of competition from domestic players as well as from global giants, which called for level playing field and investor-friendly environment. It was felt that the existing Monopolistic and Restrictive Trade Practices Act, 1969 ("MRTP Act") was not equipped adequately enough to tackle the competition aspect of the Indian economy. Hence, need arose for a new Act, shifting the focus from curbing monopolies to encouraging companies to invest and grow, thereby promoting competition while preventing any abuse of market power. Thus, a new competition law, Competition Act, 2002 was enacted in 2003.

Source : *Dept. of Company Affairs, Annual Report 2010-11.*

The Competition Act, which extends to the whole of India except the State of Jammu and Kashmir, deals mainly with anti-competitive agreements, combinations and abuse of dominance and it provides for the establishment of a Competition Commission to control these.

Objective

According to the introductory paragraph of the Act, it is an Act to provide, keeping in view of the economic development of the country, for the establishment of a Commission to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interests of consumers and to ensure freedom of trade carried on by other participants in markets, in India, and for matters connected therewith or incidental thereto.

Main Provisions

Main provisions of the Act pertain to prohibition of anti-competitive agreements, prevention of abuse of dominant position and regulation of combinations. The Act also provides for the establishment of a Competition Commission to take care of these provisions and to protect the interests of consumers.

The Competition Act has essentially four components. The Act:

- Prohibits anti-competitive agreements like cartels, which restrict freedom of trade and cause consumer harm by way of limiting production and distribution of goods and services and fixing prices higher than normal.
- Prohibits abusive behaviour of a dominant firm, who through its position of dominance may restrict markets and set unfair and discriminatory conditions.
- Regulates mergers and acquisitions of large corporations in order to safeguard competitive markets.
- Mandates competition advocacy. (With the objective to create awareness on competition issues, the Commission organises interactive meetings, workshops and seminars, etc., with different regulatory bodies, policymakers, trade organisations, consumer associations and public at large.)

The Competition Act deals with anti-competitive agreements, abuse of dominant position and M&As detrimental to social interests.

All the four components are interrelated and form an integrated whole. The first three essentially relate to enforcement, while the last one is related to the mandate for promoting competition enshrined in Section 49 of the Act.

COMPETITION COMMISSION AND COMPETITION APPELLATE TRIBUNAL

The Competition Commission of India (CCI), established under the Competition Act, consisting of a Chairperson and six Members, became functional with effect from 1st March, 2009.

The following are the objectives of the Commission.

(a) To prevent practices having adverse effect on competition.

(b) To promote and sustain competition in markets.

(c) To protect the interests of consumers.

(d) To ensure freedom of trade.

The overarching aim of the Commission is to make markets work well for consumers using competition as the means. The Commission, in pursuance of its objectives, endeavours to do the following:

- Ensure fair and healthy competition in economic activities in the country for faster and inclusive growth and development of economy.
- Implement competition policies with an aim to effectuate the most efficient utilisation of economic resources.
- Develop and nurture effective relations and interactions with sectoral regulators laws in tandem with the competition law.
- Effectively carry out competition advocacy and spread the information on benefits of competition among all stakeholders to establish and nurture competition culture in Indian economy.

The CCI is the authority for the administration, implementation and enforcement of the Competition Act. Appeals against the directions/decisions of CCI may be made to the COMPAT.

The CCI is empowered for imposition of a penalty for contravention of its orders and in certain cases of continued contravention a penalty which may extend to rupees twenty-five crore or imprisonment which may extend to three years or with both.

The Government of India also set up a Competition Appellate Tribunal (COMPAT) on 19th October, 2009, under the provisions of the Competition Act, 2002, to hear and dispose of appeals against any direction issued or decision made or order passed by the Competition Commission of India.

The Competition Appellate Tribunal is empowered to adjudicate on claims for compensation and to pass orders for the recovery of compensation from any enterprise for any loss or damage suffered as a result of any contravention of the provisions of the Act.

For implementation of the orders of the Competition Appellate Tribunal as a decree of a civil court, an appeal against the orders of the Competition Appellate Tribunal can be filed to the Supreme Court.

ANTI-COMPETITIVE AGREEMENTS

The Act prohibits agreements in respect of production, supply, distribution, storage, acquisition or control of goods or provision of services, which causes or is likely to cause an appreciable adverse effect on competition within India.

According to the Act, agreements or decisions which have any of the following effects shall be presumed to have an appreciable adverse effect on competition:

(a) Directly or indirectly determining purchase or sale prices.

(b) Limiting or controlling production, supply, markets, technical development, investment or provision of services.

(c) Sharing the market or source of production or provision of services by way of allocation of geographical area of market, or type of goods or services, or number of customers in the market or any other similar way.

(d) Directly or indirectly resulting in bid rigging or collusive bidding, shall be presumed to have an appreciable adverse effect on competition.

Further, any agreement amongst enterprises or persons at different stages or levels of the production chain in different markets, in respect of production, supply, distribution, storage, sale or price of, or trade in goods or provision of services, shall be deemed as an agreement in contravention of the relevant provisions of this Act if such agreement causes or is likely to cause an appreciable adverse effect on competition in India. Such agreements include:

(a) tie-in arrangement;

(b) exclusive supply agreement;

(c) exclusive distribution agreement;

(d) refusal to deal;

(e) resale price maintenance.

ABUSE OF DOMINANT POSITION

Section 4 of the Competition Act lays down that no enterprise shall abuse its dominant position. Dominant position means a position of strength, enjoyed by an enterprise, in the

relevant market, in India, which enables it to: *(i)* operate independently of competitive forces prevailing in the relevant market; or *(ii)* affect its competitors or consumers or the relevant market in its favour.

The Competition Act prohibits agreements in respect of production or sale of goods and services having appreciable adverse effect on competition.

The following cases are regarded as an abuse of dominant position, *viz.,* an enterprise—

(a) directly or indirectly, imposes unfair or discriminatory —

(i) condition in purchase or sale of goods or service; or

(ii) price in purchase or sale (including predatory price, *i.e.,* price which is kept below the cost with a view to reduce competition or eliminate the competitors) of goods or services.

However, such discriminatory condition or price which may be adopted to meet the competition is excluded from the application of this Section.

(b) limits or restricts —

(i) production of goods or provision of services or market therefore; or

(ii) technical or scientific development relating to goods or services to the prejudice of consumers; or

(c) indulges in practice or practices resulting in denial of market access; or

(d) makes conclusion of contracts subject to acceptance by other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts; or

(e) uses its dominant position in one relevant market to enter into, or protect, other relevant market.

Division of Enterprise Enjoying Dominant Position: According to Section 28 of the Act, the Competition Commissions may order the division of the enterprise enjoying dominant position to ensure that such enterprise does not abuse its dominant position.

Such an order may provide for all or any of the following matters, namely:—

(a) the transfer or vesting of property, rights, liabilities or obligations;

(b) the adjustment of contracts either by discharge or reduction of any liability or obligation or otherwise;

(c) the creation, allotment, surrender or cancellation of any shares, stocks or securities;

(d) the formation or winding up of an enterprise or the amendment of the memorandum of association or articles of association or any other instruments regulating the business of any enterprise;

(e) the extent to which, and the circumstances in which, provisions of the order affecting an enterprise may be altered by the enterprise and the registration thereof;

(f) any other matter which may be necessary to give effect to the division of the enterprise.

Prevention of abuse of dominant position by firms is a very important objective of the Competition Act.

REGULATION OF COMBINATIONS

The Act provides for regulation of combination through mergers and acquisitions which causes or is likely to cause an appreciable effect on competition. The Competition Commission has the power to regulate mergers or combinations and to reverse mergers or combinations if it is of the opinion that a merger or combination has or is likely to have an 'Appreciable Adverse Effect' (AAE) on competition in India. The Competition (Amendment) Act, 2007 has mandated pre-merger clearances from CCI to ascertain whether a 'combination' has an 'AAE' on competition within India. Combinations include mergers, amalgamations and acquisition of control, shares, voting rights or assets.

POWER TO EXEMPT

The Central Government is empowered to exempt from the application of this Act, or any provision thereof, and for such period as it may specify:

(a) any class of enterprises if such exemption is necessary in the interest of security of the State or public interest;

(b) any practice or agreement arising out of and in accordance with any obligation assumed by India under any treaty, agreement or convention with any other country or countries;

(c) any enterprise which performs a sovereign function on behalf of the Central Government or a State Government, provided that in case an enterprise is engaged in any activity including the activity relatable to the sovereign functions of the Government, the Central Government may grant exemption only in respect of activity relatable to the sovereign functions.

SUMMARY

The economic liberalisation has increased the need for and relevance of competition policy and law because while the liberalisation unleashes competitive forces, in the absence of safeguards, this may also provide scope for unfair competition, like powerful competitors crushing small firms through unfair means, collusion, and M&As detrimental to competition. Further, there may still be some government policies like reservation for small business, trade restrictions, cross subsidisation, preferences in government procurements etc. which hamper competition.

Competition policy refers to the government policy designed to ensure contestability and fair competition by removing/preventing factors and forces that tend to distort fair competition.

The main objective of competition laws is to preserve and promote competition as a means to ensure the efficient allocation of resources in an economy, resulting in the best possible choice of quality, the lowest prices and adequate supplies for consumers. In addition to promoting efficiency, many competition laws make reference to other objectives, such as the control of concentration of economic power, promoting the competitiveness of domestic industries, encouraging innovation, supporting small and medium-size enterprises and encouraging regional integration.

Most competition laws deal with enterprise *behaviour* by prohibiting such restrictive business practices as competition-restricting horizontal agreements, acquisitions and abuses of dominant positions, as well as substantially restrictive vertical distribution agreements. In addition, an increasing number of competition laws deals with alterations to the *structure* of markets, through the control of M&As, as well as joint ventures aimed at avoiding the creation of dominant firms, monopolies, or even oligopolies. In some laws, the divestment of parts of monopolies is also authorised to change the structure of markets.[5]

According to the High Level Committee on Competition Policy and Law, appointed by Government of India, competition process is likely to run smoothly and thus lead to desirable results, only if several prerequisites are met. Micro-industrial Governmental policies that may support or adversely impinge on the application of competition policy would include the industrial policy; reservation for the small-scale industrial sector; privatisation and regulatory reforms; trade policy, including tariffs, quotas, subsidies, anti-dumping action etc.; state monopolies policy; and labour policy.

The focus for most Competition Laws in the world today being in the three areas, *viz.*, agreement among enterprises; abuse of dominance; mergers or, more generally, Combinations among enterprises, the Committee centred its recommendations on the same. Horizontal and Vertical agreements between firms have the potential of restricting competition. The Committee, therefore, recommended that both these types of agreements should be covered by the Competition Law.

The Committee felt that abuse of dominance rather than dominance should be the key for Competition Policy/Law. Abuse of dominance will include practices like restriction of quantities, markets and technical development. Abuse of dominance which prevents, restricts or distorts competition needs to be frowned upon by Competition Law. Relevant market needs to be an important factor in determining abuse of dominance.

The Committee which recommended that mergers need to be discouraged, if they reduce or harm competition, however, cautioned against monitoring of all mergers by the adjudicating Authority, for the reason that very few Indian companies are of international size and that in the light of continuing economic reforms, opening up of trade and foreign investment, a great deal of corporate restructuring is taking place in the country and that there is a need for mergers, amalgamations etc. as part of the growing economic process before India can be on an equal footing to compete with global giants, as long as the mergers are not prejudicial to consumer interest. It is in this context that the Committee recommended that mergers beyond a threshold limit in terms of assets should require pre-notification.

Competition Policy/Law needs to have necessary provisions and teeth to examine and adjudicate upon anti-competition practices that may accompany or follow developments arising out of the implementation of *WTO* Agreements. In particular, agreements relating to foreign investment, intellectual property rights, subsidies, countervailing duties, anti-dumping measures, sanitary and phytosanitary measures, technical barriers to trade and Government procurement need to be reckoned in the Competition Policy/Law with a view to dealing with anti-competition practices.

Furthermore, the Committee recommended that the State Monopolies, Government procurement and foreign companies should be subject to the Competition Law. The Law should cover all consumers who purchase goods or services, regardless of the purpose for which the purchase is made.

The Competition Act, **2002** is a landmark legislation that aims at promoting competition through prohibition of anti-competitive practices, abuse of dominance and regulation of combinations beyond a certain sizes. Certain amendments to this Act were made in 2007 and 2009.

The main provisions of the Competition Act pertain to prohibition of anti-competitive agreements; prevention of abuse of dominant position and regulation of combinations. The Act provides for the establishment of a Competition Commission and a Competition Appellate Tribunal to take care of these provisions and to protect the interests of consumers.

With the coming into effect of the Competition Act, 2002 from September 1, 2009, the Monopolies and Restrictive Trade Practices (MRTP) Act, 1969, was repealed and later the Monopolies and Restrictive Trade Practices Commission was replaced by Competition Commission of India (CCI).

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5. *Ibid.*, p. 190.
6. *Ibid.*, p. 190.
7. Cited by Chakravarthy, *op. cit.*, p. 393.
8. UNCTAD, *World Investment Report 1997*, p. 190
9. UNCTAD, *World Investment Report 2000*, p. xxvii.

ANNEXURE 21.1

MRTP Act

The principal law in India to deal with competition was the Monopolies and Restrictive Trade Practices Act, 1969. The MRTP Act, brought into force from 1st June 1970, was a very controversial piece of legislation. The High Level Committee on Competition Policy and Law, appointed by Government of India, recommended that a new Competition Act may be enacted and the MRTP Act may be repealed. The Government has accepted this recommendation. The MRTP Act, one of the most controversial pieces of legislation in India, has thus become a document of historical value. The salient features of this Act is given here because of the importance with which it reined the industrial sector of the country.

The main objectives of the Monopolies and Restrictive Trade Practices (MRTP) Act, 1969, the principal law in India to deal with competition, were: (1) Prevention of concentration of economic power to the common detriment, and (2) Control of monopolistic, restrictive and unfair trade practices which are prejudicial to public interest.

As a part of the economic reforms ushered in 1991, the MRTP Act was drastically amended by repealing the provisions of the Act pertaining to concentration of economic power, except the provisions empowering the Government to defuse concentration of economic power to the common detriment. In other words, the main thrust of the MRTP Act now is the achievement of prevention of monopolistic, restrictive and unfair trade practices. Thus, the 'M' has almost been knocked out of the MRTP Act. In other words, large companies have been freed from the MRTPA requirement of prior permission of the government for substantial expansion of existing undertakings, establishing new undertakings and M&As.

In accordance with the provisions of the Act, the Government of India had set up a Commission known as the Monopolies and Restrictive Trade Practices Commission. The MRTP Commission was vested with power to inquire into restrictive, monopolistic and unfair trade practices.

The MRTP Act empowered the Central Government to control and prohibit those monopolistic, restrictive and unfair trade practices that are, or are likely to be prejudicial to the public interest.

A monopolistic trade practice is a trade practice which has, or is likely to have, the effect of unreasonably preventing or lessening competition in the production, supply or distribution of any goods or services; limiting technical development and capital investment to the common detriment; or allowing the quality of goods or services to deteriorate.

A restrictive trade practice is a trade practice which has the effect, actual or probable of restricting, lessening or destroying competition. Such trade practices may tend to obstruct the flow of production or to bring about manipulation of prices or conditions of delivery etc. to the common detriment.

An unfair trade practice is a trade practice which, for the purpose of promoting the sale, use or supply of any goods or the provision of any services, adopts one or more unfair trade practices (like misleading advertisements) and thereby causes loss or injury to the consumers of such goods or services, whether by eliminating or restricting competition or otherwise.

The Act also empowered the Commission to make any undertaking or person to pay compensation to the party who suffered a loss or damage as a result of the unfair trade practice carried on by the undertaking or person.

The MRTP Act was severely criticised because of its growth defeating provisions. We had a very inept situation of not allowing Indian companies to grow by capacity expansion, establishment

of new units or by M&A and because of the short supply importing goods produced by foreign multinationals which were far larger in size than the Indian biggies, spending the scarce foreign exchange.

As mentioned earlier, the High Level Committee on Competition Policy and Law has recommended that a new law called the Indian Competition Act may be enacted and the MRTP Act may be repealed.

The MRTP Act, besides adversely affecting economic growth, blunted Indian companies' ability to grow, consolidate and improve competitiveness. This has had a very dampening effect on their global competitiveness.

BOX 21.3 : POLICY PARADOX

It is indeed a paradox that laws like the MRTP Act which were designed to prevent monopoly have in effect restricted competition. The MRTP Act has helped to protect the market position of the large houses by restricting the competition between the large houses.

It is quite evident that the restrictions on the big houses have had many adverse effects – they have retarded competition, decelerated growth in the industrial and consequently in other sectors, and contributed to the foreign trade gap. For example, in the early seventies, having failed to make any headway within India, the only alternative left for the Birlas was to set up firms in other countries and it put up several successful companies in all the ASEAN countries. "This was surely a paradox. The same government which refused us permission to set up manufacturing capacities within the country, allowed us to set up industries outside the country for the same products for which it had said no in India. Thus, we set up a viscose staple fibre plant in Thailand, and started exporting fibre back to India" (Aditya Birla, "State and Industry Must Work Together", Business India, 30th April 1988, p. 94.)

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Part 4

THE FINANCIAL SYSTEM

The characteristics of the financial system have important bearing on the business and economic development of the country. The State, through several promotional and regulatory measures, has been making a significant contribution towards the healthy development of the financial system.

The financial system of a nation consists of all those interdependent factors which promote, facilitate and regulate financial flows within the economy. These include:

- The financial intermediaries like banks, NBFIs and other financial service providers.
- Promotional and regulatory organisations like the central bank (RBI) and SEBI.
- Financial instruments like securities
- Facilitating markets like stock exchange, bill market and call money market.
- Laws and other regulations.

In other words, the financial system comprises of the financial markets and their functional mechanisms, including the promotional and regulatory factors. The financial market is made up, broadly, of two markets, *viz.,* the money market and the capital market.

Chapter 22

MONETARY AND FISCAL POLICIES

Structure

Monetary Policy
Fiscal Policy
Importance of the Budget
Summary

Monetary and fiscal policies can affect the levels of investment and consumption, i.e., the aggregate demand.

The Monetary and Fiscal Policies affect the financial sector and the economy in general. They can also be attuned to influence specific sectors or industries or segments.

The Monetary and Fiscal Policies have important influence on the Gross National Product (GNP).

GNP = C + I + G + X

where:

C = Private consumption expenditure

I = Private investment expenditure

G = Government expenditure

X = Net exports

Three of the components of the GNP, namely C, I and X can be influenced by the monetary policy which can also influence the private consumption and investment spendings and exports and imports.

The Government and the Central Bank (*i.e.*, the Reserve Bank, in India) make use of various fiscal and monetary weapons respectively to achieve stability and growth by influencing and regulating the behaviour of the various classes of spenders as savers, consumers and investors. In other words, the fiscal and monetary policies are also important determinants of business prospects and investment decisions. They can help make the overall economic situation and business prospects bright or check an unwarranted boom or unhealthy demand explosion. They can encourage investment and production in certain priority sectors and discourage them in the non-priority sectors. They are also capable of influencing technological choice and investment and production patterns. In short, the fiscal and monetary policies can influence the aggregate supply and demand and the associated level of employment, wages, interest, rent, prices and profit. Hence, the importance of monetary and fiscal policies.

BOX 22.1 : ₹ 5,376 CRORE BONANZA FOR CORPORATE SECTOR

The corporate sector was reported to be in for a ₹ 5,376 crore bonanza during the financial year 2001-02 due to the cuts in borrowing rates due to the reduction of the Bank Rate by one percentage point by the RBI and relief in direct and indirect tax proposed in the union budget for 2001-02.

A quick study by Business Standard Research Bureau, based on certain assumptions, covering 1025 companies has shown that they were likely to get a whopping ₹ 5,376 crore relief during financial year 2000 and 2001 on account of the above.

The major benefits for the corporates was estimated to come from the interest rate cuts. The 1025 companies were estimated to save ₹ 2, 733 crore from the reduction in their borrowing costs.

On removal of ten per cent surcharge on distributable dividend, the data available with BSRB has shown that 690 companies which paid dividend of ₹ 11,307 crore during 1999-2000 were likely to save ₹ 1,131 crore, assuming that they would maintain the rate of dividend distribution during 2001-02. The proposed removal of ten per cent surcharge on corporate tax would be another benefit for the corporate sector. The 1025 companies would save ₹ 1,072 crore annually on account of the cut. The benefits on account of removal of surcharge on custom duty has been estimated at about ₹ 440 crore.

Courtesy: *B.G. Shirsat, "Corporate Sector in for ₹ 5,376 Crore Bonanza", Business Standard, March 2, 2001.*

MONETARY POLICY

Monetary Policy refers to the use of instruments within the control of the Central Bank to influence the level of aggregate demand for goods and services or to influence the trends in certain sectors of the economy. Monetary policy operates through varying the cost and availability of credit, these producing desired changes in the assets pattern of credit institutions, principally commercial banks. These variations affect the demand for, and the supply of credit in the economy, and the level and nature of economic activities.

The cost and availability of credit can affect the level of demand and economic activities.

The modern economy is regarded as a credit economy in the sense that credit forms the basis of most of the economic activities in such an economy. The level and nature of economic activities such an economy, obviously, are influenced by the cost and availability of credit. The central bank's policies that affect the demand for and the supply of money, therefore, are very important to the industrial and commercial sectors. In a developed economy, credit forms a very important component of money supply.

Measures of Money Stock

A knowledge of the measures of money stock in an economy would help us to understand monetary policy better.

The Reserve Bank of India employs four measures of money stock, namely, M1, M2, M3 and M4.

M1: The measure of money stock designated by M1 is usually described as the money supply. The components of money supply are currency with the public (*i.e.,* notes in circulation, circulation of rupee coins and circulation of small coins) and deposits (demand deposits with banks and other deposits with the RBI).

Currency with the public forms less than half of the total money supply, whereas the demand deposits constitute more than 50 per cent of the money supply today.

In advanced countries, demand deposits form a major part of the money supply. In India, the proportion of the currency in money supply has been declining. Two decades ago, it formed about three-fourths as against less than 50 per cent today.

M2: M2 is M1 + Post Office Savings Bank Deposits.

M3: M3 is M1 + Time Deposits with the banks. In other words, M3 is money supply plus fixed deposits with the banks. M3 is usually referred to as aggregate monetary resources.

M4: M4 is M3 plus the total Post Office Deposits.

Monetary Policy and Money Supply

As has been mentioned earlier, money supply comprises currency with the public and demand deposits. Both the monetary and fiscal policies can affect money supply.

The budgetary operations of the Government considerably affect the money supply. If the Government meets its budgetary deficits by borrowing from the Reserve Bank, there will be an increase in money supply, both in currency and bank deposits. The RBI has no control over

budgetary operations, though it has opportunities of tendering advice to Government on this matter.

Another source of variation in money supply, over which the RBI's influence is restricted, is the country's international payments position.

Demand deposits are a very important determinant of money supply. As has already been mentioned above, in advanced countries demand deposits form a major part of money supply. In many developing countries, the proportion of demand deposits in money supply has been increasing. This is a trend associated with economic development and improvements in the bankisation and banking habits of the people.

Deposits with banks may originate in two ways through passive creation or active creation. The former occurs when banks open deposit accounts for customers against the receipt of value either in cash or cheques drawn on other banks. The latter takes place when banks create deposits by extending credits. In the first case, the immediate effect is that there is no addition to the quantum of money, though its distribution may undergo a change; but ultimately it enables the banks to extend credit and thus results in an increase in money. In the second instance, the supply of money is augmented immediately. When a bank extends credit, it would result partly in a rise in deposits either with itself or with other banking institutions. Under the fractional reserve system, the banks can create deposits by a multiple of the reserves, since the payments made with the proceeds of bank loans are eventually redeposited with banks, leading to additional reserve funds.

Central banking instruments of control operate by varying the cost and availability of credit, and these produce desired changes in the assets pattern of credit institutions, principally commercial banks. The item among banks' assets having special significance in this connection is the credit extended by banks to their constituents, which is the sum of what are usually called loans and discounts. The capacity of banks to provide credit depends on their cash reserves (comprising cash in hand and balances with the Reserve Bank), a substantial portion of the reserves being generally held in the form of balances with the Reserve Bank. These increase through a rise in the deposit resources of banks, or by their borrowing from the Reserve Bank, or by sale of their investments. The regulation of credit by the Reserve Bank in essence means regulation of the quantum of the reserves of banks. If the Bank desires to bring about an expansion in credit, it adopts measures to augment the banks' reserves. If credit is to be restricted, it attempts to curtail the reserves.

Instruments of Monetary Policy

The instruments of monetary policy (methods of credit control) may be broadly divided into:

- General (Quantitative) methods; and
- Selective (Quantitative) methods.

The general methods affect the total quantity of credit and affect the economy generally. The selective methods, on the other hand, affect certain select sectors. In other words, under the selective methods, certain qualitative distinctions are made between different sectors and segments of the economy; and selectivity is applied in regulating the flow of credit.

The statutory basis for the regulation of credit in India is embodied in the Reserve Bank of India Act and the Banking Regulation Act. The former Act confers on the Bank the usual powers available to central banks generally, while the latter provides special powers of direct regulation of the operation of commercial and cooperative banks.

General Credit Controls

There are three general or quantitative instruments of credit control, namely, the Bank Rate, Open Market Operations and Variable Reserve Requirements.

In considering the general methods of credit control, it is important to stress that these are closely interrelated and have to be operated in coordination. All the three instruments affect the level of bank reserves. Open Market Operations and the Reserve Requirements directly affect the reserve base, while the Bank Rate produces its impact indirectly by variations in the cost of acquiring the reserve.

General credit controls are indiscriminate in their application and effects.

The use of one instrument rather than another at any point of time is determined by the nature of the situation and the range of influence it is desired to wield as well as the rapidity with which the change is required to be brought about. Open Market Operations, for instance, are suited to carry out day-to-day adjustments on even the smallest scale. Changes in Reserve Requirements produce an impact at once and affect the banks generally. The effects of Bank Rate changes are not confined to the banking system and the short-term money market; they have wider repercussions on the economy as a whole.

Bank Rate Policy: The Bank Rate, also known as the Discount Rate, is the oldest instrument of monetary policy. The traditional definition of Bank Rate is that it is the rate at which the central bank discounts or, more accurately, rediscounts eligible bills. However, today, the term Bank Rate is used in a broader sense and refers to the minimum rate at which the central bank provides financial accommodation to commercial banks in the discharge of its function as the lender of the last resort.

The Bank Rate policy seeks to affect both the cost and availability of credit. The availability depends largely on the statutory requirements regarding the eligibility of bills for rediscounting, and securities for collateral for advances, as also the maximum period for which the credit is available.

As the central bank is the lender of the last resort, a commercial bank which is loaned up can obtain financial accommodation (*i.e.,* loan) from the central bank and re-lend it to its own customers.

Changes in the lending rate of the Central Bank (RBI) to commercial banks influences money supply and demand and price level.

An increase in the Bank Rate means an increase in the rate of interest charged by the central bank on its advances to commercial banks. Hence, an increase in the Bank Rate compels commercial banks to raise the rate of interest they charge on their loans and advances to their customers and *vice versa*.

The importance of the Bank Rate lies in the fact that it acts as a pace-setter to all the other rates of interests. In a well-developed money market, like the London Money Market, all the market rates quickly and effectively respond to a variation in the Discount rate.

An increase in the Bank Rate implies an increase in the cost of credit and *vice versa*. The demand for credit usually varies with the variation in the cost of credit. The central bank can,

therefore, hope to bring about a contraction in the money supply by raising the Bank Rate and an expansion in the money supply by lowering it.

As per the theory of Bank Rate, an increase in the Bank Rate reduces the extent of borrowings from the money market, the level of inventory holding, investment, employment and prices. A reduction in the Discount Rate has the opposite effects. The central bank may, therefore, attempt to contain an inflationary situation by raising the Bank Rate and fight a depression or recession by lowering it.

Open Market Operations: Open Market Operations refer broadly to the purchase and sale by the Central Bank of a variety of assets, such as foreign exchange, gold, Government securities and even company shares. In India, however, in practice, they are confined to the purchase and sale of Government securities.

Under the Open Market Operations, the central bank seeks to influence the economy either by increasing the money supply or by decreasing the money supply.

To increase the money supply, the central bank buys securities from commercial banks and public. For instance, if the Reserve Bank of India buys securities worth ₹ 100 crore, in the first instance, the reserves of the commercial banks and currency with the public will increase by ₹ 100 crore. However, the ultimate increase in money supply might be much more than this. When the central bank purchases securities from commercial banks, the increase in their reserves might result in a multiple credit creation. Sometimes, the purchase from the public may lead to an increase in the reserves of the banking system and credit expansion if the sellers of securities deposit the receipts with commercial banks. A sale of securities by the central bank has the opposite effects.

OMO is used to absorb excess liquidity or to increase money supply.

Open Market Operations have been employed by the Reserve Bank primarily to assist the Government in its borrowing operations and to maintain orderly conditions in the gilt-edged market. In this process, this instrument has been used to groom the market by purchasing securities nearing maturity to facilitate redemption and to make available on tap a variety of loans to broaden the gilt-edged market. As banker to the Government, it is the duty of the Reserve Bank to create in the gilt-edged market conditions that are favourable to the successful implementation of the Government's borrowing and refunding operations. On the other hand, the Government's loan operations themselves are so arranged as to be in harmony, as general stability of the money and capital markets. Open Market Operations have also been used to provide seasonal finance to banks. In the slack season, banks generally invest their surplus funds in Government securities, which they sell (or against which they borrow) during the busy season, in order to expand credit to industry and commerce, the Reserve Bank being generally ready to deal in these securities.

Variable Reserve Ratios: Commercial banks in every country maintain, either by the requirement of law or by custom, a certain percentage of their deposits in the form of balances with the central bank. The central bank has the power to vary this reserve requirement; and the variation in the reserve requirements affect the credit creating capacity of commercial banks. For instance, if the reserve requirement is 10 per cent, the maximum amount the bank can lend is equivalent to 90 per cent of the total reserves. If the reserve ratio is raised to 20 per cent, the bank cannot lend more than 80 per cent of the total reserves.

A small variation in the CRR causes substantial change in the money supply.

The Reserve Bank of India is empowered to vary the cash reserve ratio between 3 per cent and 15 per cent of the total demand and time liabilities. To facilitate the flexible operation of this system, the RBI has also been vested with the power to require the scheduled banks to maintain with it additional cash reserves, computed with reference to the excess of their total demand and time liabilities over the level of such liabilities on the base date to be notified by the Reserve Bank, subject to the proviso that the total reserve to be maintained with the Bank should not exceed 15 per cent of their demand, and time liabilities.

In March 2001, the Reserve Bank of India cut the CRR by half a percentage to 7.5 per cent and this was estimated to release over ₹ 4000 crore to the economy. This indicates the impact that variations in the CRR can have on the money supply and the economy.

Statutory Liquidity Ratio (SLR): Action has also been taken to prevent banks from offsetting the impact of variable reserve requirements by liquidating their Government security holdings. The Banking Regulation Act has been amended, requiring all banks to maintain a minimum amount of liquid assets which shall not be less than a certain specified percentage of their demand and time liabilities in India, exclusive of the cash balances maintained under Section 42 of the Reserve Bank of India Act in the case of schedule banks, and exclusive of the cash balances maintained under Section 18 of the Banking Regulation Act in the case of non-scheduled banks. This ensures that with every increase in the cash reserve requirements, the overall liquidity obligations are also correspondingly raised.

Selective Credit Regulation

Selective and qualitative credit control refers to regulation of credit for specific purposes or branches of economic activity. While general credit controls operate on the cost and total volume of credit, selective controls relate to the distribution or direction of available credit supplies. It may be mentioned here that some element of selectivity can be imparted to general credit controls also by giving concessions to priority sectors or activities. This has often been done in India.

The aim of selective controls is to discourage such forms of activity as are considered to be relatively inessential or less desirable. Selective credit controls have been used in the Western countries to prevent the demand for durable consumer goods outrunning the supply, and generating inflationary pressure. In the USA, they have been used to regulate stock market credit as well. In India, such controls have been used to prevent speculative hoarding of commodities like foodgrains and essential raw materials to check an undue rise in their prices. In addition to selective credit controls, many central banks have acquired powers of direct regulation of the total magnitude, as also the distribution of advances and investments of individual banks as well as of the entire banking system.

Selective credit controls are considered to be a useful supplement to general credit regulation. From available experience, it appears that their effectiveness is greatly enhanced when they are used together with general credit controls. They are designed specifically to curb excesses in selected area without affecting other types of credit. They attempt to achieve a reasonable stabilisation of the prices of particular commodities on the demand side, by regulating the availability of bank credit for purchasing and holding them. It should, however, be noted that prices are determined by the interaction of supply and demand, and that when supply is substantially short, what selective credit controls are likely to accomplish is to moderate the price rise rather than arrest the basic trend.

Selective credit controls target-specific sectors.

The Banking Regulation Act confers on the Reserve Bank the power to give directions to banking companies, either generally or to any banking company or group of banking companies in particular, as to—

(a) the purposes for which advances may or may not be made;

(b) the margin to be maintained in respect of secured advances;

(c) the maximum amount of advances or other financial accommodation which, having regard to the paid-up capital, reserves and deposits of a banking company and other relevant considerations, may be made by that banking company to any one company, firm, association of persons or individual;

(d) the maximum amount up to which, having regard to the considerations referred to in clause *(c)* guarantees may be given by a banking company on behalf of any one company, firm, association of persons or individual; and

(e) the rate of interest and other terms and conditions on which advances or other financial accommodation may be made or guarantees may be given.

The Reserve Bank is also empowered to issue, from time to time, to banking companies generally or to any banking company in particular, such directions as it deems fit in the public interest; or in the interest of banking policy; or to prevent the affairs of any banking company from being conducted in a manner detrimental to the interests of the depositors; or in a manner prejudicial to the interests of the banking company, or to secure the proper management of any banking company generally. The banking companies or the banking company, as the case may be, shall be bound to comply with such directions.

Further, the Reserve Bank may caution or prohibit banking companies generally or any banking company in particular against entering into any particular transaction or class of transactions, and generally give advice to any banking company.

From time to time, the Reserve Bank has asked banks in its circular letters to exercise caution in their lending in general as well as lending against the security of specified commodities and shares.

The techniques of selective credit controls used generally are:

(a) Minimum margins for lending against specific securities;

(b) Ceilings on the amounts of credit for certain purposes; and

(c) Discriminatory rates of interest charged on certain types of advances;

In India, selective credit controls are operated under all the three techniques. While imposing selective controls, care is generally taken to ensure that credit for production, the movement of commodities and exports, is not affected. Selective controls are focused mainly on credit to traders financing inventories.

Moral Suasion: In addition to the abovementioned methods of credit control, both quantitative and qualitative, it may be noted that the use has also been made in this country of moral suasion. Periodically, letters are issued to banks urging them to exercise control over credit in general or

advances against particular commodities or unsecured advances. Discussions are also held with bankers for the same purpose. Such discussions between the bank and commercial banks have been frequent. The RBI has been able to build up over the years good informal relations with banks. Moral suasion, backed as it is by the Bank's vast powers of direct regulation, has proved quite useful. The use of this instrument is facilitated by the concentration of banking business in the hands of the Government.

FISCAL POLICY

Fiscal Policy is that part of Government policy which is concerned with raising revenue through taxation and other means and deciding on the level and pattern of expenditure.

Budget is an instrument for resources mobilisation for government and resources reallocation in the economy.

The fiscal policy operates through the budget. The Budget is an estimate of Government expenditure and revenue for the ensuing financial year, presented to Parliament (in case of Union Budget) usually by the Finance Minister. Occasionally, in times of financial crisis, Interim Budgets may be introduced later in the year to increase taxation, expenditures, etc. Sometimes there may be slight modifications in taxation and expenditure without the formality of a revised budget.

THE UNION BUDGET

The Constitution of India provides that –

1. No tax can be levied or collected except by authority of law.
2. No expenditure can be incurred for public funds except in the manner provided in the Constitution.
3. The executive authorities must spend public money only in the manner sanctioned by Parliament in the case of the Union and by the State legislature in the case of a State.

An estimate of all anticipated revenue and expenditure of the Union Government for the ensuing financial year is laid before Parliament on the last working day of February every year. This is known as the Annual Financial Statement or the Budget and covers the Central Government's transactions of all kinds in and outside India during the year in which the statement is prepared as well as ensuing year, or the Budget year, as it is known.

All receipts and disbursements of the Union Government are kept under two separate headings, namely, the Consolidated Fund of India and the Public Account of India. All revenues received, loans raised and money received in repayment of loans by the Union Government form the Consolidated Fund. No money can be withdrawn from this Fund except under the authority of an Act of Parliament. All other receipts and disbursements, such as deposits, service funds and remittances go into the Public Account, which is not subject to the vote of Parliament. To meet unforeseen needs not provided in the Annual Appropriation Act, a Contingency Fund of India has also been established under Article 267(I) of the Constitution.

The presentation of the Annual Financial Statement is followed by a general discussion on the Budget in both the Houses of Parliament. The estimates of expenditure from the Consolidated

Fund of India are then placed before the Lok Sabha in the form of Demands for Grants. Ordinarily, a separate demand is made for each Ministry. All withdrawals of money from the Consolidated Fund are thereafter authorised by an Appropriation Act passed embodied in another Bill, which is passed as the Finance Act of the Year.

The receipts and expenditure of the Central and State Governments are audited by the Comptroller and Auditor-General who is independent of the executive, and his reports on the accounts are submitted to the President/Governor for having them laid before Parliament/State Legislature.

The Structure of the Budget

The Budget is divided vertically into revenue (receipts) and expenditure (disbursements). Horizontally, it is divided into revenue account and capital account. The receipts are, thus, broken up into Revenue Receipts and Capital Receipts; and disbursements are broken up into Revenue Expenditure and Capital Expenditure.

The revenue expenditure includes all current expenditure of the Government on administration, and the capital expenditure includes all the capital transactions of the Government.

The revenue receipts include revenue from taxes, while capital receipts include market loans, external aid, income from repayments and other receipts, such as income from public undertakings.

STATE BUDGETS

Like the Union Government, State Governments, too, have their own budgets. Estimates of receipts and expenditure are presented by the State Governments to their legislatures before the beginning of the financial year and legislative sanction of expenditure is secured through similar procedure.

As in the case of the Union Government, the Constitution has provided for the establishment of a Consolidated Fund, a Public Account and a Contingency Fund for each State.

FINANCES OF THE UNION AND STATES

The Constitution of India has earmarked separate sources of revenue for the Union and the States.

Sources of Revenue for the Union

The Union List in the Constitution includes the following revenue subjects:

1. Taxes on income other than agricultural income;
2. Duties and customs, including export duties;
3. Duties of excise on tobacco and other goods manufactured or produced in India, except alcoholic liquors for human consumption and opium, Indian hemp and other narcotic drugs and narcotics;
4. Corporation tax;

5. Taxes on the capital value of assets, exclusive of agricultural land, of individual companies; taxes on the capital of companies;
6. Estate duty in respect of property other than agricultural land;
7. Duties in respect of succession to property other than agricultural land;
8. Terminal taxes on goods of passengers carried by the railways, by sea, or air; taxes on railway fares and freight;
9. Taxes other than stamp duties on transactions on stock exchanges;
10. Rate of stamp duty on bills of exchange;
11. Taxes on sale or purchase of newspapers and on advertisements published therein;
12. Fees in respect of any of the matters in the Union List, but not including fees taken in any court;
13. Any tax not mentioned in the State List or Concurrent List.

Sources of Revenue for the State

The State List in the Constitution includes the following revenue subjects:

1. Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes and records of rights and alienation of revenue.
2. Taxes on agricultural income.
3. Duties in respect of succession to agricultural lands.
4. Estate duty in respect of agricultural land.
5. Taxes on lands and buildings.
6. Taxes on mineral rights, subject to any limitations imposed by Parliament by law relating to mineral development.
7. Duties of excise on the following goods manufactured or produced elsewhere in India: *(a)* alcoholic liquors for human consumption; *(b)* opium, Indian hemp and other narcotic drugs and narcotics.
8. Taxes on the entry of goods into a local area for consumption, use or sale therein.
9. Taxes on the consumption or sale of electricity.
10. Taxes on the sale or purchase of goods (other than newspapers).
11. Taxes on advertisements (other than those on newspapers).
12. Taxes on goods and passengers carried by road or inland waterways.

13. Taxes on vehicles, whether mechanically propelled or not, used on roads.
14. Taxes on animals and boats.
15. Tolls.
16. Taxes on profession, trades, callings and employment.
17. Capitation taxes.
18. Taxes on luxuries, including taxes on entertainment, amusements, betting and gambling.
19. Rates of stamp duty in respect of documents other than those specified.
20. Fees in respect of any of the matters in this list but not including fees taken in any court.
21. Fisheries.
22. Forests.
23. Irrigation, water storage and water power.

Concurrent List

The main revenue items in the Concurrent List under the Constitution are:

1. Stamp duties other than duties or fees collected by means of judicial stamps but including rates of stamp duty.
2. Fees in respect of any of the matters in this list but no including fees taken in any court.

The Finance Commission

The Finance Commission is a statutory body for recommending norms and principles of revenue sharing between the Union and States.

Under the Constitution of India, a Finance Commission is to be constituted every fifth year or at such earlier time as the President considers necessary to make recommendations to the President as to:

1. The distribution between the Union and States of the net proceeds of taxes which are to be or may be divided between the States of the respective shares of such proceeds;
2. The principles which should govern the grants-in-aid of the revenues of the State in need of such assistance out of the Consolidated Fund of India; and
3. Any other matters referred to the Commission by the President in the interest of sound finance.

The recommendation of the Commission, together with an explanatory memorandum as to the action taken thereon, are laid before each House of Parliament. The government accepted the recommendations of the Fourteenth Finance Commission (FFC) covering the period April 1, 2015 to March 31, 2020.

IMPORTANCE OF THE BUDGET

There is no other Government measure that affects the whole economy as the Budget. No wonder all sections of the people await the Annual Budget with mixed feelings – anxiety, fear and hope. The endeavour of the Finance Minister is to present a Budget which gives maximum support to forces that can move the country forward on the path of growth with stability and social justice. The Budget should set the stage for the achievement of economic and social goals.

The importance of functional finance and pump priming are recognised all over the world.

In India, today, about a half of the GDP is channelled into the Government sector by the Union, State and UT Budgets and disbursed by the Union, State and UT Governments under various development and non-development heads. These indicate the development and distributive importance and implications of the Budgetary operations.

There has been a steep increase in the Government expenditures, both in absolute and relative terms. The total budgetary expenditures (of the Centre, States and Union Territories) are about 50 per cent of the GDP today. The Central Government expenditures alone account for over one-fourth of the GDP today.

Gross capital formation out of the budgetary operations of the Central Government has increased substantially over the years. In a developing economy like India, the Budget policy has to serve the following purposes:

1. Accelerate the pace of economic development by mobilising resources for the public sector and their optimal allocation;
2. Effect improvement in production in the private sector in accordance with the national priorities;
3. Effect improvements in income distribution;
4. Promote exports and encourage import substitution; and
5. Achieve economic stabilisation.

Promoting growth with stability and justice and balancing the interests of different sections are the major challenges of fiscal policy.

To serve these purposes, apart from the judicious allocation of the budgetary resources, various fiscal incentives and disincentives are also employed by the Budget. An examination of the Budget Proposals will make these very clear.

Certain sectors or industries may be significantly impacted by the budget proposals like tax proposals or budgetary allocations. See Box 22.2.

BOX 22.2 : BUDGET BLUES

Car and two-wheeler companies announced an across-the-board cut in prices of their various models as a result of the eight per cent reduction in excise duty on passenger cars and two-wheelers announced in the Union Budget for 2001-2002. Prices of Hyundai Motor`s Santro have been slashed between ₹ 19,000-20,500. Rival Daewoo Motor`s Matiz will become cheaper by around ₹ 16,500 to ₹ 23,000 across its four variants, nationwide.

The impact of the excise reduction is being felt on the mid-size segment also. General Motors has announced a reduction in the prices of its cars, Opel I Astra and Corsa, ranging from ₹ 30,000-₹ 48,000 across all models including the Astra 2001 I and Corsa Royalle.

Honda Siel Cars India Ltd has slashed ex-showroom prices in Delhi of all its models in the range of ₹ 27,000 to ₹ 39,000.

Hindustan Motors` Contessa car will be priced ₹ 30,000 lower. Company sources also disclosed that the ex-showroom prices of the premium mid-size car Lancer, manufactured in collaboration with Mitsubishi Motors of Japan, have been reduced by ₹ 40,000 to ₹ 50,000. Even the old workhorse Ambassador will come cheap: it will cost almost ₹ 20,000 to ₹ 25,000 less.

In the two-wheeler segment, India`s largest motorcycle maker Hero Honda Motors today effected a ₹ 1,740-₹ 3000 price cut and predicted that it would exceed its ₹ 3,000 crore turnover target for this fiscal.

Courtesy: *Business Standard*, March 2, 2001.

In short, both monetary and fiscal operations have repercussions on the whole economy, affecting the price level, the balance of payments, the levels of industrial activity and employment. While the monetary policy influences economic trends, especially investment, through the cost and availability of credit, fiscal policy directly affects the financial resources and purchasing power in the hands of the public. In a country which has adopted a programme of planned economic development, in which the public sector has an important part to play, fiscal policy is concerned largely with effecting structural changes in the economy, while monetary policy aims at regulating investment in the private sector and short-run management of the economy. When economic objectives are set, both monetary and fiscal policies should aim at achieving these objectives. If they are to be successful, a close coordination of monetary and fiscal policies is necessary, for they are complementary and not competitive.

SUMMARY

The Monetary and Fiscal Policies are two important instruments employed by the authorities to influence the behaviour and performance of the financial sector and the economy in general. They may also be used to influence specific sectors or industries or segments. In other words, the fiscal and monetary policies are also important determinants of business prospects and investment decisions. They can help make the overall economic situation and business prospects bright or check an unwarranted boom or unhealthy demand explosion. They can encourage investment and production in certain priority sectors and discourage them in the non-priority sectors. They are also capable of influencing technological choice and investment and production patterns.

Monetary Policy refers to the use of instruments within the control of the monetary authority (*i.e.,* the Central Bank of the country – the Reserve Bank of India) to influence the level of aggregate demand for goods and services or to influence the trends in certain sectors of the economy. Monetary policy operates through varying the cost and availability of credit. These variations affect the demand for, and the supply of credit in the economy, and the level and nature of economic activities.

There are, broadly, two instruments of monetary policy (methods of credit control), *viz.,* General (Quantitative) methods; and Selective (Qualitative) methods.

The general methods affect the total quantity of credit and the economy generally. There are three general or quantitative instruments of credit control, namely, the Bank Rate, Open Market Operations and Variable Reserve Requirements.

The Bank Rate, also known as the Discount Rate, refers to the minimum rate at which the central bank provides financial accommodation to commercial banks in the discharge of its function as the lender of the last resort. The lending rate of the commercial banks increase or decrease in accordance with the Bank Rate. The variation in the lending rate affects the demand for credit and, thereby, the money supply. Open Market Operations refer broadly to the purchase and sale by the central bank of a variety of assets, such as foreign exchange, gold, Government securities and even company shares. Under the Open Market operations, the central bank seeks to influence the economy either by increasing the money supply or by decreasing the money supply. To increase the money supply, the central bank buys securities from commercial banks and public. A sale of securities by the central bank will have the effect of reducing the money supply. Commercial banks in every country maintain, either by the requirement of law or by custom, a certain percentage of their deposits in the form of balances with the central bank. The central bank has the power to vary this reserve requirement; and the variation in the reserve requirements affects the credit creating capacity of commercial bank.

In considering the general methods of credit control, it is important to stress that these are closely interrelated and have to be operated in coordination. All the three instruments affect the level of bank reserves. Open Market Operations and the Reserve Requirements directly affect the reserve base, while the Bank Rate produces its impact indirectly by variations in the cost of acquiring the reserve. The use of one instrument rather than another at any point of time is determined by the nature of the situation and the range of influence it is desired to wield as well as the rapidity with which the change is required to be brought about.

The selective methods are intended to affect certain select sectors. In other words, under the selective methods, certain qualitative distinctions are made between different sectors and segments of the economy; and selectivity is applied in regulating the flow of credit. While general credit controls operate on the cost and total volume of credit, selective controls relate to the distribution or direction of available credit supplies. The aim of selective controls is to discourage such forms of activity as are considered to be relatively inessential or less desirable.

The Fiscal Policy is that part of Government policy which is concerned with raising revenue through taxation and other means and deciding on the level and pattern of expenditure.

The fiscal policy operates through the budget. The Budget is an estimate of Government expenditure and revenue for the ensuing financial year, presented to Parliament (in case of Union Budget) usually by the Finance Minister.

The Budget is divided vertically into revenue (receipts) and expenditure (disbursements). Horizontally, it is divided into revenue account and capital account. The receipts are, thus, broken up into Revenue Receipts and Capital Receipts; and disbursements are broken up into Revenue Expenditure and Capital Expenditure.

The revenue expenditure includes all current expenditure of the Government on administration, and the capital expenditure includes all the capital transactions of the Government.

The revenue receipts include revenue from taxes, while capital receipts include market loans, external aid, income from repayments and other receipts, such as income from public undertakings.

Like the Union Government, State Governments, too, have their own budgets.

The Constitution of India has earmarked the sources of revenue for the Union and States. Further, under the Constitution of India, a Finance Commission is to be constituted every fifth year or at such earlier time as the President considers necessary to make recommendations to the President as to the distribution between the Union and States of the net proceeds of taxes which are to be or may be divided between the States of the respective shares of such proceeds; the principles which should govern the grants-in-aid of the revenues of the State in need of such assistance out of the Consolidated Fund of India; and any other matters referred to the Commission by the President in the interest of sound finance.

The Budget should strive to give maximum support to forces that can move the country forward on the path of growth with stability and social justice. The Budget should set the stage for the achievement of economic and social goals.

Certain sectors or industries may be significantly impacted by the budget proposals like tax proposals or budgetary allocations. The business community, therefore, awaits the budget with a lot of anxiety.

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Chapter 23

FINANCIAL MARKET STRUCTURE

Structure

Constituents of Financial Market

Summary

Reference

CONSTITUENTS OF FINANCIAL MARKET

The Indian financial market comprises, in the main, the:

- Credit market
- Money market
- Capital market
- Foreign exchange market
- Debt market
- Derivatives market.

Besides the above, there are also some markets like the household finance market, NBFC market, and insurance market which hold considerable promise in the years to come. These markets are not yet as developed and regulated as the credit/foreign exchange/money/capital/gilt-edged markets. With banks having already been allowed to undertake insurance business, bancassurance market is also likely to emerge in a big way.[1]

Financial sector reforms from the early 1990s deepened and widened the market, imparted dynamism and improved transparency and governance.

Most of the financial markets were characterised till the early nineties by controls over the pricing of financial assets, restrictions on flows or transactions, barriers to entry, low liquidity and high transaction costs. These characteristics came in the way of developments of the markets and allocative efficiency of resources channelled through them. The initiation of financial sector reforms in the early nineties was essentially to bring about a transformation in the structure, efficiency and stability of financial markets, as also an integration of the markets. Some of the important structural changes enabled by financial sector reforms relate to introduction of free pricing of financial assets in almost all segments, relaxation of quantitative restrictions, removal of barriers to entry, new methods of floatation/issuance of securities, increase in the number of instruments and enlarged participation, improvement in trading, clearing and settlement practices, improvement in the informational flows, transparency and disclosure practices, to name a few.

This chapter provides a brief account of the market structures and some instruments of the financial sector, *viz.*, the credit market, the foreign exchange market, the debt market, the money and capital markets and the recently established derivatives market are dealt with separately in the subsequent chapters.

Credit Market

The credit market is the predominant source of finance. As the Indian capital market is relatively underdeveloped, firms or economic entities depend largely on financial intermediaries for their fund requirements. In terms of sources of credit, they could be broadly categorised as institutional and non-institutional.

The major institutional purveyor of credit in India are banks and non-banking financial institutions, *i.e.,* development financial institutions (DFIs) and other financial institutions (FIs) and non-banking financial companies (NBFCs) including housing finance companies (HFCs).

The non-institutional or unorganised sources of credit include moneylenders, indigenous bankers and sellers for trade credit.

An important aspect of the credit market is its term structure, *viz.*, *(i)* short-term credit, *(ii)* medium-term credit, and *(iii)* long-term credit. While banks and NBFCs predominantly cater to short-term needs, FIs provide mostly medium- and long-term funds.

Banks: Banks in India can be broadly classified as commercial banks and cooperative banks. In terms of ownership and function, commercial banks can be grouped into three categories — public sector banks, regional rural banks and private sector banks (both domestic and foreign). These banks have a very large member of branches spread wide across the country. After initiation of financial sector reforms, competition in the banking sector has increased. As result of the removal of restrictions on project financing, the share of term loans as percentage of total bank loans went up considerably.

An important development in the financial sector in the recent years has been the diversification and growth of *para-banking* activities such as, leasing, hire purchase, factoring, *etc.* The reasons for banks entering para-banking activities include the need for diversifying earnings, maximising economies of scale and scope, making profits, and also the desire to have leading market positions in financial services. Following the erstwhile UK model, in India, these diversified financial activities are undertaken mostly by subsidiaries of banks.

Underdeveloped nature of the credit market makes the role of financial intermediation particularly important.

Merchant banking is an important area where subsidiaries of banks have made their presence felt. Merchant banking includes services such as pre-issue, management of public issue, *etc.,* and as such is dependent on the conditions in the stock market.

The dealing in government securities is another area where banks have been fairly active. Venture capital is a new area where banks have entered. Many banking subsidiaries, are also quite active in the field of housing finance. Banking subsidiaries are also operating in the credit card business.

There is a shared responsibility between the Reserve Bank and SEBI in the regulation of para-banking activities of banks. In India, a prudential regulatory framework based on capital adequacy is in place in the case of para-banking subsidiaries as well.

Financial Institutions: A large variety of financial institutions has come into existence over the years to perform a variety of financial activities. While some of them operate at all-India level, others are state level institutions. All-India financial institutions (AIFIs) consist of all-India development banks, specialised financial institutions, investment institutions and refinance institutions. The state level institutions, on the other hand, comprise a number of State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs).

All-India development banks (IDBI, IFCI, ICICI, SIDBI and IIBI) occupy an important position in the financial system as the main source of medium- and long-term project finance to industry. Besides, specialised financial institutions are also operating in the areas of export-import (EXIM Bank, infrastructure (IDFC), tourism (TFCI) and venture capital (IVCF, ICICI Venture). Investment institutions in the business of mutual fund (UTI) and insurance activity (LIC, GIC and its subsidiaries) have also played significant roles in the mobilisation of household sector savings and their deployment in the credit and the capital markets. In the agriculture and rural sector and the housing sector, the NABARD and NHB respectively, are acting as the chief refinancing institutions. Both of them are also vested with certain supervisory functions.

Besides providing direct loans (including rupee loans, foreign currency loans), financial institutions also extend financial assistance by way of underwriting and direct subscription and by issuing guarantees. Recently, some development financial institutions (DFIs) have started extending short-term/working capital finance, although term-lending continues to be their primary activity.

Non-banking Financial Companies (NBFCs): Non-banking financial companies (NBFCs) are financial intermediaries engaged primarily in the business of accepting deposits and making loans and advances, investments, leasing, hire purchase, *etc.* NBFCs are a heterogeneous lot. NBFC sector is characterised by a large number of privately owned, decentralised and relatively small-sized financial intermediaries. NBFCs are of various types, such as, loan companies (LCs), investment companies (ICs), hire purchase finance companies (HPFCs), equipment leasing companies (ELCs),

There are different categories of institutions catering to the varied financial requirements of different sectors and sections.

mutual benefit financial companies (MBFCs) also known as Nidhis, miscellaneous non-banking companies (MNBCs) also known as Chit Funds and residuary non-banking companies (RNBCs). Loan companies, investment companies, hire purchase finance companies and equipment leasing companies are defined on the basis of the principal activity of their business. Although NBFCs in India have existed for a long time, they shot into prominence in the second half of the eighties and in the first-half of the nineties, as deposits raised by them grew rapidly. Customer orientation, concentration in the main financial centres and attractive rates of return offered by them are some of the reasons for their rapid growth. Primarily engaged in the area of retail banking, they face competition from banks and financial institutions.

Housing Finance Companies (HFCs): In India, investment in housing is mainly financed by own sources or from informal credit market. The formal housing finance institutions contribute only a small percentage of housing investments in the country. However, within the formal housing finance sector, the conventional sources of housing finance in India have been the public sector institutions. Over the years, they were found to be grossly inadequate to meet the requirements of the new investments and maintenance of housing and habitat systems. Accordingly, since the mid-eighties, efforts have been directed at the development of housing finance institutions to meet the large resource gap that exists for housing finance in the country. A policy shift to encourage private and cooperative sectors in housing could be discerned and the necessary legal and regulatory changes are being effected in this regard.

The formal segment of housing finance includes funding provided by the Central and State Governments and funds from financial institutions like GIC, LIC, commercial banks, specialised housing finance institutions and cooperative banks. HUDCO was set up in April 1970 as an apex techno-finance organisation in order to provide loans and technical support to state and city level organisations. The State Governments are responsible for implementing social housing schemes. Almost all the States have set up Housing Boards in order to facilitate the implementation of the social housing schemes. Cooperative banks have been financing housing schemes. Cooperative banks cater to economically weaker sections, low and middle income groups as well as cooperative or group housing societies. The second formal tier of the housing finance consists of insurance corporations, commercial banks and housing finance companies.

In recognition of the need for developing a network of specialised housing finance institutions in the country, the National Housing Bank was set up in July, 1988 as a wholly owned subsidiary of the Reserve Bank under the National Housing Bank Act, 1987, to function as an apex bank for the housing finance. NHB regulates HFCs, refinances their operations and expands the spread of housing finance to different income groups all over the country, while functioning within the overall framework of the housing policy. It has also helped in diverting increasing proportions of annual provident fund accumulations for housing finance through housing linked savings schemes for provident fund subscribers.

Foreign Exchange Market

The foreign exchange market in India comprises customers, authorised dealers (ADs) and the Reserve Bank.

With the transition to a market determined exchange rate system in March 1993 and the subsequent gradual but significant liberalisation of restrictions on various external transactions, the forex market in India has acquired more depth.

The Indian forex market has grown in depth in the 1990s as a result of the implementation of a number of recommendations of three important committees, *viz.,* the High Level Committee on Balance of Payments (Chairman: Dr. C. Rangarajan), the Report of the Expert Group on Foreign Exchange Markets in India (Chairman: Shri O.P. Sodhani) and the Committee on Capital Account Convertibility (Chairman: Shri S.S. Tarapore).

Since the unification of the exchange rate in March 1993, several measures have been introduced to widen and deepen the forex market. First, banks have been given the freedom to: *(i)* fix net overnight position limits and gap limits (with the Reserve Bank formally approving the limits), *(ii)* initiate trading position in the overseas markets, *(iii)* determine the interest rates of NRI deposits (linked to LIBOR in the case of FCNR(B) deposits) and maturity period [minimum maturity of one year in the case of FCNR(B) deposits]. Secondly, inter-bank borrowings have been exempted from statutory pre-emptions. Thirdly, banks have been permitted the use of derivative products for asset-liability management. Fourthly, in order to facilitate integration of domestic and overseas money markets, ADs have been allowed to borrow abroad. However, as a prudential measure, their external borrowings have been related to their capital base. Fifthly, corporates have been provided significant freedom in managing their foreign exchange exposures. They are permitted to hedge anticipated exposures, though this facility has also been temporarily suspended after the Asian crisis. Exchange Earners' Foreign Currency (EEFC) account entitlement has also been rationalised. Risk management strategies like freedom to cancel and rebook forward contracts have been allowed to corporates. Other risk management tools like cross-currency options on back-to-back basis, lower cost option strategies like range forwards and ratio range forwards and hedging of external commercial borrowing (ECB) exposures have been allowed subject to prudential requirements.

The increase in foreign investment, both FDI and FPI, has imparted considerable dynamism to the forex market.

The customer segment of the spot market in India essentially reflects the transactions reported in the balance of payments. Although as percentage of GDP, gross inflows and outflows have not increased significantly, in absolute value terms, there has been a twofold increase in the merchant transactions in the nineties. Current transactions, however, continue to dominate the capital transactions. The merchant segment of the market continues to be dominated by select public sector units, in particular, the Indian Oil Corporation (IOC), and the Government of India. In the post-1993 period, the foreign institutional investors (FIIs) have also emerged as major players in the foreign exchange market with some evidence of links between the FII flows and the behaviour of the exchange rate.

There has been a considerable improvement in the forex market turnover in the recent years, particularly during the post-reform period.

In the Indian forex market, which is essentially transactions driven, inter-bank transactions in the spot segment mostly facilitate market making. At times, however, inter-bank transactions also reflect the "day trading" pattern. With restrictions on overnight overbought and oversold positions, day trading allows one to benefit from the intra-day exchange rate movements without violating the close of the day position limits. During normal market conditions, the ratio between inter-bank and merchant transactions should be somewhat stable. In the face of disorderly conditions, tendency for day trading may increase and, as a result, the ratio may increase. Whenever the Indian rupee was under pressure, the ratio of inter-bank spot transactions to merchant transactions tended to exceed the average, suggesting that day trading activities increase during volatile market conditions.

India is one of the largest holders of forex reserves in the world.

In the forward/swap segment of the market, importers and corporates generally tend to rush for cover when the spot market turns disorderly and prefer to keep their positions open during stable market conditions. This creates occasional large mismatches in the forward segment of the market. If merchant sale in the forward segment is used as a proxy for forward demand by importers and merchant purchase in the forward segment is used as a proxy for supplies by exporters in the forward market, then the ratios of monthly forward demand to monthly imports and monthly forward supply to monthly exports could explain the sensitivity of exporters and importers to forward market in India. Two-way movement in the exchange rate is essential to increase the sensitivity of exporters and corporates to the forward market.

RBI intervenes to maintain orderly conditions in the forex market.

Initiation of longer maturity contracts up to one year represents another healthy development in the forex market.

The Reserve Bank's presence in the market essentially reflects its policy of ensuring orderly market conditions. Reflecting its stance, net intervention sales of the Reserve Bank generally coincided with conditions of excess demand in the market, while net intervention purchases coincided with surplus market conditions and contributed to reserve build-up.

Debt Market

The domestic debt market comprises two main segments, *viz*., the Government securities and other (mainly corporate) securities comprising private corporate debt, PSU bonds and DFIs' bonds. The government securities market is predominant, while the other segment is not very deep and liquid.

Government Securities Market: The size of the Government securities market is large and growing.

The Government securities market witnessed significant transformation in the 1990s. Its development was constrained mainly by lack of definite limits on the automatic monetisation of the Central Government budget deficits and by relatively low coupon rates offered on the Government securities. The artificially low yield on Government securities had an impact on the entire yield structure of financial assets in the system. Both these factors were corrected during the nineties. As regards the secondary market, there was not much activity which was hindered by low bond yields and predominance of captive investors. The secondary market activity increased following the introduction of auction-based yields. The activity in the secondary market could further pick up once bond yields are better aligned and investors, other than institutions (banks and insurance companies) start actively transacting in the market.

As a part of developing money market instruments, a variety of Treasury bills, *viz*., 14-day, 91-day, 182-day, 364-day maturities have been introduced. Innovations have also been introduced with respect to long-term bonds, which include zero coupon bonds, floating rate bonds and capital indexed bonds.

The government securities market is a major component of the Indian debt market.

The main investors in the Government securities market in India are commercial banks, cooperative banks, insurance companies, provident funds, financial institutions (including term-lending institutions), mutual funds especially the gilt funds, primary dealers, satellite dealers, non-bank finance companies and corporate entities. The Reserve Bank also absorbs primary issuance of Government securities, either through private placement or devolvement. Though banks have traditionally been the dominant investors in the Government securities due mainly to SLR requirements, they have, in recent years, found it advantageous to invest in the Government securities beyond the statutory requirements partly because of the better risk-return characteristic of such securities in the context of adherence to capital adequacy requirements and partly because of relatively sluggish demand for commercial credit.

A large participant base reduces the borrowing cost for the Government, reduces market volatility and imparts competition in the market. A market with adequate depth and liquidity for participants with different perceptions and liquidity requirements should emerge; this is also essential to avoid unidirectional movements in the market. The present structure of the Government securities market is predominantly institutional, while the household participation is negligible or nearly absent. Foreign Institutional Investors (FIIs) are also permitted to invest in the dated Government securities and Treasury bills, both in the primary and secondary markets, within the overall debt ceilings.

A crucial issue in the development of the Government securities market is the need for a well functioning secondary market, which requires: *(i)* a transparent system of trading; *(ii)* a secure system of settlement of transactions; *(iii)* an institutional structure whereby the market players have

divergent perceptions about liquidity and interest rates; and *(iv)* a liquid market with a matured system of price determination. To develop the secondary market for the Government securities, the following measures were initiated.

Secondary Market Window: The central banks often play the role of market makers providing two-way quotes through their sales window to infuse liquidity in the secondary market for the Government securities. Generally, two approaches are adopted for operating the secondary market window by the central banks: *(i)* fixing buying and selling prices and announcing them to the market, and *(ii)* using a dynamic approach whereby the secondary market window pricing is continuously adjusted in response to the market dynamics. During the initial stages of market development, the Reserve Bank used to announce the sale and purchase prices of securities. In the recent period, however, the Reserve Bank has offered a select list of securities for sale, depending upon supply and demand conditions. A few securities are also included in the purchase list, with a view to improving liquidity through select securities. The sale/purchase prices and the securities offered on sale are frequently revised.

Discount House Arrangements: The DFHI was originally set up in April 1988 for developing the money market. It was also allowed to participate in Treasury bills and dated securities. Further, for developing an efficient institutional infrastructure for an active secondary market in Government securities and public sector bonds, the Securities Trading Corporation of India (STCI) was set up in May 1994. Both DFHI and STCI later transformed themselves into PDs.

Primary Dealer System: The primary dealer system was evolved and made functional in 1996 with the objective of strengthening the securities market infrastructure and bringing about improvement in the secondary market trading, liquidity and turnover in Government securities as also encouraging their voluntary holding amongst a wider investor base. PDs have ensured maximum participation in the auctions of Government securities. In the secondary market, they act as market makers by providing continuous two-way quotes thereby ensuring liquidity and support to the success of primary market operations. The system also creates appropriate conditions for open market operations of the Reserve Bank and facilitates the transfer of market-making activities from the Reserve Bank to the market agents.

Satellite Dealers: With a view to broadening the market with a second tier of dealer system in trading and distribution and imparting greater momentum in terms of increased liquidity and turnover, a system of SDs was put in place in December 1996. The network of satellite dealers provides retail outlets thereby encouraging voluntary holding of Government securities among a wide investor base. The SDs are also given limited liquidity support from the Reserve Bank.

RBI has taken several initiatives for the orderly development of the Indian debt market.

Gilt Funds: The Reserve Bank also encouraged setting up of mutual funds dealing exclusively in gilts, called gilt funds with a view to encouraging schemes of mutual funds dedicated to Government securities and creating a wider investor base for them. Mutual funds dedicated exclusively to investment in Government securities are also provided liquidity support by the Reserve Bank by way of reverse repos in Central Government securities outstanding at the end of the previous calendar month.

The market efficiency is significantly influenced by the transaction costs or costs of trading. The transaction costs are, in turn, determined by the type of trading, clearing and settlement system existing in a market. A well developed market in Government securities requires a system of transparent pricing and allotment, which, in a special sense, refers to information needs. In turn, such a system would imply active market-making activity and broad-based participation. The National Stock Exchange (NSE) introduced a transparent screen-based trading system in the wholesale debt market, including Government securities in June 1994. The trading system known as National Exchange for Automated Trading (NEAT) is a fully automated screen-based trading system. The Over the Counter Exchange of India (OTCEI) also started trading in Government securities in July 1997. However, a major part of government securities transaction in the secondary market is operated through over-the-counter negotiated deals. The brokers, who are members of

the NSE and OTCEI, can transact business on behalf of commercial banks. The OTCEI and NSE markets complement each other. As announced in the Mid-term Review of Monetary and Credit Policy for 2000-01, the Reserve Bank has taken an in-principle decision to move over in due course to order-driven screen-based trading in Government securities on the stock exchanges. The screen-based trading system would be applicable to all stock exchanges on which banks and FIs can operate.

Clearing System: The presence of a fast, transparent and efficient clearing system constitutes the basic foundation of a well developed secondary market in Government securities. In India, a major step in this direction was the establishment of the DvP system. The Reserve Bank presently operates a Government securities settlement system for those having Subsidiary General Ledger (SGL) Accounts in its Public Debt Offices through DvP System. The DvP system ensures settlement by synchronising the transfer of securities with the cash payment. This reduces settlement risk in securities transactions and also prevents diversion of funds through SGL transactions.

Other Debt Markets: The corporate debt market still constitutes a small segment of the debt market despite policy initiatives taken during the nineties. The interest rate ceiling on corporate debentures was abolished in 1991 paving the way for market-based pricing of corporate debt issues. In order to improve the quality of debt issues, all publicly issued debt instruments, irrespective of their maturity, are presently required to be rated. The role of trustees in case of bond and debenture issues has also been strengthened over the years.

A large proportion of corporate debentures in India is of hybrid variety combining features of both debt and equity. The corporate sector has been issuing debt instruments of longer maturity, incorporating features of liquidity and often at floating rates of interest. Besides the public issue of debt instruments, the private placement route has also emerged as an important mode of floatation of new corporate debt issues during the nineties. Some privately placed debt instruments are subsequently listed on stock exchanges for trading.

DFI bonds have emerged as an important segment of the debt market. During the last 8 years or so, DFIs made large issues of bonds in varying maturity ranging from 1 year to as long as 20 years. Some of the bond issues of DFIs offered innovative features including call and put options at various points of time during the currency of the bonds. DFIs have issued bonds by way of public issues as well as on a private placement basis.

Since the middle of the eighties, long-term bond issues (maturity 5-10 years) by public sector undertakings (PSUs) imparted a new dimension to the debt market. While traditionally most of the PSU bonds were floated in the public issues market, in the recent years, most of such bond issues were privately placed. This is one reason why secondary market activity in PSU bonds has been limited. Further, the secondary market activity in the debt segment, in general, remains low and subdued both at BSE and the Wholesale Debt Market Segment of the NSE, partly due to lack of sufficient number of securities and partly due to lack of interest by retail investors. In order to improve the secondary market activity in this segment, the Union Budget for 1999-2000 abolished stamp duty on transfer of dematerialised debt instruments.

Derivatives Market

There is a lot of scope for development of the derivatives market.

Financial derivatives in the Indian financial markets are of recent origin barring trade related forward contracts in the forex market. Recently, over-the-counter (OTC) as well as exchange traded derivatives have been introduced, marking an important development in the structure of financial markets in India. Forward contracts in the forex market have also been liberalised. Exchange traded derivatives tend to be more standardised and offer greater liquidity than OTC contracts, which are negotiated between counterparties and tailored to meet the needs of the parties to the contract. Exchange traded derivatives also offer centralised limits on individual positions and have formal rules for risk and burden sharing. (For more information on *Derivatives,* see *Annexure* to the chapter on *Stock Exchange and its Regulation*).

Bancassurance

In Europe the synergy between banking and insurance has given rise to the concept of 'bancassurance' – a package of financial services that can fulfil both banking and insurance needs.

In developing countries, one important character of insurance business and of long-term life insurance, in particular, is that insurance policies are generally a combination of risk coverage and savings. The savings component in the insurance policies is seen as a possible source of competition for the banking industry, as the insurance industry develops on a competitive basis. There are, however, other considerations, that point to the possible complementarities and synergies between the insurance and banking business.

The most important source of complementarity arises due to the critical role that banks could play in distributing and marketing of insurance products. So far, direct branch network of LIC, GIC and its subsidiaries together with their agents have been instrumental in marketing of insurance products in India. With further simplification of insurance products, however, the vast branch network and the depositor base of commercial banks are expected to play an important role in marketing insurance products over the counter. The eagerness on the part of several banks and NBFCs to enter into insurance business following the opening up of the industry to private participation reflects this emerging process. The present interest of banks to enter into insurance business also mirrors the global trend.

Bancassurance seeks to synergise the banking and insurance needs and services.

In India, the Reserve Bank, in recognition of the symbiotic relationship between banking and the insurance industries, has identified three routes of banks' participation in the insurance business, *viz.*, *(i)* providing fee-based insurance services without risk participation, *(ii)* investing in an insurance company for providing infrastructure and services support and *(iii)* setting up of a separate joint venture insurance company with risk participation. The third route, due to its risk aspects, involves compliance to stringent entry norms. Further, the bank has to maintain an 'arms length' relationship between its banking business and its insurance outfit. For banks entering into insurance business with risk participation, the prescribed entity (*viz.*, separate joint venture company) also enables to avoid possible regulatory overlaps between the Reserve Bank and the Government/ IRDA. The joint venture insurance company would be subjected entirely to the IRDA/Government regulations.

SUMMARY

The Indian financial market comprises, mainly, the Credit Market, Money Market, Capital Market, Foreign Exchange Market, Debt Market and the Derivatives Market. Besides, there are also some markets like the household finance market, NBFC market, and insurance market which hold considerable promise in the years to come. These markets are not yet as developed and regulated as the credit/foreign exchange/money/capital/gilt-edged markets. With banks having already been allowed to undertake insurance business, bancassurance market is also likely to emerge in a big way.

Until the ushering in of economic reforms in the early 1990s, most of the financial markets were characterised by controls over the pricing of financial assets, restrictions on flows or transactions, barriers to entry, low liquidity and high transaction costs. These characteristics came in the way of developments of the markets and allocative efficiency of resources channelled through them. The initiation of financial sector reforms in the early nineties was essentially to bring about a transformation in the structure, efficiency and stability of financial markets, as also an integration of the markets. Some of the important structural changes enabled by financial sector reforms relate to introduction of free pricing of financial assets in almost all segments,

relaxation of quantitative restrictions, removal of barriers to entry, new methods of floatation/ issuance of securities, increase in the number of instruments and enlarged participation, improvement in trading, clearing and settlement practices, improvement in the informational flows, transparency and disclosure practices.

The credit market is the predominant source of finance in India as the capital market is relatively underdeveloped, firms or economic entities depend largely on the credit market for their fund requirements. In terms of sources of credit, the financial intermediaries providing credit could be broadly categorised as institutional and non-institutional.

The major institutional purveyors of credit in India are banks and non-banking financial institutions, *i.e.,* development financial institutions (DFIs) and other financial institutions (FIs) and non-banking financial companies (NBFCs) including housing finance companies (HFCs). The non-institutional or unorganised sources of credit include moneylenders, indigenous bankers and sellers for trade credit.

The foreign exchange market in India comprises customers, authorised dealers (ADs) and the Reserve Bank. With the transition to a market determined exchange rate system in March 1993 and the subsequent gradual but significant liberalisation of restrictions on various external transactions, the forex market in India has acquired more depth.

There has been a considerable improvement in the forex market turnover in the recent years, particularly during the post-reform period. The inter-bank turnover constitutes the predominant part of total turnover. As regards the classification by way of spot and forward transactions, available data for the recent period indicate that the merchant segment is dominated by spot transactions, while the inter-bank segment is dominated by forward transactions.

The Reserve Bank's presence in the market essentially reflects its policy of ensuring orderly market conditions. Reflecting its stance, net intervention sales of the Reserve Bank generally coincided with conditions of excess demand in the market, while net intervention purchases coincided with surplus market conditions and contributed to reserve build-up.

The domestic debt market comprises two main segments, *viz.*, the Government securities and other (mainly corporate) securities comprising private corporate debt, PSU bonds and DFIs' bonds. The government securities market is predominant, while the other segment is not very deep and liquid. The corporate debt market still constitutes a small segment of the debt market despite policy initiatives taken during the nineties. DFI bonds have emerged as an important segment of the debt market. Since the middle of the eighties, long-term bond issues (maturity 5-10 years) by public sector undertakings (PSUs) imparted a new dimension to the debt market. While traditionally most of the PSU bonds were floated in the public issues market, in the recent years, most of such bond issues were privately placed. This is one reason why secondary market activity in PSU bonds has been limited.

REFERENCE

1. **The material of this chapter is drawn mostly from the Reserve Bank of India, *Report on Currency and Finance, 1999-2000*, Reserve Bank of India, Mumbai, 2001.**

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Chapter 24

MONEY AND CAPITAL MARKETS

Structure

Money Market

The Indian Money Market

Capital Market

The Indian Capital Market

Summary

References

Money and Capital Markets are two most important components of the Financial Market.

MONEY MARKET

Meaning of Money Market

Money Market is the market for short-term funds, as distinct from the Capital Market which deals in long-term funds.

Sometimes, the term Money Market is used in a very broad sense to include markets for both the short-term, and long-term funds. When the term is used in such a broad sense, Money Market includes, obviously, the Capital Market also. However, when a distinction is drawn between the Money Market and the Capital Market, the former refers only to the market for short-term funds, and the latter for long-term funds. As we draw, in this chapter, a distinction between these two, Money Market should be interpreted as the market for short-term funds.

Money market is a mechanism facilitating and promoting transactions in short-term funds.

In the words of the Reserve Bank of India, a Money Market is a "centre for dealings, mainly of a short-term character, in monetary assets; it meets the short-term requirements of the borrowers and provides liquidity or cash to lenders. It is the place where short-term surplus investible funds at the disposal of the financial and other institutions and individuals are bid by borrowers, again comprising institutions and individuals and also by the government."[1]

Thus, a Money Market is a place where the lending and borrowing of short-term funds are arranged and it comprises the short-term credit instruments and the institutions and individuals who participate in the lending and borrowing business.

Constituents of Money Market

Dr. Lavington divides the money market into inner and outer spheres—the inner constituting "a nucleus of specialised institutions such as the banks, the market for negotiable securities, the bill brokers and the trust and finance companies, and the outer extending beyond this centre, including the work of solicitors, of brokers, of securities and the entire system of trade and credit."

The central bank, commercial banks, cooperative banks, savings banks, discount houses, acceptance house, etc., are the main constituents of a well developed money market. However, some of these institutions would not be found in some money markets.

The central bank usually occupies a pivotal position in the money market. It is regarded as the 'presiding deity' of the money market. A strong central bank in an organised money market can very significantly influence the conditions and activities of the market. In developing economies like India, organisation and development of a full-fledged money market is one of the prime responsibilities of the central bank.

In developing countries like India, the money market is broadly divided into organised and unorganised markets or sectors. The unorganised segment is, by and large, outside the control of the central bank and is characterised by lack of uniformity and formality in their business dealings. In India, the indigenous bankers and moneylenders are important constituents of the unorganised money market.

A developed money market consists of certain specialised sub-markets which help the mobilisation of savings by providing fruitful investment opportunities. They are also very helpful in imparting liquidity.

Certain specialised organisations like information bureaus, chambers of commerce, trade associations, etc. help the smooth and efficient functioning of the money market by helping the collection and dissemination of information to industry, trade and commerce.

FUNCTIONS OF MONEY MARKET

As the Reserve Bank of India observes, "a well developed money market is the basis for an effective monetary policy. It is in the money market that the Central Bank comes into contact with the financial sectors of the economy as a whole and it is through varying the liquidity in the market and thereby influencing the cost and availability of credit that the Bank achieves its economic objectives."

The important functions of a well developed money market may be listed down in more precise terms as follows.

1. By providing various kinds of credit instruments suitable and attractive for different sections, a money market augments the supply of funds.
2. Efficient working of a money market helps to minimise the gluts and stringencies in the money market due to the seasonal variations in the flow of and demand for funds.
3. A money market helps to avoid wide seasonal fluctuations in the interest rates.
4. A money market, by augmenting the supply of funds and making them readily available to the legitimate borrowers, helps in making funds available at cheaper rates.
5. A well organised money market, through quick transfer of funds from one place to another, helps to avoid the regional gluts and stringencies of funds.
6. It enhances the amount of liquidity available to the entire country.
7. A money market, by providing profitable investment opportunities for short-term surplus funds, helps to enhance the profit of financial institutions and individuals.

Financial intermediation is a very important function of the money market.

A money market functions like a dam-canal-irrigation system. Like a reservoir, it collects and augments the resources and channelises it to the various needed areas.

A well organised money market is an essential condition for the successful operation of the Central Banking policies. The money market is "the locus of central banking policies for holding the conditions of liquidity within the bounds of what the monetary authorities consider desirable".

THE INDIAN MONEY MARKET

As the Reserve Bank observes, "as in most developing countries, the money market in India comprises two sectors which may broadly be termed as the Organised and Unorganised markets, with substantially higher rates of interest in the unorganised sector".

The organised market comprises in the first place the Reserve Bank which is "the key constituent of the money market being the residual source of supply of funds and it is this which invests the bank's operations with great significance," and occupies "a strategic position in the money market."

Then come the commercial banks. They include the public sector banks and other joint stock banks, Indian and foreign.

The Indian money market has two broad segments – organised and unorganised.

In the past, quasi-government bodies and large size joint stock companies also used to participate in the operations of the money market as lenders, the money lent by them being usually termed 'house money'. In later years, such 'house money' declined to negligible proportions as most of the joint stock companies did not have surplus fund to lend and they were in fact in search of funds which they obtained partly by accepting deposits from the public.

Then there are the financial intermediaries such as call loan brokers and general finance and stock brokers. "The core of the Indian money market is the inter-bank call money market". Although the magnitude of funds dealt in this market is not large in relation to the deposit resources of banks, "perhaps this is the most sensitive sector of the money market." The banks have been directing their demands for accommodation to the Reserve Bank.

According to the Reserve Bank, despite its limitations, "from the point of view of specialisation of functions and organised relationships, the Indian money market may be considered to be comparatively well developed".

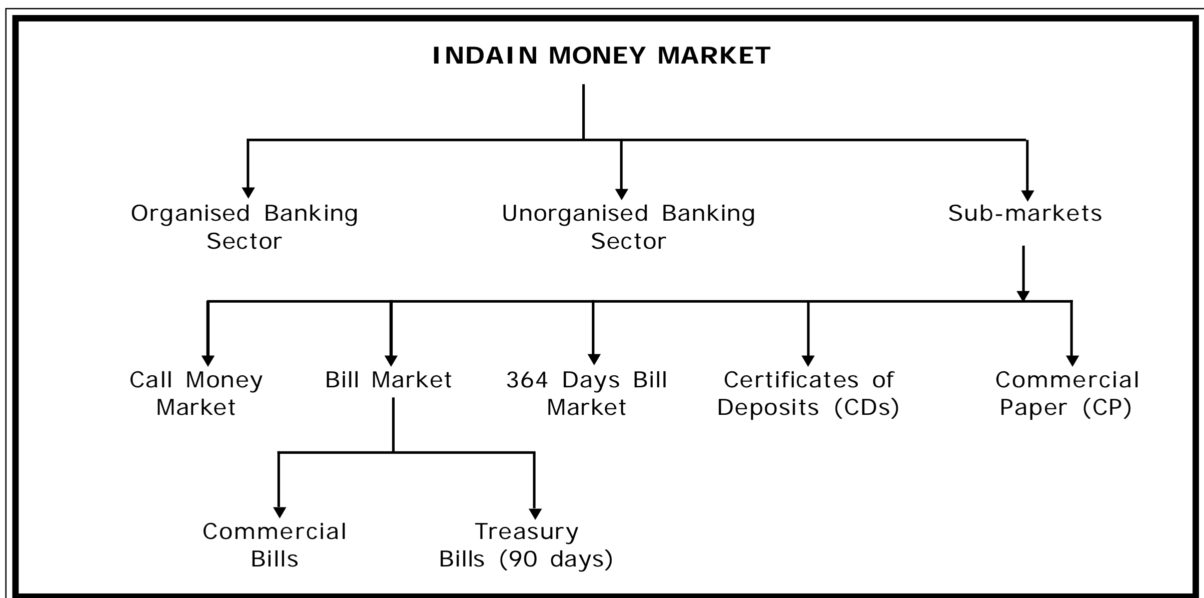

Fig. 24.1 : Structure of Indian Money Market

The unorganised sector, which itself is not homogeneous, is largely made up of what are known as "indigenous" bankers. In this market, there is no clear demarcation between short-term or long-term finance, inasmuch as there is usually nothing on the *hundi* (an indigenous bill of exchange) to indicate whether it is for financing trade or providing financial accommodation—in other words, whether it is genuine trade bill or financial paper. By and large, these bills are accommodation bills.

The cooperative credit institutions occupy a somewhat intermediate position between the organised and unorganised sectors of the money market. With the notable increase in the number of commercial bank branches in the rural and semi-urban areas, closer links have been forged between the cooperative credit system and the organised money market, especially with the State Bank and its subsidiaries.

The money market structure in India, loosely knit as it is, is not entirely uncoordinated. The indigenous bankers enjoy rediscount facilities from the commercial banks which in turn have access to the Reserve Bank.

A well developed money market will have close links with the leading money markets of the world and will be sensitive to the developments in these foreign markets. But the Indian money market was an insular one with little contact with foreign money markets". The money

markets of advanced Western Countries are characterised by large movements of capital between them. Due partly to the exchange control restrictions on capital movements, there was hardly any movement of funds between the Indian money market and the foreign market. Consequent to the economic reforms ushered in 1991, the Indian market has been getting linked, albeit in a limited way, to the global market.

The money market structure has undergone a change over the years, particularly under the impetus of the economic reforms. Unlike in developed economies where money markets are promoted by financial intermediaries out of efficiency considerations, in India, as in many other developing countries, the evolution of the money market and its structure has been integrated into the overall deregulation process of the financial sector.

The Reserve Bank has gradually developed money markets through a five-pronged effort. First, interest rate ceilings on inter-bank call/notice money, inter-bank term money, rediscounting of commercial bills and inter-bank participation without risk were withdrawn effective May 1, 1989. Secondly, several financial innovations in terms of money market instruments, such as, auctions of Treasury Bills, certificates of deposit, commercial paper and RBI repos were introduced. Thirdly, barriers to entry were gradually eased by: *(i)* increasing the number of players (beginning with the Discount and Finance House of India (DFHI) in April 1988 followed by primary and satellite dealers and money market mutual funds), *(ii)* relaxing both issuance restrictions and subscription norms in respect of money market instruments and allowing determination of yields based on demand and supply of such paper, and *(iii)* enabling market evaluation of associated risks, by withdrawing regulatory restrictions, such as, bank guarantees in respect of CPs. Fourthly, the development of markets for short-term funds at market determined interest rates has been fostered by a gradual switch from a cash credit system to a loan-based system, shifting the onus of cash management from banks to borrowers and phasing out the 4.6 per cent 91-day tap Treasury Bills, which in the past provided an avenue for investing short-term funds. Finally, institutional development has been carried out to facilitate inter-linkages between the money market and the foreign exchange market, especially after a market-based exchange rate system was put in place in March 1993.

The Indian money market has developed commendably thanks to the initiatives of the RBI and government.

The changes in the money market structure need to be seen in the context of a gradual shift from a regime of administered interest rates to a market-based pricing of assets and liabilities. The development of money markets in India in the last half of the 1990s has been facilitated by three major factors. First, the limiting of almost automatic funding of the government, largely realised with the replacement of *ad hoc* Treasury Bills (which bore a fixed coupon rate of 4.6 per cent per annum from July 1974, implying a negative real interest rate for most part of the period) by ways and means advances (WMA) at interest rates linked to the Bank Rate and the development of the government securities market, discussed later in the chapter, permitting a gradual deemphasis on cash reserve ratio as a monetary policy instrument. Secondly, the development of an array of instruments of indirect monetary control, such as, the Bank Rate (reactivated in April 1997), the strategy of combining auctions, private placements and open market operations in government paper and the liquidity adjustment facility (LAF). Thirdly, the enabling institutional framework was introduced in the form of primary and satellite dealers and money market mutual funds. The monetary authority uses money markets to adjust primary liquidity in the domestic economy and monetary policy is often, in turn, shaped by developments in the money and the foreign exchange markets.

Money Market Instruments and Constituents[2]

The money market instruments in India mainly comprise: *(i)* call money, *(ii)* certificates of deposit, *(iii)* treasury bills, *(iv)* other short-term government securities transactions, such as, repos, *(v)* bankers' acceptances/commercial bills, *(vi)* commercial paper, and *(vii)* inter-corporate funds.

While inter-bank money markets and central bank lending *via* repo operations or discounting provide liquidity for banks, private non-bank money market instruments, such as, commercial bills and commercial paper provide liquidity to the commercial sector.

Call/Notice Money Market: Call and notice money are money dealt for one to 14 days. The period of term money ranges from 14 days to 90 days. This is sometimes a very volatile market and the interest rate is determined by the market forces. This market is of vital importance to banks and financial institutions because of the avenue it provides for investing surplus funds and meeting the deficits. The Inter-bank lending is the major component of this market.

The overnight inter-bank call money market, in which banks trade positions to maintain cash reserves, is the key segment of the money market in India. It is basically an 'over the counter' (OTC) market without the intermediation of brokers. Participation has been gradually widened to include other financial institutions, primary/satellite dealers, mutual funds and other participants in the bills rediscounting market and corporates (through primary dealers) besides banks, LIC and UTI. While banks and primary dealers are allowed two-way operations, other non-bank entities can only participate as lenders. As per the announced policies, once the repo market develops, the call money market would be made into a pure inter-bank market, including primary dealers.

Call money market is the key segment of the Indian money market. The call money rate often reflects the liquidity position in the market.

The call money market is influenced by liquidity conditions (mainly governed by deposit mobilisation, capital flows and the Reserve Bank's operations affecting banks' reserve requirements on the supply side and tax outflows, government borrowing programme, non-food credit off-take and seasonal fluctuations, such as, large currency drawals during the festival season on the demand side). At times of easy liquidity, call rates tend to hover around the Reserve Bank's repo rate, which provides a ready avenue for parking short-term surplus funds. During periods of tight liquidity, call rates tend to move up towards the Bank Rate and more recently the Reserve Bank's reverse repo rate (and sometimes beyond) as the Reserve Bank modulates liquidity in pursuit of monetary stability. Besides, there are other influences, such as, (i) the reserve requirement prescriptions (and stipulations regarding average reserve maintenance), (ii) the investment policy of non-bank participants in the call market which are among the large suppliers of funds in the call market, and (iii) the asymmetries of the call money market, with few lenders and chronic borrowers.

Term Money Market: The term money market in India is still not developed. Select financial institutions (IDBI, ICICI, IFCI, IIBI, SIDBI, EXIM Bank, NABARD, IDFC and NHB) are permitted to borrow from the term money market for 3-6 months maturity, within stipulated limits for each institution.

Repos: Repo, is a money market instrument, which enables collateralised short-term borrowing and lending through sale/purchase operations in debt instruments. Under a repo transaction, a holder of securities sells them to an investor with an agreement to repurchase at a predetermined date and rate. In the case of a repo, the forward clean price of the bonds is set in advance at a level which is different from the spot clean price by adjusting the difference between repo interest and coupon earned on the security. Repo is also called a ready forward transaction as it is a means of funding by selling a security held on a spot (ready) basis and repurchasing the same on a forward basis. Reverse repo is a mirror image of repo as in the case of former, securities are acquired with a simultaneous commitment to resell.

Subsequent to the irregularities in securities transactions, repos were initially allowed in the Central Government Treasury Bills and dated securities created by converting some of the Treasury Bills. In order to activate the repos market essentially to be an equilibrating force between the money market and the Government securities market, the Reserve Bank gradually extended repos facility to all Central Government dated securities and Treasury Bills of all maturities. Recently, while the State Government securities were made eligible for repos, the Reserve Bank

also allowed all non-banking entities, maintaining SGL and current account with its Mumbai office, to undertake repos (including reverse repos). Furthermore, it has been decided to make PSU bonds and private corporate securities eligible for repos to broaden the repos market.

The Reserve Bank also undertakes repo/reverse repo operations with PDs and scheduled commercial banks, as part of its open market operations. It also provides liquidity support to SDs and 100 per cent gilt mutual funds through reverse repos. There is no limit on the tenor of repos.

Repos help to manage liquidity conditions at the short-end of the market spectrum. Repos have often been used to provide banks an avenue to park funds generated by capital inflows to provide a floor to the call money market. During times of foreign exchange market volatility, repos have been used to prevent speculative activity as the funds tend to flow from the money market to the foreign exchange market. For instance, a fixed rate repo auction system was instituted in November 1997 with a view to ensuring an effective floor for the short-term interest rates in order to ward off the spread of contagion during the South-East Asian crisis. The repo rates were reduced with the return of capital flows, which imparted stability to the foreign exchange market.

Commercial Paper: Commercial papers are unsecured promissory notes of short-term maturity of highly rated companies, issued to meet working capital requirements. The CP is subject to credit rating by any of the recognised credit rating agencies in India. As the CPs are tradable in the secondary market, including National Stock Exchange, they are regarded liquid.

Commercial Paper (CP) is issued by non-banking companies and All-India Financial Institutions (AIFIs) as an unsecured promissory note or in a dematerialised form at a rate of discount not tied to any transaction. It is privately placed with investors through the agency of banks. Banks act as both principals (*i.e.*, as counterparties in purchases and sales) and agents in dealership and placement. Banks are not allowed to either underwrite or co-accept issue of CP.

The pricing of CP usually lies between the scheduled commercial banks' lending rate (since corporates do not otherwise have the incentive to issue CP) and some representative money market rate (which represents the opportunity cost of bank funds). The Indian CP market is driven by the demand for CP by scheduled commercial banks, which, in turn, is governed by bank liquidity. Banks' investments in CP, despite a positive interest rate differential between the bank loan rate and the CP rate, may be explained by two factors, *viz.*, *(i)* the higher transactions costs of bank loans, and *(ii)* the relative profitability of CP as an attractive short-term instrument to park funds during times of high liquidity. As inter-bank call rates are typically lower than the CP rates, some banks also fund CP by borrowing from the call money market and, thus, book profit through arbitrage between the two money markets. Most of the CPs seem to have been issued by the manufacturing companies for a maturity period of approximately three months or less, mainly due to the fact that investors do not wish to lock funds for long periods of time. In most international markets, CP is issued on a short-term basis with a roll-over facility; this facility, however, is not allowed in the Indian CP market.

The secondary activity is subdued in most CP markets on account of the investors' preference to hold the instrument due to higher risk-adjusted return relative to those of other instruments. However, mutual funds find the secondary market relatively remunerative, since stamp duty for the issuer will be higher in case the buyer is a mutual fund rather than a bank. Hence, there is a tendency to route a CP through an institution (usually a bank), which attracts lower stamp duty in the primary market, to a mutual fund in the secondary market.

Certificates of Deposit: Certificates of Deposit (CD), introduced in June 1989, are essentially securitised short-term time deposits issued by banks during periods of tight liquidity, at relatively high interest rates (in comparison with term deposits). But the transaction cost of CDs is often lower as compared with that of retail deposits. When credit picks up, placing pressure on banks'

liquidity, banks try to meet their liquidity gap by issuing CDs, often at a premium. The required amounts are mobilised in larger amounts through CD, often for short periods in order to avoid interest liability overhang in the subsequent months when credit demand slackens. As banks offer higher interest rates on CDs, subscribers find it profitable to hold CDs till maturity. As a result, the secondary market for CDs has been slow to develop.

Commercial Bills Market: Commercial Bills (Bills of Exchange) are important instruments used to facilitate credit sales. Commercial bills can be discounted with banks and the banks, when they are in need of funds, may rediscount them in the money market.

The commercial bill market in India is very limited. The commercial bills market was constricted by the cash credit system of credit delivery where the onus of cash management rested with banks. The success of the bills discounting scheme is contingent upon financial discipline on the part of borrowers. As such discipline did not exist, the Reserve Bank, in July 1992, restricted the banks to finance bills to the extent of working capital needs based on credit norms. However, in order to encourage the 'bills' culture, the Reserve Bank advised banks in October 1997 that at least 25 per cent of inland credit purchases of borrowers should be through bills.

Money Market Mutual Funds (MMMFs): In April 1992, scheduled commercial banks and public financial institutions were allowed to set up MMMFs, subject to certain terms and conditions. The prescribed restrictions were relaxed subsequently between November 1995 and July 1996 in order to impart more flexibility, liquidity and depth to the market. MMMFs are allowed to invest in rated corporate bonds and debentures with a residual maturity of one year. The minimum lock-in period for units of MMMFs was relaxed from 30 days to 15 days in May 1998. In 1999-2000, MMMFs were allowed to offer 'cheque writing facility' in a tie-up with banks to provide more liquidity to unit holders. MMMFs, which were regulated under the guidelines issued by the Reserve Bank, have been brought under the purview of the SEBI regulations since March 7, 2000. Banks are now allowed to set up MMMFs only as a separate entity in the form of a trust. Currently, there are only three MMMFs in operation.

Treasury Bills: Treasury bills are promissory notes issued by the Central Government to raise short-term funds to bridge short-term mismatches between receipts and expenditures. The RBI which issues the TBs on behalf of the Government does not purchase them before maturity but investors can sell them in the secondary market through the DFHI or get it rediscounted.

CAPITAL MARKET

Capital market often refers to the market for long-term funds.

Capital Market is generally understood as the market for long-term funds. However, sometimes the term is used in a very broad sense to include also the market for short-term funds. For instance, by capital market, some people mean "the market for all the financial instruments, short-term and long-term, as also commercial, industrial and government paper". When 'Capital Market' is used in such a broad sense, it embraces, obviously, the money market also.

However, in most cases, the term Capital Market is used to refer to the market for long-term loanable funds as distinct from the money market which deals in short-term funds. It should, however, be added that there is no clear-cut distinction between the two markets. Many a time, the same institutions receive and supply both short- and long-term funds. The money and capital markets are in fact interdependent, developments and trends in one affecting the other.

Nature and Constituents

The capital market consists of a number of individuals and institutions (including the government) that channelise the supply and demand for long-term capital and claims on capital. The stock exchanges, commercial banks, cooperative banks, savings banks, development banks, insurance companies, investment trust or companies, etc. are important constituents of the capital market.

The capital market, like the money market, has three important components, namely, the suppliers of loanable funds, the borrowers and the intermediaries who deal with the lenders on the one hand and the borrowers on the other.

Like the money market, capital market has three categories of players, lenders, borrowers and the intermediaries.

In the capital market, the supply of funds comes from the individual and corporate savings, institutional investors and surplus of governments. The demand for capital comes mostly from agriculture, industry, trade and the government.

With the emergence of joint stock companies as the predominant form of industrial organisation, developed capital market became a necessary infrastructure for fast industrialisation. Business firms can raise funds from the capital market by issuing shares and credit instruments. Capital market is not concerned solely with the issue of new claims on capital, but also with dealing in existing claims. In fact, marketability of securities is an important element in the efficient working of the capital market, since investors would be reluctant to make loans if their claims could not be easily disposed of.

The developed countries have comparatively well developed money and capital markets. But, in the developing countries, the capital market, like the money market, is generally underdeveloped.

Importance of Capital Market

The pace of economic development is conditioned, among other things, by the rate of long-term investment and capital formation. And capital formation is conditioned by the mobilisation, augmentation and channelisation of investible funds. The capital market serves a very useful purpose by pooling the capital resources of the country and making them available to the enterprising investors. Well developed capital markets augment resources by attracting and lending funds on a global scale. The Euro-currency and Eurobond markets are international finance markets in terms of both the supply and demand for funds.

A vibrant capital market is a prerequisite for the development of industry and commerce.

The increase in the size of the industrial units and business corporations due to technological developments, economies of scale and other factors has created a situation where in the capital at the disposal of one or few individuals is quite insufficient to meet the investment demands. A developed capital market can solve this problem of paucity of funds. For an organised capital, market can mobilise and pool together even the small and scattered savings and augment the availability of investible funds. While the rapid growth of capital markets, the growth of joint stock business has in its turn encouraged the development of capital markets.

A developed capital market provides a number of profitable investment opportunities for the small savers.

THE INDIAN CAPITAL MARKET

BOX 24.1 : INDIAN CAPITAL MARKET IN TRANSITION

Although the Indian capital market witnessed some significant changes during the eighties, both the primary and the secondary segments continued to suffer from some serious deficiencies. Many unhealthy practices prevailed in the primary market to attract the retail investors. Another disturbing feature was the high cost of new issues. Although over the years, a number of agencies came into existence offering different types of services in connection with the new issues of capital, their activities were not overseen by any regulatory authority. The problems were even more serious in the secondary market. The general functioning of stock exchanges was not satisfactory. The exchanges were governed by their internal bye-laws and managed by their Governing Bodies, which were dominated by elected member-brokers. Trading members were also not adequately capitalised. Insider trading was rampant and was one of the major causes of excessive speculative activity, leading to default by stock brokers, frequent payment crises and disruption of market activity. The stock exchanges followed inefficient and outdated trading systems. This, in turn, led to lack of transparency in trading operations, besides resulting in long and uncertain settlement cycles.

The risk management system in the market was also not satisfactory. Though the margin system was operative, the margins were inadequate and the system of collection of margins was not enforced strictly. Post-trade settlement procedures also suffered from some serious drawbacks, such as, high share of bad deliveries, delayed settlements, sometimes clubbing of settlements, etc. The procedures relating to investor protection were also not satisfactory.

Some measures were initiated to reform the capital market in the eighties. However, major reforms, which have altered the face of the capital market, were initiated beginning with the year 1992. In the primary market, all controls relating to pricing of equity issues and the time when they should be issued have been removed, while in the secondary market, the traditional open outcry system has been replaced with transparent screen-based computerised trading system. Physical securities are being increasingly dematerialised. The settlement period has been shortened to one week uniformly across all stock exchanges. The domestic capital market is also increasingly integrating with the international capital markets.

Courtesy: *Reserve Bank of India, Report on Currency and Finance, 1999-2000.*

Nature of the Indian Capital Market

Like the money market, the Indian capital market also consists of an organised sector and an unorganised sector. In the organised market, the demand for capital comes mostly from corporate enterprises and government and semi-government institutions and the supply comes from household savings, institutional investors like banks, investment trusts, insurance companies, finance corporations, government and international financing agencies.

The unorganised market consists mostly of the indigenous bankers and moneylenders on the supply side. While in the organised sector the demand for funds is mostly for productive investment, a large part of the demand for funds in the unorganised market is for consumption purposes. In fact, many purposes, for which funds are very difficult to get from the organised market, are financed by the unorganised sector. Like the unorganised money market, the unorganised capital market in India is characterised by the existence of multiplicity of interest rates, exorbitant rates of interest and lack of uniformity in their business dealings.

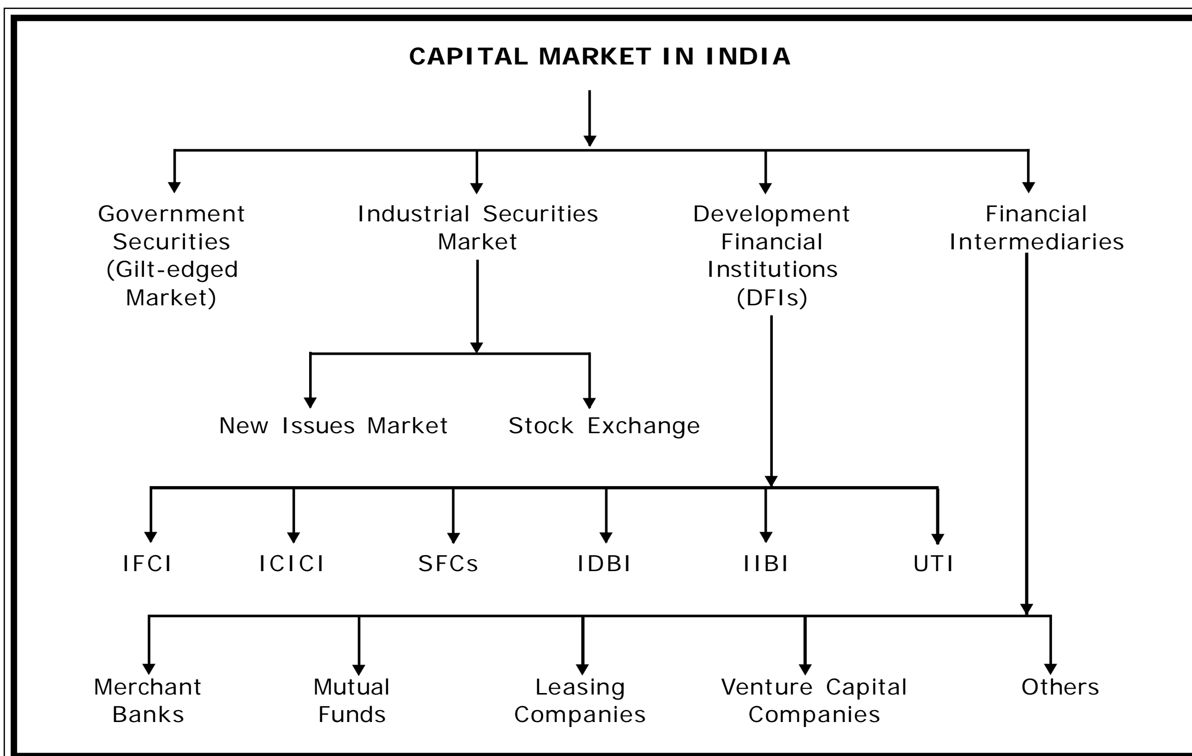

Fig. 24.2 : Structure of Indian Capital Market

While the activities of the organised market are subject to a number of government controls, the unorganised sector is by and large outside effective government control.

The organised sector has been subjected to increasing insitutionalisation. A large chunk of the business of this sector is accounted for by the public sector financial institutions, and there is government control over other segments of the organised capital market.

Development of the Market

The Indian capital market has undergone remarkable changes in the post-independence era. Certain steps taken by the government to place the market on a strong footing and develop it to meet the growing capital requirements of fast industrialisation and development of the economy have significantly contributed to the developments that took place in the Indian capital market over the last five decades or so.

The important facts that have contributed to the development of the capital market in India are the following.

1. *Legislative measures:* Laws like the Companies Act, the Securities Contracts (Regulation) Act and the Capital Issues (Control) Act empowered the government to regulate the activities of the capital market with a view to assuring healthy trends in the market, protecting the interests of the investors, efficient utilisation of the resources, etc.

2. *Establishment of development banks and expansion of the public sector:* Starting with the establishment of the IFCI, a number of development banks have been established at the national and regional levels to provide financial and other development assistance to the entrepreneurs and enterprises. These institutions today account for a large chunk of the industrial finance.

The Indian capital market has shown a healthy development due to several promotional and regulatory measures.

The expansion of the public sector in the money and capital markets has been accelerated by the nationalisation of the insurance business and the major part of the banking business. The Life Insurance was nationalised in 1956 and the General Insurance in 1972. The Reserve Bank of India was nationalised as early as 1949. The Imperial Bank, the largest commercial bank in India, was nationalised and established the State Bank of India in 1955. The fourteen major private commercial banks were nationalised in 1969. With the nationalisation of the six leading private banks in 1980, over 90 per cent of the commercial banking business came to be concentrated in the government sector.

Thus, an important aspect of the Indian capital market is that a large part of the investible funds available in the organised sector is owned by the government. The new economic policy will change the trend.

3. *Growth of underwriting business:* There has been a phenomenal growth in the underwriting business thanks mainly to the public financial corporations and the commercial banks. After the elimination of the forward trading, brokers have begun to take on underwriting risks in the new issue market. In the last one decade, the amount underwritten as percentage of total private capital issues offered to public varied between 72 per cent and 97 per cent.

4. *Public confidence:* Impressive performance of certain large companies encouraged public investment in industrial securities.

5. *Increasing awareness of investment opportunities:* The improvement in education and communication has created more public awareness about the investment opportunities in the business sector. The market for industrial securities has become broader.

6. *Capital Market Reforms:* A number of measures have been taken to check abuses and to promote healthy development of the capital market. For details, see the next chapter.

SUMMARY

Money and Capital Markets are the two most important components of the Financial Market.

The term Money Market refers to the market for short-term funds, as distinct from the Capital Market which deals in long-term funds. However, sometimes, these terms are used very broadly to include markets for both short- and long-term funds.

The money market and the capital market have three important components, namely, the suppliers of loanable funds, the borrowers and the intermediaries who deal with the lenders on the one hand and the borrowers on the other. In developing countries like India, the money and capital markets are broadly divided into organised and unorganised markets or sectors. The unorganised segment is, by and large, outside the control of the central bank and is characterised by lack of uniformity and formality in their business dealings. In India, the indigenous bankers and moneylenders are important constituents of the unorganised market. The cooperative credit institutions occupy a somewhat intermediate position between the organised and unorganised sectors of the money market.

The central bank, commercial banks, cooperative banks, savings banks, discount houses, acceptance house, etc. are the main constituents of the money market. However, some of these institutions would not be found in some money markets. The central bank usually occupies a pivotal position in the money market. It is regarded as the 'presiding deity' of the money market. A strong central bank in an organised money market can very significantly influence the conditions and activities of the market.

A well developed money market helps efficient operation of the monetary policy, channelisation of the savings of the society, reduction of seasonal and regional imbalances in the supply of and demand for funds, and reduction of gap between borrowing and lending rates. A money market functions like a dam-canal-irrigation system. Like a reservoir, it collects and augments the resources and channelises it to the various needed areas.

The money market instruments in India mainly comprise: *(i)* call money, *(ii)* certificates of deposit, *(iii)* treasury bills, *(iv)* other short-term government securities transactions, such as, repos, *(v)* bankers' acceptances/commercial bills, *(vi)* commercial paper, and *(vii)* inter-corporate funds.

The capital market serves a very useful purpose by pooling the capital resources and making them available to the enterprising investors. Well developed capital market augment resources by attracting and lending funds on a global scale.

The capital market consists of a number of individuals and institutions (including the government) that channelise the supply and demand for long-term capital and claims on capital. The stock exchanges, commercial banks, cooperative banks, savings banks, development banks, insurance companies, investment trust or companies, etc. are important constituents of the capital market.

The developed countries have comparatively well developed money and capital markets. But, in the developing countries, the capital market, like the money market, is generally underdeveloped.

The Indian capital market has undergone remarkable changes in the post-independence era. Certain steps taken by the government to place the market on a strong footing and develop it to meet the growing capital requirements of fast industrialisation and development of the economy have significantly contributed to the developments that took place in the Indian capital market over the last five decades or so.

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2. **This section is based on Reserve Bank of India, *Report on Currency and Finance, 1999-2000.***

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Chapter 25

STOCK EXCHANGE AND ITS REGULATION

Structure

Meaning, Importance and Functions
Dealings on the Stock Exchange
Speculation on the Stock Exchange
Organisation of Stock Exchanges in India
Over the Counter Exchange of India (OTCEI)
National Stock Exchange of India (NSE)
Stock Holding Corporation of India
Regulation of Stock Exchange
SEBI
Capital Market Reforms and Developments
Summary
References
Annexure 25.1: Derivatives
Annexure 25.2: Sensex and Nifty

MEANING, IMPORTANCE AND FUNCTIONS

Stock Exchange is a market in which securities are brought and sold and it is an essential component of a developed capital market.

According to the Securities Contracts (Regulation) Act, 1956, *stock exchange means any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities.*

According to this Act, *securities* include: *(i)* shares, scrips, stocks, bonds, debentures, stock or other marketable securities of a like nature in or of any incorporated company or body corporate; *(ii)* Government securities; such other instruments as may be declared by the Central Government to be securities; and *(iii)* right or interest in securities.

Stock exchange is regarded as "an essential concomitant of the capitalistic system of economy. It is indispensable for the proper functioning of corporate enterprise. It brings together large amounts of capital necessary for the economic progress of a country. It is the citadel of capital and the pivot of money market.

It provides necessary mobility to capital and directs the flow of capital into profitable and successful enterprises. It is the barometer of general economic progress in a country and exerts a powerful and significant influence as a depressant or stimulant of business activity. It may be defined as the place or market where securities of joint stock companies and of government or semi-government bodies are dealt in."[1]

Speaking in the *Lok Sabha* in connection with his motion for reference of the Securities Contracts (Regulation) Bill to a Joint Committee of the Houses of Parliament in 1955, the Finance Minister made the following observations.

The economic services, which a well constituted and efficiently run securities market can render to a country with a large private sector, operating under the normal incentives and impulses of private enterprises are considerable.

In the first place, it is only an organised securities market which can provide sufficient marketability and price continuity for shares, so necessary for the needs of investors.

Secondly, it is only such a market that can provide a reasonable measure of safety and fair dealing in the buying and selling of securities.

BOX 25.1 : OBJECTIVES AND ROLE OF STOCK EXCHANGE

The objectives and the role of the Bombay Stock Exchange, which have remained the same as enunciated by founding fathers and given as a mandate in 1887 through the charter, highlight the functions and objectives of stock exchanges. These objectives are:

1. *To safeguard the interest of investing public having dealings on the Exchange and the members.*
2. *To establish and promote honourable and just practices in securities transactions.*
3. *To promote, develop and maintain a well regulated market for dealing in securities.*
4. *To promote industrial developments in the country through efficient resource mobilisation by way of investment in corporate securities.*

The Exchange while providing an efficient market also upholds the interests of the investors and ensures redressal of their grievances, whether against the companies or its own member-brokers. It also strives to educate and enlighten the investors by making available necessary informative inputs.

Thirdly, through the interplay of demand for and supply of securities, properly organised stock exchange assists in a reasonably correct evaluation of securities in terms of their real worth. *Lastly*, through such evaluation of securities, the stock exchange helps in the orderly flow and distribution of savings as between different types of competitive investments.

DEALINGS ON THE STOCK EXCHANGE

Dealings on the stock exchange are subject to the bye-laws and rules of the stock exchange. Stock exchange dealings in India are regulated by the Securities Contracts (Regulation) Act and the Securities and Exchange Board of India (SEBI).

On the trading floor of the stock exchange, dealings are permitted only in the listed securities through the members or their authorised clerks during fixed working hours.

There are two important types of trading on the stock exchange namely *Ready Delivery* contract and *Forward Delivery* contract. The important differences between these two dealings are the following:

Ready delivery contracts, also known as *cash trading* or *cash transactions,* are to be settled either on the same date or within a short period that may extend at best up to seven days. (If the payment and delivery of securities is on the same day or on the next day, it may be called *spot delivery contract).* As against these, the forward delivery contracts are discharged on fixed settlement days. Ready delivery contracts can be made in respect of all securities whereas forward delivery contracts are confined to those securities which are placed oft the forward list.

SPECULATION ON THE STOCK EXCHANGE

Stock exchange transactions are made either for the purpose of investment or for speculation. Investment transactions are made with the intention of earning a return on the securities by holding them more or less permanently whereas speculative transactions are made with the intention of making gains by disposing of the securities at favourable prices.

The nature of the investment transaction and speculative transaction differs. The investment transactions require the actual delivery of securities on the part of sellers and the payment of their full price by the buyers. Speculative transactions, on the other hand, does not involve full payment for and taking delivery of the securities that the speculators have contracted to transfer. As the speculative transactions do not call for the payment of the full price but can be made by the deposit of a fractional part of the price, the volume of speculative transactions usually far exceed that of the investment transactions on any stock exchange. It is, therefore, argued that speculation is necessary to ensure sufficient volume and continuity of business in the stock exchange. However, unregulated speculation is not conducive. Introducing the Securities Contracts (Regulation) Bill, the then Finance Minister Mr. C.D. Deshmuk observed:

"Sceptics may argue that it is impossible for any securities market to function properly because of the undesirable activities of speculators, and yet genuine speculation, which is based on a reasoned forecast of the real value of the investments, represented by the securities which are dealt with on the exchanges, performs a very important function. No stock exchange can operate purely on the basis of investment buying or selling, because "pure" investors in that sense are necessarily few in number and usually possess very limited resources. They cannot provide the requisite volume or continuity of business, which alone would enable a large number of buyers and sellers to trade at all times in the exchanges, and to bring about an adjustment of the

It is mostly speculative transactions which provide business volume and dynamism to the stock exchange.

relative values of the securities in which they trade, in conformity with their real worth. It is the buying and selling of securities on a large scale on the basis of reasoned forecasts which alone can give the necessary breadth and continuity to the market. Informed speculation, which takes a reasonable view of future prospects, and thus brings about an appropriate adjustment security values, thus helps not only in the channeling of savings into the most productive lines, but also attracts new savings for investment into particular classes of securities. Too often, unfortunately, speculation in shares and scripts is not based on any reasoned calculation of the prospects of a company, and comes very close to gambling. The basic object of stock exchange reform is, therefore, to regulate speculative activities so that they may not degenerate into gambling; it is not the object of such reform to interfere with investment buying or selling or even with speculation as long as it conforms to the rules of the game."

Types of Speculators: The speculators on a stock exchange may be categorised into the following three *(i) Bull:* A bull, also known as *Tejwalla,* is a speculator who buys shares in the expectation of selling it at a higher price later; *(ii) Bear:* A bear, also known as *Mundiwalla,* who sells securities in the expectation of a fall in their prices in future; *(iii) Stag:* A stag neither buys nor sells but applies for subscription to the new issues expecting that he can sell them at a premium.

Option Dealing: Option is the right to buy or sell a certain quantity of security at a certain price within a certain time. The option to buy is known as *call option* (or *Teji Sauda*) and the option to sell is known *as Put Option (Mandi Sauda)*. The *Put* and *Call* is a double option (known as *Teji-Mandi)* giving the right either to purchase or to sell securities. In an option dealing, a speculator is given the right or option to buy or sell, or both buy and sell, as the case may be on the settlement day or else he will forfeit the option money.

Blank Transfers: Blank transfer means the transfer of a security without specifying the transferee. Although a blank transfer is not, by itself, a speculative transaction, it encourages speculation in securities because the same transfer deed without any stamp duty revolves into many sale transactions in securities embodied that therein. It also encourages tax evasion.

Carry-over (Badla) Transactions: Carry-over or Badla refers to the facility of carry-over of the completion of a forward contract to another/next settlement period any number of times on payment of the badla charge. The badla charge paid by a bull is known as *contago* and that paid by the bear is called *backwardation*.

ORGANISATION OF STOCK EXCHANGES IN INDIA

There are a number of stock exchanges functioning in India including the OTCEI and the NSE. Some of the regional stock exchanges are in the process of winding up.

The Bombay Stock Exchange, which was established in 1875 as "The Native Share and Stockbrokers Association" (a voluntary non-profit making association) is the oldest one in Asia; the Tokyo Stock Exchange was founded only in 1878. Since 8th August, 2005, BSE is a public limited company.

With about 10,000 listed companies, India holds the unique distinction of having the largest number of listed companies in the world. The number of investors is one of the largest in the world.[2]

Since the coming into effect of the Securities Contracts Act, 1956, only those stock exchanges which are recognised by the Government can function in the country. The policy of the Government is that there shall be only one stock exchange in one area. In pursuance of this policy, where more than one stock exchange existed as in Bombay, only one stock exchange was given recognition and the active members of the non-recognised stock exchanges were admitted.

Voluntary Association, Public Limited Company and Guarantee Company are the common forms of organisation of stock exchanges in India.

Each stock exchange is managed by an Executive Committee/Council of Management/ Governing Body to which the Government is empowered to nominate not more than three members. The rules and bye-laws of the stock exchange shall be in conformity with such conditions as may be prescribed by the Government. The Securities Contracts (Regulation) Act empowers the Government also to withdraw the recognition granted to a stock exchange, in the interest of trade or in public interest. Further, in order to deal with abnormal and extraordinary situations which may develop from time to time. Government is empowered to supercede a governing body after giving an opportunity to the governing body to be heard in the matter and to appoint in its place any person or persons to perform the functions of the governing body; and to suspend such of the business of a stock exchange under certain circumstances, for such period not exceeding seven days as may be specified, in the interest of trade or in public interest. The period of suspension can be extended from time to time, but after the governing body has been given an opportunity of being heard in the matter.

Dealers and brokers dealing outside the area of the recognised stock exchange have to obtain licence from the Government.

Only members and their authorised clerks can enter the trading floor and conduct buying and selling of securities. There are brokers and other intermediaries who assist the buyers and sellers in their dealings.

Members: In the past, only an individual (not a firm or company) could be a member. Now, companies can also become members. Multiple membership, *i.e.,* membership in more than one stock exchange is also permitted.

Authorised Clerks: To assist the members for making transactions on the exchange, members are permitted to appoint a fixed number of authorised clerks. The number of authorised clerks varies from one exchange to another. The authorised clerks, as agents of the members, can enter the trading floor and buy or sell on behalf of their employers; but they cannot buy or sell on their own account.

Remisiers: The remisiers are sub-brokers employed by a member to secure business. The remisiers are not permitted to enter the trading floor for exchange dealing. They are meant primarily to secure business from the outsiders. The remisiers are very important in securing business because the share brokers are prohibited from making advertisement to solicit business.

BSE is the oldest stock exchange in Asia.

Taravaniwalas and Brokers: Indian stock exchange has two categories of members namely Taravaniwalas and brokers. The Taravaniwala in India does the work similar to the *Jobber* in the London Stock Exchange. A jobber is a dealer in securities, while a broker is an agent of a buyer or seller of securities. Jobbers deal only with brokers and not with the public whereas the broker is a middleman between the jobber and the real buyer/seller. But Taravaniwalas in India have been found to play a double role of broker-cum-dealer.

Clearing House: It is an agency that performs the task of arranging for delivery of securities and their payment by the concerned parties. The clearing house pools together all the bargains made by each member of the stock exchange so as to find out the result position and it traces the ultimate buyers and sellers of securities to put them in touch with each other. The clearing house thus simplifies and expedites the work.

According to the present regulations, regional stock exchanges which do not satisfy specified criteria will have to wind up. Other regional exchanges have the option to exit.

OVER THE COUNTER EXCHANGE OF INDIA (OTCEI)

The establishment of the Over The Counter Exchange of India (OTCEI) marked the dawn of a new era in the history of stock exchanges in India. The OTC Exchange is regarded a blessing

for the small, both existing and new, companies and for investors, particularly small investors. The OTCEI which was incorporated in 1990 became fully operational in 1992.

The OTCEI is meant primarily to trade securities of the listed companies, like the other stock exchanges. It is, however, a stock exchange with a lot of differences with those of other. "Although the basic framework of the OTC Exchange is that of a *national market, yet there is no physical location, no counters, no trading ring, no stock exchange building and no hustle and bustle scenes as the conventional stock exchanges*. The buyers and sellers living apart from each other trade in corporate securities over the telephone. The system cuts across urban and rural areas extending the frontiers of the stock market to the entire country. These OTC markets are fully automated exchanges where transactions are completed through a network of telephones/tellers computers right from the first centre to the last centre. In addition, only professional people are authorised to render financial services."[3]

The OTCEI has been promoted jointly by ICICI, UTI, IFCI, IDBI, SBI Capital Markets Ltd., Canara Bank Financial Services Ltd., GIC and LIC. These institutions are sponsor members of this Exchange.

Over The Counter basically implies trading across the counter in scrips which are listed on the OTC exchange.

The term *counter* refers to the location of the member or a dealer of the OTCEI where dealing actually takes place. All the counters trade in all the scrips listed on the OTC Exchange. At every counter, an investor can see the quotes on the PTI-OTC Scan, complete a transaction, as well as ask for investor services. In other words, each counter acts as a trading floor of the OTCEI. Thus, as against a single trading floor in a regular stock exchange, there would be as many trading floor as the number of counters on the OTC Exchange.

Distinguishing Features

The OTCEI has a number of distinguishing features *vis-à-vis* other Stock Exchanges.

1. While other stock exchanges are associations formed by stock brokers, the OTCEI is a company promoted by financial institutions.
2. There are many restrictions on listing on the OTCEI. Several types and categories of companies which are eligible for listing on a regular Stock Exchange are not eligible on the OTCEI. Further, a company listed on any other recognised stock exchange in India would not simultaneously be eligible for listing on the OTC Exchange.
3. The method of price fixation differs between the OTCEI and other Exchanges. On the OTC Exchange, the pricing of scrips is regulated. The market makers compulsorily offer buy-sell quotes which are based on proper evaluation of the company. In other Stock Exchanges, the share prices need not necessarily have any relation to the fundamentals. Speculation could cause wide price fluctuations on the regular Exchanges.
4. The OTC Exchange is a market for spot deals only.
5. On the OTCEI, the settlement takes place daily, unlike on the other exchanges.
6. The OTC Exchange permits automatic transfer up to 0.5 per cent of a company's equity whereas in other cases permission of the companies required for all transfers.
7. In the OTC Exchange, the spread does not exceed a specific percentage whereas in a volatile market there is no restriction on spreads.
8. The OTCEI is characterised by a decentralised working with national work. Other exchanges are centralised in nature, members operating from a single location.

OTCEI is different from other exchanges in several ways.

Benefits to the Investors

The OTC Exchange offers a number of benefits to the investors. The important advantages of it from the point of view of the investors are:

1. Quick payment of money to the sellers and quick delivery of shares to buyers.
2. Price transparency: On the OTCEI, the investor clearly knows the buying and selling prices whereas he is not able to know the actual price at which the scrips are bought or sold for him in other stock exchanges.
3. The OTCEI saves the investors from other unscrupulous behaviour of the brokers.
4. Liquidity even for scrips of small and new companies.
5. Fair prices.
6. Simple procedure of buying and selling
7. Facility to sell even odd lots.

OTCEI is beneficial to investors and companies in several ways.

Benefits to the Companies

The OTC Exchange offers certain advantage to the companies also. The important benefits to the companies are that it:

1. Enables even smaller and less liquid companies to get listed.
2. Facilitate new issues at lower costs.
3. Makes raising capital through issues easy for small, new and closely held companies.
4. Helps create market for scrips of small and new companies.

Listing on the OTCEI

The minimum issued equity capital of a company for eligibility for listing on the OTCEI is ₹ 30 lakh, subject to a minimum public offer of equity shares worth ₹ 20 lakh. For companies with an issued equity capital of more than ₹ 30 lakh but less than ₹ 300 lakh, the minimum public offer should be 40 per cent of the issued capital or ₹ 20 lakh worth shares in face value, whichever is highest. Companies with an issued equity capital of more than ₹ 300 lakh seeking listing on the OTCEI will have to comply with the listing requirements and guidelines as are applicable to such companies for enlistment on other recognised Stock Exchanges.

Any company which wants to list its shares on the OTCEI will have to be sponsored by a sponsor. The responsibilities of the sponsors include appraising the project/company properly, valuing the scrip fairly and promoting its sales.

For listing on OTCEI, a sponsor who will act as a 'compulsory market maker' is a must.

One of the main functions of the sponsor is *market making, i.e.,* giving two way (both buy and sell) quotes for the scrip concerned. The sponsor has to do *compulsory market making* for at least three years from the date trading commences. This is intended to provide enforced liquidity for investors. After a period of three years, the sponsor will continue to make market in the scrip till an alternative market maker is arranged for. A sponsor, who is the *compulsory market maker* (CMM), may appoint *additional market maker* (AMM) or dealer. An AMM has to make market in the scrip for at least one year continuously.

Both members and dealers can act as *voluntary market makers* (VMMs) on the OTC Exchange. An VMM has to make market in a scrip for at least three months continuously.

A company listed on any other recognised stock exchange in India would not simultaneously be eligible for listing on the OTCEI.

(For more information about the OTCEI, refer V.A. Avadhani, *Investment and Securities Markets in India* (Himalaya Publishing House, Mumbai).

NATIONAL STOCK EXCHANGE OF INDIA (NSE)

The National Stock Exchange of India (NSE) was established in 1994 by financial institutions and banks with IDBI as a nodal agency.

The NSEI has been conceived as a model exchange with a nationwide electronic screen based "scripless" and "floorless" trading system in securities which is both efficient and transparent and offer equal and nationwide access to investors.

NSE operates on the 'National Exchange for Automated Trading' (NEAT) system, a fully automated screen-based trading system, which adopts the principle of an order-driven market. NSE consciously opted in favour of an order-driven system as opposed to a quote-driven system. This has helped reduce jobbing spreads not only on NSE but in other exchanges as well, thus reducing transaction costs.

Till the advent of NSE, an investor wanting to transact in a security not traded on the nearest exchange had to route orders through a series of correspondent brokers to the appropriate exchange. This resulted in a great deal of uncertainty and high transaction costs. NSE has made it possible for an investor to access the same market and order book, irrespective of location, at the same price and at the same cost.

NSE is the second largest stock exchange in South Asia and the third largest in the world in terms of the number of trades in equities.

The National Stock Exchange operates mainly in two different segments, *viz., (i)* Wholesale Debt Market, (WDM), *(ii)* Capital Market (CM) and *(iii)* Derivatives market.

The WDM is concerned with trading in instruments like Government Securities, PSU bonds, units 64 of UTI, CDs and CPs by corporate entities (like banks, institutions, brokerage houses).

The CM is concerned with equity and corporate debt instruments by both corporate entities and individuals. It will encourage high net worth corporate trading members with dealer network and short settlement cycles.

Objectives

The NSE has the following objectives.[4]

1. To establish nationwide trading facility for equities, debts and hybrids.
2. To facilitate equal access to investors across the country.
3. To provide fairness, efficiency and transparency to the securities trading.
4. To enable shorter settlement cycles.
5. To meet international securities market standard.

Features of NSE

The important features of the NSE are the following.[5]

1. The NSE employs a fully automated screen-based trading system.
2. It has two segments: the capital market segment and wholesale debt market segment. The capital market segment covers equities, convertible debentures.

3. The market operates with all participants stationed at their offices and making use of their computer terminals, to receive market information, to enter orders and to execute trade.
4. The trading member is the capital market segment, connected to the central computer in Bombay, through a satellite link-up using VSATs (Very Small Aperture Terminals). The trading members in the wholesale debt market segment are linked, through dedicated high speed lines, to the central computer at Bombay.
5. The NSE has opted for an order-driven system. The system provides enormous flexibility to trading members. A trading member can place various conditions on the order in terms of price, time or size. When an order is placed by a trading member, an order confirmation slip is generated. All orders received are staked in price and time priority. The computer system automatically searches for a match and no sooner to the same is found, the deal is struck. If it does not find a match immediately as may happen in the case of less liquid securities, the order is kept pending in the computer unless specified otherwise by the trading member.
6. When a trade takes place, a trade confirmation slip is printed at the trading member's workstation. It gives details like price, quantity, code number of the party and so on.
7. The identity of the trading member is not revealed to others when he places an order or when his pending orders are delayed. Hence, large order can be placed in NSE without the fear of influencing the market sentiment.
8. The automated trade matching system secures the best price available in the market to the investor. The trading member can transact a high volume of business efficiently.

NSE is the second fastest growing stock exchange in the world.

TABLE 25.1 : COMPARISON BETWEEN STOCK EXCHANGE, OTCEI AND NSE

	Stock Exchange	*OTCEI*	*NSE*
1. Membership	Individuals, Firms & Corporates	Corporates only	Individuals, Firms & Corporates
2. Method of Trading	Floor-based	Screen-based	Screen-based
3. System of Trading	Quote-driven	Code-driven	Order-driven
	Manual	Computers linked to central OTCEI through telephone lines	Computer linked by satellite through VSAT
4. Settlement	T+14	T+3 rolling settlement	Same day to T+5 in WDM. Standard Delivery in Equity market
5. Transparency	NIL	Ensured	Total transparency
6. Intermediary	Jobber needed	Not needed	Not needed

Source: E. Gordon and K. Natarajan, *Capital Market in India* (Himalaya Publishing House, Mumbai).

Types of Market

The NEAT system has four types of market. They are:

Normal Market: All orders which are of regular lot size or multiples thereof are traded in the Normal Market. For shares which are traded in the compulsory dematerialised mode, the market lot of these shares is one. Normal market consists of various book types wherein orders

are segregated as Regular Lot Orders, Special Term Orders, Negotiated Trade Orders and Stop Loss orders depending on their order attributes.

Odd Lot Market: All orders whose order size is less than the regular lot size are traded in the odd lot market. An order is called an odd lot order if the order size is less than regular lot size. These orders do not have any special terms attributes attached to them. In an odd lot market, both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place. Currently, the odd lot market facility is used for the Limited Physical Market as per the SEBI directives.

Spot Market: Spot orders are similar to the normal market orders except that spot orders have different settlement periods *vis-à-vis* normal market. These orders do not have any special terms attributes attached to them. Currently, the Spot Market is being used for the Automated Lending and Borrowing Mechanism (ALBM) session.

Auction Market: In the Auction Market, auctions are initiated by the Exchange on behalf of trading members for settlement related reasons.

STOCK HOLDING CORPORATION OF INDIA

A new company, namely, the Stock Holding Corporation of India Ltd. (SHCI), was recently established with its registered office in Mumbai, in order to secure efficient post-trade processing services for transactions in securities carried out by the all-India financial and investment institutions (IDBI, ITCI, ICICI, IRBI, LIC, UTI and GIC). SHCI is owned at the outset by the seven sponsoring institutions. It would hold custody of securities of the sponsoring institutions and handle transfer of securities as also collection of dividend/interest in respect of such securities on their behalf. It was also intended to extend its services to others such as stock-brokers and individual investors after setting up the infrastructural facilities and gaining experience in the field.

REGULATION OF STOCK EXCHANGE

In India, the development of the Stock market is directed and the dealings on the stock exchanges are regulated by the Central Government in accordance with the Securities Contracts (Regulation) Act, 1956 (SCRA), and the Securities and Exchange Board of India (SEBI) established by the Central Government.

SECURITIES CONTRACTS (REGULATION) ACT

The Securities Contracts (Regulation) Act, enacted in 1956, came into force on February 20, 1957.

Objectives of the Act

According to the Preamble to the Securities Contracts (Regulation) Act, 1956, (SCRA), the objective of the Act is to *prevent undesirable transactions in securities by regulating the business of dealings in securities and by providing for certain other matters connected with transaction in securities.*

SCRA gives enormous powers to the Central Government for proper regulation of stock exchanges.

A perusal of the important provisions of the SCRA will indicate that the important objectives of the Act are:

1. To empower the Central Government to regulate the dealings in and functioning of the stock exchange in India.
2. To promote healthy and orderly development of the stock market in India.
3. To prevent unhealthy speculation and other undesirable activities on the stock exchange.
4. To protect the interest of the investors.
5. To provide for reasonable uniformity in respect of the bye-laws and rules of the different stock exchanges in India.

Main Provisions

The Securities Contracts (Regulation) Act, 1956, empowers the Central Government to take appropriate measures to achieve the objectives mentioned above. The important provisions of the Act encompass the authority given to the Central Government, or, in certain cases the SEBI, pertaining to:

1. The grant of recognition or withdrawal of recognition to any stock exchange.
2. Approval of the bye-laws and rules of stock exchanges.
3. Power to direct the stock exchange to make or amend roles and bye-laws in certain cases.
4. Power to make or amend bye-laws or roles for stock exchanges.
5. Monitoring the activities and functioning of the stock exchanges by calling for periodic returns and specific information as and when required and by conducting inquiry into certain matters when the situation so warrants.
6. Power to suspend business of stock exchanges.
7. Power to supersede governing body of any stock exchange on account of specific reasons.
8. Regulation of listing of securities.

Recognition to Stock Exchanges

After the coming into effect of the Securities Contracts (Regulation) Act, 1956, only those stock exchanges which are granted recognition by the Central Government can function in India.

Any stock exchange which is desirous of being recognised may apply to the Central Government in the prescribed manner with the required particulars and a copy of the bye-laws of the stock exchange and the rules relating to the constitution of the stock exchange.

Only those stock exchanges recognised by the Central Government can function in India. Central Government can withdraw the recognition in specific cases.

The Central Government may grant recognition to a stock exchange if it is satisfied that the rules and bye-laws of the stock exchange are in conformity with such conditions as may be prescribed with a view to ensure fair dealing and to protect investors. The conditions which the Central Government may prescribe in this respect may relate to: *(a)* the qualifications for membership of the stock exchange, *(b)* the manner in which contracts shall be entered into and enforced between members, *(c)* the representation of the Central Government on the stock exchange, and the maintenance of accounts of members and their proper audit. Further, the stock exchange shall be bound to comply with any other conditions which the Central Government may impose in accordance with the Act.

The Act lays down that the Central Government shall not refuse grant of recognition to a stock exchange without giving it an opportunity to be heard and that the reasons for the refusal shall be communicated to the stock exchange in writing.

If the Central Government is of the opinion that the recognition granted to a stock exchange should be withdrawn in the interest of the trade or in the public interest, may do so after properly serving a notice on the governing body of the stock exchange and after giving the governing body an opportunity for being heard in the matter.

A Stock Exchange may establish additional trading floor with the prior approval of the SEBI in accordance with the terms and conditions stipulated by SEBI.

Power of Recognised Stock Exchange to Make Rules Restricting Voting Rights, etc.

A recognised stock exchange may make rules or amend any rules made by it to regulate the voting rights.

No such rules of a recognised stock exchange made or shall have effect until they have been approved by the Central Government and published by that Government in the Official Gazette and, in approving the rules so made or amended, the Central Government may make such modifications therein as it thinks fit, and on such publication, the rules as provided by the Central Government shall be deemed to have been validly made.

The Act empowers the Central Government, subject to certain conditions, direct recognised stock exchanges generally or any recognised stock exchange in particular, as the case may be, to make any rules or to amend any rules already made.

If any recognised stock exchange fails or neglects to comply with any such order within the period specified therein, the Central Government may make the rules for, or amend the rules made by, the recognised stock exchange, either in the form proposed in the order or with such modifications thereof as may be agreed to between the stock exchange and the Central Government.

Bye-laws of Stock Exchanges

Any recognised stock exchange may, subject to the previous approval of the SEBI, make bye-laws for the regulation and control of contracts. The SEBI is empowered, on the basis of a request received from the governing body of a stock exchange or on its own motion, to make or amend any bye-laws in accordance with the SCRA.

Where the governing body of any stock exchange objects to any bye-laws made or amended by the SEBI on its own motion, it may apply to the SEBI for a revision of it within specified period. After giving an opportunity to the governing body to be heard in the matter, the SEBI may revise the bye-laws so made or amended.

Power to Obtain Information and to Conduct Inquiry

SEBI is empowered to scrutinise the bye-laws of stock exchanges and to monitor their functioning.

Every recognised stock exchange shall furnish the Central Government with a copy of the annual report containing all the particulars prescribed. Further, every recognised stock exchange shall furnish to the SEBI such periodical returns relating to its affairs as may be prescribed.

It is also laid down by the Act that every recognised stock exchange and every member of such stock exchange shall maintain and preserve for such periods not exceeding five years such books of account and other documents as the Central Government may prescribe. These books of account and other documents shall be available for inspection by the SEBI at all reasonable time.

The SEBI is also authorised to call upon any recognised stock exchange or any member of such exchange to furnish any information or explanation relating to the affairs of the stock exchange or the member in relation to the stock exchange.

Besides, the SEBI may call upon a recognised stock exchange or any member thereof to furnish such information or explanation relating to the stock exchange as it may require.

The SEBI is also empowered to appoint one or more persons to make an inquiry in the prescribed manner in relation to the affairs of any of the members of the stock exchange in relation to the stock exchange.

Power to Supersede Governing Body

If the Central Government has sufficient reasons to think that the governing body of any stock exchange should be superseded, it may do so after serving a written notice on the governing body and giving the governing body an opportunity to be heard in this matter. When the governing body is superseded, the Government may appoint any person or persons to exercise and perform all the powers and duties of the governing body for such period as may be specified. The Government may vary this period, from time to time, by proper notification. The Central Government may call upon the stock exchange to reconstitute the governing body before the termination of this period.

These powers are exercisable by the SEBI also.

Power to Suspend Business of Stock Exchange

The SCRA empowers the Central Government to suspend the business of any stock exchange, under certain circumstances, for a period not exceeding seven days in the interest of trade or public interest. The period of suspension may be extended from time to time but after the governing body has been given an opportunity of being heard in the matter.

This powers are exercisable by the SEBI also

Listing of Securities

Listing of securities refers to the sanction of the right to trade the securities on the stock exchange.

Listing has some advantages.

Only listed securities are allowed to be traded on a stock exchange.

1. Listing enhances the marketability and liquidity of the security.
2. Another attractiveness of the listed securities is that they command higher collateral value for purpose of bank credit.
3. Listing lends prestige to the security and widens its market.
4. Listed securities enjoy more public confidence as the stock exchange compels the issuer to comply with high standards.
5. Listing provides greater publicity for the company concerned because the prices and their trends in respect of the listed securities are often published by financial and business publications.

A public company desirous of getting its securities listed on a stock exchange shall apply to the stock exchange for this purpose with the required documents such as Memorandum and Articles of Association, copies of all prospects or statements in lieu of prospectuses issued by the company at any time etc. and the company shall abide by the conditions of the listing agreement with the stock exchange. Where any stock exchange refuses listing, the company shall be entitled to be furnished with the reasons for that. The company may appeal to the Central Government against the refusal.

SEBI

The establishment of the Securities and Exchange Board of India (SEBI) was a landmark government measure to monitor and regulate capital market activities and to promote healthy development of the market.

The SEBI was constituted in 1988 by a resolution of Government of India and it was made a statutory body by the Securities and Exchange Board of India Act, 1992.

Management

Section 4 of the Act lays down the constitution of the management of SEBI. The Board of members of SEBI shall consist of a Chairman, two members from amongst the officials of the Ministries of the Central Government dealing with Finance and Law, one member from amongst the officials of the Reserve Bank of India, two other members to be appointed by the Central Government, who shall be professionals and *inter alia* have experience or special knowledge relating to securities market.

The Act empowers the Central Government to supersede SEBI, if on account of grave emergency, SEBI is unable to discharge the functions and duties under any provisions of the Act, or SEBI persistently defaults in complying with any direction issued by the Central Government under the Act, or in the discharge of its functions and duties under the Act and as a result of such default the financial position of SEBI or its administration has deteriorated, or in public interest.

Objectives

According to the Act, the objectives of SEBI are *to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market for matters connected therewith or incidental therewith.*

Powers and Functions

The SEBI Act casts upon SEBI the duty to protect the interests of investors in securities and to promote the development of and to regulate the securities market through appropriate measures, These measures provide for:

SEBI is a statutory body with a triple mandate: protection of interests of investors, proper regulation of the stock exchanges and healthy development of securities market.

1. Regulating the business in stock exchanges and any other securities market.
2. Registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities market in any manner.
3. Registering and regulating the working of collective investment schemes, including mutual funds.
4. Promoting and regulating self-regulatory organisations.
5. Prohibiting fraudulent and unfair trade practices in securities market.
6. Promoting investor education and training of intermediaries in securities market.
7. Prohibiting insider trading in securities.
8. Regulating substantial acquisition of shares and takeover of companies.
9. Calling for information from, undertaking inspection, conducting enquiries and audits of the stock exchanges and intermediaries and self-regulatory organisations in the securities market.

10. Performing such functions and exercising such powers under the provisions of the Capital Issues (Control) Act, 1947, (subsequently repealed) and the Securities Contracts (Regulations) Act, 1956, as may be delegated to it by the Central Government.
11. Levying fees or other charges for carrying out the purposes of Section 11 of the Act.
12. Conducting research for the above purpose.
13. Performing such other functions as may be prescribed by the government.

The Board may, for the protection of investors, specify, by regulations, the matters relating to issue of capital, transfer of securities and other matters incidental thereto and the manner in which such matters, shall be disclosed by the companies.

The SEBI is also empowered to issues such directions as may be appropriate to certain person or class of persons or company, intermediary or other persons referred to in Section 12 (stock broker, sub-broker, share transfer agent, banker to an issue, trustee of trust deed, merchant banker, underwriter, registrar to an issue, investment adviser, portfolio manager etc.): *(i)* in the interest of investors, or orderly development of securities market; or *(ii)* to prevent the affairs of any intermediary or other persons referred to in Section 12, being conducted in a manner detrimental to the interests of investors or securities market; or *(iii)* to secure the proper management of any such intermediary or person.

CAPITAL MARKET REFORMS AND DEVELOPMENTS

The number of Stock Exchanges has increased and the capital market has expanded substantially. However, the functioning of the stock exchanges were characterised by many shortcomings with long delays, lack of transparency in procedures and vulnerability to price rigging and insider trading. A number of measures have been taken to overcome these problems. The objectives of these measures, broadly, have been to:

Several measures taken by the Central Government and SEBI have made the Indian stock market one of the vibrant and well governed stock markets in the world.

- Provide for effective control of the stock exchange operations.
- Increase the information flow and disclosures so as to enhance the transparency.
- Protect the interests of investors.
- Check insider trading.
- Improve the operational efficiency of the stock exchanges.
- Promote healthy development of the capital market.

Important measures of reform and development include the following.[6]

Free Pricing

Raising of capital from the securities market before 1992 was regulated under the Capital Issues (Control) Act, 1947, which required companies to obtain approval from the Controller of Capital Issues (CCI) for raising resources in the market. New companies were allowed to issue shares only at par. Only the existing companies with substantial reserves could issue shares at a premium, which was based on some prescribed formula. In 1992, the Capital Issues (Control) Act, 1947 was repealed and with this ended all controls relating to raising of resources from the market. Since then, the issuers of securities could raise the capital from the market without requiring any consent from any authority either for making the issue or for pricing it. Restrictions on rights and bonus issues have also been removed. New as well as established companies are

now able to price their issues according to their assessment of market conditions. However, issuers of capital are required to meet the guidelines of SEBI on disclosure and investor protection. Companies issuing capital are required to make sufficient disclosures, including justification of the issue price and also material disclosure about the 'risk factors' in their offering prospectus. These guidelines have served as an important measure for protecting investor interest and promoting the development of the primary market along sound lines.

Introduction of Book Building

To help overcome the problem of determining the right price at which the market would clear an issue the book building mechanism which introduced in 1995. The Book building mechanism is a method through which an offer price of an Initial Public Offering (IPO) is based on investors' demand. The introduction of book building mechanism gave the issuer the choice to raise resources either through this or the fixed price mechanism. The book building mechanism of floating new capital issues has been devised in such a way that small investors are also able to subscribe to securities at a price arrived at through a transparent process. As the book building process is both time and cost-effective, it is becoming quite popular.

Book building mechanism has become popular in India.

Electronic Trading

Till recently, trading on the Indian stock exchanges took place through open outcry system barring NSE and OTCEI, which adopted screen-based trading system from the beginning (*i.e.,* 1994 and 1992 respectively). At present, all other stock exchanges have adopted online screen-based electronic trading, replacing the open outcry system.

There are three main advantages of electronic trading over floor-based trading as observed in India, *viz.,* transparency, more efficient price discovery, and reduction in transaction costs. Transparency ensures that stock prices fully reflect available information and lowers the trading costs by enabling the investor to assess overall supply and demand. Owing to computer-based trading, the speed with which new information gets reflected in prices has increased tremendously. The quantity and quality of information provided to market participants during the trading process (pre-trading and post-trading) having significant bearing on the price formation has also improved. Besides, the screen-based trading has the advantage of integrating different trading centres all over the country into a single trading platform. It may be noted that prior to screen-based trading, the very presence of stock markets in different regions implied segmentation of markets affecting the price discovery process. Investors in other locations were, under such conditions, unable to participate in the price formation process at the major stock exchange, namely the BSE. However, with screen-based trading spread across various locations, the process of price discovery has improved in the Indian stock markets. Screen-based trading has also led to significant reduction in the transaction cost since it enabled the elimination of a chain of brokers for execution of orders from various locations at BSE and NSE.

Instruments and Market Participants

The capital market has widened and deepened considerably in the recent years with enlargement of participants and emergence of new instruments. In the Indian capital market, traditionally mainly two instruments were traded, *i.e.*, debt and equity. However, starting from the mid-eighties and especially during the first-half of the nineties, a wide range of innovative/ hybrid instruments combining both the features of debt and equity were introduced to suit varied needs of investors and issuers/borrowers. Besides DFIs, PSUs also issued many debt instruments with innovative features.

Markets have also widened with the increase in the number of players, such as, mutual funds and foreign institutional investors.

Improvements in Trading, Clearing and Settlement Systems

The trading, clearing and settlement systems, which had suffered from several bottlenecks, have been considerably improved with measures taken to shorten the settlement cycle through the introduction of rolling settlement system and acceleration of the process of electronic book entry transfer through depository.

Increased Dematerialisation

Safe and quick transfer of securities is an important element for smooth and efficient functioning of the securities market. Apart from the problems involved in the movement of physical security certificates, bad deliveries due to faulty paperwork, theft, forgery *etc.* added to the transaction cost and restricted liquidity. To overcome these difficulties, legislative changes were carried out for maintaining ownership records in an electronic book-entry form. Under this mode, securities are transferred in a speedy and safe manner without interposition of issuers in the process, except in few circumstances. In order to catalyse the process of dematerialisation of securities and dematerialised trading, an element of compulsion was introduced by requiring the individual and institutional investors to settle trades compulsorily in dematerialised form in shares of select companies.

Near Elimination of Counterparty Risk

One of the shortcomings of the clearing and settlement process of the Indian stock markets was the absence of a system to reduce counterparty risk. Managing this risk is essential for promoting a safe and efficient market. To provide the necessary funds and ensure timely completion of settlements in cases of failure of member brokers to fulfil their settlement obligations, major stock exchanges have set up Settlement Guarantee Funds. The aggregate corpus of the Fund at the stock exchanges is presently over ₹ 1,000 crore. The NSE has set up a clearing corporation which guarantees settlement of all trades. The clearing corporation, thus, assumes the counterparty risk involved in all the transactions.

All stock exchanges in the country have established clearing houses. Consequently, all transactions are settled through the clearing houses. In the past, while some transactions were settled through the clearing houses, others were settled directly between the members. Routing of transactions through clearing houses has substantially reduced the credit risk in the settlement system.

Circuit Breakers/Price Bands

Circuit breakers were first introduced in 1987 in the US in the wake of sharp fall in the share prices. To contain abnormal price variations, scrip-wise specific daily price bands or circuit breakers in India were introduced in 1995 whereby the trading automatically got suspended if the prices varied either side beyond 8 per cent; further trading was allowed only up to the price band. Price bands, which were originally fixed at 8 per cent, were relaxed in January 2000, whereby a further variation of 4 per cent in the scrip beyond 8 per cent, after a cooling off period of 30 minutes, was allowed. This was made applicable in the case of 100 scrips. In June 2000, for all scrips under compulsory rolling settlement, the price band was relaxed by 8 per cent (from 4 per cent earlier) with half an hour cooling period after the scrip had hit the initial price band of 8 per cent.

While recent experiences in some countries, such as, Brazil, Taiwan and Thailand, showed that circuit filters were successful in slowing down the market momentum, there has been some controversy over the effectiveness of circuit filters over the medium to long-term. Although the circuit filters could have their adverse effects on the process of price formation, they are favoured mainly on the ground that they are the best available tool for containing volatility. This is based on the belief that containing of excess volatility helps to maintain investor confidence in the market.

Structure of Informational Flows

Several measures have been taken to enhance the transparency of the companies. A company offering securities in the Indian capital market is required to make a public disclosure of all relevant information through its offer documents, as indicated earlier. After a security is issued to the public and subsequently listed on a stock exchange, the stock exchange requires the issuing company to make continuing disclosures under the listing agreement. In India, all listed companies are now required to furnish to the stock exchanges and also publish mandated unaudited financial results on a quarterly basis. India is one of the few countries in the world to have a system of quarterly disclosures and it has served a useful purpose in that price-sensitive information on earnings and revenues is now available at greater frequency. The publication of half-yearly corporate results on the basis of limited review by its auditors has also been made mandatory for listed companies. The disclosures of material information, which would have a bearing on the performance/operations of the company, are now required to be made available to the public immediately. Recently, a decision has been taken that the companies would be required to make decisions regarding dividend, bonus and rights announcements or any material event within 15 minutes of the conclusion of the board meeting where the decisions are taken. Following the international practices, companies in India are also required to provide shareholders with cash flow statements in the prescribed format along with the complete balance sheet and profit and loss statement. Companies are also required to furnish to the stock exchanges on a quarterly basis, a statement on the actual utilisation of funds and actual profitability, as against projected utilisation of funds and projected profitability. As part of better corporate governance practices, disclosures about segment reporting, related party transactions and consolidated balance sheet are also expected to be introduced.

Emphasis on Fair Trading Practices

Several measures have been taken to prevent unhealthy practices and to improve transparency.

Insider trading has been made a criminal offence punishable in accordance with the provisions under the SEBI Act, 1992. The Regulations define an insider as a person who has access to price-sensitive non-public information with regard to a company. Such a person is prohibited from trading in the securities of such a company under the regulations.

There are now separate regulations in place governing substantial acquisition of shares and takeovers of companies. The regulations are aimed at making the takeover process more transparent and to protect the interests of minority shareholders.

Increasing Integration of Various Segments of Securities Markets

In India, different stock exchanges have so far followed their own practices relating to settlement procedures creating segmentation of the market. While stock exchanges continue to follow different systems, certain developments have resulted in better integration of the various segments of the Indian securities market. The two major stock exchanges, *viz.,* BSE and NSE, have expanded their operations in different locations, thus, providing investors across the country with the facility to trade in the stocks listed/permitted in these stock exchanges. The Interconnected Stock Exchange of India Ltd. (ICSI) has been set up as an interconnected market system and provides its trading members a facility to trade on the national market in addition to the trading facility at the regional stock exchanges. This has integrated the various regional stock exchanges, although the trading activity in the ICSI has not been very significant. Many regional stock exchanges have also become members of BSE and NSE, which further strengthened the integration process of various stock exchanges in the country. Equity market is also increasingly integrating with the Government securities and private corporate sector debt market. The interest rate structure of Government securities and securities issued by the corporate entities is better aligned at present than in the past.

The Impact of the Changing Structure

The changing structure of capital market has had some positive impact on the volatility, liquidity and transaction cost.

SUMMARY

According to the Securities Contracts (Regulation) Act, 1956, *stock exchange means anybody of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities*. Thus, the Stock Exchange is a market in which securities are bought and sold.

Stock exchange is an essential component of a developed capital market. It brings together large amounts of capital necessary for the economic progress of a country.

An organised securities market can provide sufficient marketability and price continuity for shares, so necessary for the needs of investors, and a reasonable measure of safety and fair dealing in the buying and selling of securities. Further, through the interplay of demand for and supply of securities, properly organised stock exchange assists in a reasonably correct evaluation of securities in terms of their real worth. Lastly, through such evaluation of securities the stock exchange helps in the orderly flow and distribution of savings as between different types of competitive investments.

There are a number of stock exchanges functioning in India including the Over The Counter Exchange of India (OTCEI) and the National Stock Exchange (NSE).

The establishment of the Over The Counter Exchange of India (OTCEI) and the National Stock Exchange of India (NSE) added significant new dimensions to the stock exchange system of India.

The OTCEI is a stock exchange with a lot of differences with those of others. "Although the basic framework of the OTC Exchange is that of a *national market, yet there is no physical location, no counters, no trading ring, no stock exchange building and no hustle and bustle scenes as the conventional stock exchanges*. The buyers and sellers living apart from each other trade in corporate securities over the telephone. The system cuts across urban and rural areas extending the frontiers of the stock market to the entire country. These OTC markets are fully automated exchanges where transactions are completed through a network of telephones/teller computers right from the first centre to the last centre. In addition, only professional people are authorised to render financial services".

In the past, an investor wanting to transact in a security not traded on the nearest exchange had to route orders through a series of correspondent brokers to the appropriate exchange. This resulted in a great deal of uncertainty and high transaction costs. The establishment of the NSE in 1994 has made it possible for an investor to access the same market and order book, irrespective of location, at the same price and at the same cost. The NSE is a nodal exchange with a nation-wide electronic screen based "scripless" and "floorless" trading system in securities which is both efficient and transparent and offer equal and nationwide access to investors.

The stock market is directed and the dealings on the stock exchanges are regulated by the Central Government in accordance with the Securities Contracts (Regulation) Act, 1956 (SCRA), and the Securities and Exchange Board of India (SEBI) established by the Central Government.

The objective of the Securities Contracts (Regulation) Act, 1956 (SCRA), is to prevent undesirable transactions in securities by regulating the business of dealings in securities and by providing for certain other matters connected with transaction in securities.

After the coming into effect of the Securities Contracts (Regulation) Act, 1956, only those stock exchanges which are granted recognition by the Central Government can function in India.

The important provisions of the Act encompass the authority given to the Central Government, or, in certain cases the SEBI, pertaining to the grant of recognition or withdrawal of recognition to any stock exchange; approval of the bye-laws and rules of stock exchanges; power to direct the stock exchange to make or amend roles and bye-laws in certain cases; power to make or amend bye-laws or roles for stock exchanges; monitoring the activities and functioning of the stock exchanges by calling for periodic returns and specific information as and when required and by conducting inquiry into certain matters when the situation so warrants; power to suspend business of stock exchanges; power to supersede governing body of any stock exchange on account of specific reasons.

Each stock exchange is managed by an Executive Committee/Council of Management/ Governing Body to which the Government is empowered to nominate not more than three members. The rules and bye-laws of the stock exchange shall be in conformity with such conditions as may be prescribed by the Government. The Securities Contracts (Regulation) Act empowers the Government also to withdraw the recognition granted to a stock exchange, in the interest of trade or in public interest. Further, in order to deal with abnormal and extraordinary situations which may develop from time to time, Government is empowered to supercede a governing body after giving an opportunity to the governing body to be heard in the matter and to appoint in its place any person or persons to perform the functions of the governing body; and to suspend such of the business of a stock exchange under certain circumstances, for such period not exceeding seven days as may be specified, in the interest of trade or in public interest. The period of suspension can be extended from time to time, but after the governing body has been given an opportunity of being heard in the matter.

Since 1988, the Securities and Exchange Board of India (SEBI) has been playing a very important role in regulating the capital market in India. The objectives of the SEBI are to protect the interests of investors in securities, to regulate the activities of the securities market and promote healthy development of the capital market.

Important powers and functions of the SEBI include regulating the business in stock exchanges and any other securities market; registering and regulating the working of stock market intermediaries; promoting and regulating self-regulatory organisations; prohibiting fraudulent and unfair trade practices in securities market; promoting investor education and training of intermediaries in securities market; prohibiting insider trading in securities; regulating substantial acquisition of shares and takeover of companies; and, calling for information from undertaking inspection, conducting enquiries and audits of the stock exchanges and intermediaries and self-regulatory organisations in the securities market.

The functioning of the stock exchanges were characterised by many shortcomings with long delays, lack of transparency in procedures and vulnerability to price rigging and insider trading. A number of measures have been taken to overcome these problems. The objectives of these measures, broadly, have been to provide for effective control of the stock exchange operations; increase the information flow and disclosures so as to enhance the transparency; protect the interests of investors; check insider trading; improve the operational efficiency of the stock exchanges and, in general, to promote healthy development of the capital market.

Important measures of reform and development include the introduction of free pricing of capital issues; introduction of book building mechanism; introduction of electronic trading, measures to widen and deepen the capital market; improvement in the trading, clearing and settlement systems; promotion of dematerialisation; measures to reduce counterparty risk, introduction of circuit breakers/price bands; measures to increase information flow and to enhance the transparency

of the companies; and, ushering in of fair trading practices, including prohibition of insider trading. These measures have had some positive impact on the volatility, liquidity and transaction cost.

Regional stock exchanges which do not satisfy specified criteria will have to wind up. Other regional exchanges have the option to exit.

The Madras Stock Exchange, one of the oldest stock exchanges of the country and the Cochin Stock Exchange are in the process of exiting.

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ANNEXURE 25.1

Derivatives

A derivative is an instrument whose value is derived from the value of one or more *underlying* asset such as commodities, precious metals, currency, bonds, stocks, stocks indices, etc. The most common examples of derivative instruments are Forwards, Futures, Options and Swaps.

Trading in derivatives, thus, means trading in instruments such as Forwards, Futures, Options and Swaps.

Forwards and Futures

A forward contract is a customised contract between two parties to buy or sell a specified quantity of a particular instrument or commodity at a specified price at a specified future date. Futures are exchange traded forward contracts, *i.e.,* forward contracts done in organised exchanges like stock exchanges and commodity exchanges.

The major difference between Forward contracts and Futures contracts are the following.[1]

1. ***Standardised vs. Customised Contract*** – Forward contract is customised while the future is standardised. To be more specific, the terms of a Forward Contracts are individually agreed between two counterparties, while Futures being traded on exchanges have terms standardised by the exchange.

   The standardised items in any Futures contract are quantity of the underlying; quality of the underlying (not required in financial Futures); the date and month of delivery; the units of price quotation (not the price itself) and minimum change in price (tick-size); and the location of Settlement.

2. ***Counterparty risk*** – In case of Futures, after a trade is confirmed by two members of exchange, the exchange/clearing house itself becomes the counterparty (or guarantees) to every trade. The credit risk, which in case of forward contracts was on the counterparty, gets transferred to exchange/clearing house, reducing the risk to almost nil.

3. ***Liquidity*** – Futures contracts are much more liquid and their price is much more transparent due to standardisation and market reporting of volumes and price.

4. ***Squaring off*** – A forward contract can be reversed only with the same counterparty with whom it was entered into. A Futures contract can be reversed with any member of the exchange.

If Futures contracts are priced above the spot price, it is known as the *Contango* market. If the Futures price prevails below the spot price, it is known as *Backwardation.*

Option

An option is a contract, which gives the buyer (holder) the right, but not the obligation, to buy or sell specified quantity of the underlying assets (such as a commodity, currency, or security), at a specific (strike) price on or before a specified time (expiration date). Unlike futures, the purchaser of an option is not obliged to buy or sell at the exercise price and will only do so if it is profitable; if the option is allowed to lapse, the purchaser loses only the initial purchase price of the option (the option money).

The strike or exercise price of an option is the specified/predetermined price of the underlying asset at which the same can be bought or sold if the option buyer exercises his right to buy/sell on or before the expiration day. The price paid by the buyer to the seller to acquire the right to buy or sell is known as the premium.

The one who is obligated to buy (in case of Put option) or to sell (in case of Call option), the underlying asset in case the buyer of the option decides to exercise his option is known as the option seller/writer. His profits are limited to the premium received from the buyer while his downside is unlimited. The premium fluctuates in response to current market value of the security/ exercise price, time period between the strike and the expiry date, supply and demand in the market, etc. The one who buys an option which can be a call or a put option is known as the option holder. He enjoys the right to buy or sell the underlying asset at a specified price on or before specified time. His upside potential is unlimited while losses are limited to the premium paid by him to the option writer.

An option to buy is known as a *call option* and is usually purchased in the expectation of a rising price, an option to sell is called a *put option* and is bought in the expectation of a falling price or to protect a profit on an investment. Options, like futures, allow individuals and firms to hedge against the risk of wide fluctuations in prices; they also allow speculators to gamble for large profits with limited liability.

When the option's strike price is equal to the underlying asset price, the option is said to be 'at-the-money'. This is true for both puts and calls. A call option is said to be 'in-the-money' when the strike price of the option is less than the underlying asset price. A call option is 'out-of-the-money' when the strike price is greater than the underlying asset price.

The significant differences in Futures and Options are as under:[2]

1. Futures are agreements/contracts to buy or sell specified quantity of the underlying assets at a price agreed upon by the buyer and seller, on or before a specified time. Both the buyer and seller are obligated to buy or sell the underlying asset. In case of options, the buyer enjoys the right and not the obligation, to buy or sell the underlying asset.

   In case of options the buyer enjoys the right and not the obligation, to buy or sell the underlying asset.

2. Futures Contracts have symmetric risk profile for both the buyer as well as the seller, whereas options have asymmetric risk profile. In case of Options, for a buyer (or holder of the option), the downside is limited to the premium (option price) he has paid while the profits may be unlimited. For a seller or writer of an option, however, the downside is unlimited while profits are limited to the premium he has received from the buyer.

3. The Futures contracts prices are affected mainly by the prices of the underlying asset. The prices of options are, however, affected by prices of the underlying asset, time remaining for expiry of the contract and volatility of the underlying asset.

4. It costs nothing to enter into a futures contract whereas there is a cost of entering into an options contract, termed as Premium.

Swap

Swap is the means by which a borrower can exchange the type of funds he can most easily raise for the type of funds he wants, usually through the intermediary of a bank. *For example*, a UK company may find it easy to raise a sterling loan when they really want to borrow Deutschmarks; a German company may have exactly the opposite problem.

A swap will enable them to exchange the currency they possess for the currency they need. The other common type of swap is an interest rate swap, in which borrowers exchange fixed for floating interest rates. Swaps are most common in the eurocurrency markets.

Hedging

Hedging is a mechanism to reduce price risk inherent in open positions. Derivatives are widely used for hedging. A Hedge can help lock in existing profits. Its purpose is to reduce the volatility of a portfolio by reducing the risk. Hedging does not mean maximisation of return. It only means reduction in variation of return. It is quite possible that the return is higher in the absence of the hedge, but so also is the possibility of a much lower return.

The basic logic is "If long in cash underlying — Short Future and if short in cash underlying — Long Future". *For example*, if one has bought 100 shares of Company A and wants to hedge against market movements, he should short an appropriate amount of Index Futures. This will reduce his overall exposure to events affecting the whole market (systematic risk). In case a war breaks out, the entire market will fall (most likely including Company A). So, his loss in Company A would be offset by the gains in your short position in Index Futures.

Some examples of where hedging strategies are useful include:[3]

- Reducing the equity exposure of a Mutual Fund by selling Index Futures;
- Investing funds raised by new schemes in Index Futures so that market exposure is immediately taken; and
- Partial liquidation of portfolio by selling the index future instead of the actual shares where the cost of transaction is higher.

Advantages of Derivatives

As Sanjiv Agarwal observes, the introduction of derivatives in the Indian Capital Market could be seen as an effort to improve the present-day mechanics of speculative trading in Forward Scrips. They are more scientific and better suited to fulfil the needs of the market participants and would lead to a mature and efficient market. He points out that derivatives have the following advantages.[4]

1. Derivatives help the market participants to hedge their underlying positions, thereby aiding them in managing their risks. It shall also act as a pro-speculative vehicle for the market traders by providing them a higher degree of leverage and would thereby provide an impetus to the liquidity of the underlying market.
2. Derivatives would insulate the small retail investors from the negative effects of the high speculative activities associated presently with the capital markets. Further, derivatives will provide a genuine risk management tool for the burgeoning institutional players in the Indian Capital Market and the trading members are also corporatising themselves and would be capable of handling sophisticated tools.
3. The major economic benefits of derivatives are that they reduce the risk/increase the willingness to hold the underlying asset; lower transaction costs; enhance the price discovery process; and enhance the liquidity of the underlying asset market.

Index-based Derivatives

As price volatility in individual stocks is very high, futures based on individual stocks are not very common. In India, L.C. Gupta Committee has not mentioned Futures on Individual Stocks as a possible derivative contract. The Index-based derivatives is very popular.

The value of an index is derived from the value of its underlying. *For example*, the value of the BSE 30 Sensex, is derived from the value of the 30 shares on which the index is based. These are shares of large well-established and financially sound companies. An index, thus, is an indicator of the broad market. For instance, tracking the changes in the Sensex enables one to effectively gauge stock market movements.

Index-based derivatives have several advantages over derivatives based on specific securities. According to the Committee on Derivatives set up by the Securities and Exchange Board of India (SEBI) under the chairmanship of L.C. Gupta, Stock index futures are internationally the most popular form of equity derivatives for the following reasons:

1. They provide portfolio hedging facility.
2. There is lesser risk of manipulation of stock index as compared to individual stock prices.
3. Their greater popularity makes them more liquid.
4. Stock index is generally less volatile than individual stock prices.
5. Index futures are cash settled all over the world as the index value is derived from the cash market.

Both the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) have launched index futures in June 2000.

According to the sources of the Stock exchange, Mumbai,[5] the Sensex futures would evolve to become the most liquid contract in the country. This is because institutional investors in India and abroad, money managers and small investors use the Sensex when it comes to describing the mood of the Indian Stock markets. Thus, it has been observed that the Sensex is an effective proxy for the Indian stock markets. Higher liquidity in the product essentially translates to lower impact cost of trading in Sensex futures. The arbitrage between the futures and the equity market is further expected to reduce impact cost. Trading in Stock index futures is likely to be predominantly retail-driven. Internationally, stock index futures are an institutional product with 60 per cent of the volumes generated from hedging needs. An immense retail participation to the extent of 80-90 per cent is expected in India based on the following factors:

1. Stock index futures will require lower capital adequacy and margin requirements as compared to margins on carry forward of individual scrips.
2. The brokerage costs on index futures will be much lower.
3. Savings in cost is possible through reduced bid-ask spreads where stocks are traded in packaged forms.
4. The impact cost will be much lower in case of stock index futures as opposed to dealing in individual scrips.
5. The market is conditioned to think in terms of the index and therefore would prefer to trade in stock index futures. Further, the chances of manipulation are much lesser.

The Stock index futures are expected to be extremely liquid given the speculative nature of our markets and the overwhelming retail participation expected to be fairly high. In the near future, stock index futures will definitely see incredible volumes in India. It will be a blockbuster product and is pitched to become the most liquid contract in the world in terms of number of contracts traded if not in terms of notional value. The advantage to the equity or cash market is in the fact that they would become less volatile as most of the speculative activity would shift to stock index futures. The stock index futures market should ideally have more depth, volumes and act as a stabilising factor for the cash market. However, it is too early to base any conclusions on the volume or to form any firm trend.

ANNEXURE 25.2

Sensex and Nifty

A stock market index reflects the composite value of a select list of shares. The shares included in the list are selected according to well-defined norms such as regularity of trading, volume of trade, size of the company, industry representation etc. The list of companies represented in the index changes as new companies enter and existing ones exit the list as per the norms applicable for inclusion in the list.

The two important stock market indices of India are the BSE Sensex and NSE Nifty.

There are also a number of indices other than the Sensex and the Nifty. More specialised indices exist tracking the performance of specific sectors of the market. Other indices may track companies of a certain size, a certain type of management, or even more specialised criteria. For example, the BSE Mid-cap Index gives an idea about whether the mid-cap stocks go up or down. There are indices for metal stocks, FMCG stocks, automobile stocks etc. The Sensex is the most popular one and is regarded as the true reflection of the stock market by many.

BSE SENSEX

The BSE Sensex, short form of Bombay Stock Exchange Sensitive Index, first compiled in 1986, is a 'Market Capitalisation Weighted' index of 30 component stocks representing a sample of large, well established and financially sound companies. The index is widely reported in both, the domestic and international, print and electronic media and is widely used to measure the performance of the Indian stock markets.[6]

The BSE Sensex is a benchmark index of the Indian capital market and is considered to be the pulse of the Indian stock markets. As the oldest index of the Indian Stock market, it provides time series data over a fairly long period of time.

The Sensex has historically been the barometer of the Indian capital markets and as such periodic reconstitution becomes mandatory in order to represent the true face of the national economy. Companies in the Sensex hold around one-fifth of the market capitalisation of the BSE. The base period of SENSEX is 1978-79 and the base value is 100 index points. Sensex is regarded as the pulse of share market, the dips and rise of the Indian share market can be identified through the Sensex.

The objectives of the Sensex are:

To Measure Market Movements Given its long history and its wide acceptance, no other index matches the BSE Sensex in reflecting market movements and sentiments. Sensex is widely used to describe the mood in the Indian stock markets.

Benchmark for Funds Performance The inclusion of Blue chip companies and the wide and balanced industry representation in the Sensex makes it the ideal benchmark for fund managers to compare the performance of their funds.

For Index-based Derivative Products Institutional investors, money managers and small investors all refer to the **BSE Sensex** for their specific purposes The BSE Sensex is in effect the proxy for the Indian stock markets. Since Sensex comprises of leading companies in all the significant sectors in the economy, we believe that it will be the most liquid contract in the Indian market and will garner a predominant market share.

Criteria for Selection of Scrips for the Sensex

Market Capitalisation: The scrip should figure in the top 100 companies listed by market capitalisation. Also market capitalisation of the scrip should be more than 0.5 per cent of the total market capitalisation of the Index, *i.e.,* the minimum weightage should be 0.5 per cent. Since the BSE Sensex is a market capitalisation weighted index, this is one of the entry criteria for scrip selection.

Industry Representation: Scrip selection would take into account a balanced representation of the economy. The index companies should be leaders in their industry group with sound management.

Trading Frequency: The scrip should have been traded on every trading day for the last six months. Exceptions can be made for extreme reasons like scrip suspension etc.

Number of Trades: The scrip should be among the top 150 companies listed by average number of trades per day for the last six months.

Volume Traded: The scrip should be among the top 150 companies listed by average volume traded per day for the last six months.

Continuity: Whenever the composition of the index is changed, the continuity of historical series of index values is re-established by linking the value of the revised index to its last previous value prior to the review. This is done by changing the base value of the index to the extent of the percentage change in the market capitalisation of the index because of the revision. The back calculation over the last one year period would be carried out and correlation of the revised index to the old index should not be less than 0.98 to ensure that the historical continuity of the index is maintained.

TABLE 25.A.1: SENSEX CONSTITUENTS (COMPOSITION REVISED FROM JANUARY 12, 2009)*

Name of Company	*Sector*
ACC Ltd.	Housing Related
Bharat Heavy Electricals Ltd.	Capital Goods
Bharti Airtel Ltd.	Telecom
DLF Ltd.	Housing Related
Grasim Industries Ltd.	Diversified
HDFC	Finance
HDFC Bank Ltd.	Finance
Hindalco Industries Ltd.	Metal, Metal Products and Mining
Hindustan Unilever Ltd.	FMCG
ICICI Bank Ltd.	Finance
Infosys Technologies Ltd.	Information Technology
ITC Ltd.	FMCG
Jaiprakash Associates Ltd.	Housing Related
Larsen and Toubro Limited	Capital Goods
Mahindra and Mahindra Ltd.	Transport Equipments
Maruti Suzuki India Ltd.	Transport Equipments
NTPC Ltd.	Power
ONGC Ltd.	Oil and Gas
Ranbaxy Laboratories Ltd.	Healthcare
Reliance Communications Limited	Telecom
Reliance Industries Ltd.	Oil and Gas
Reliance Infrastructure Ltd.	Power
State Bank of India	Finance
Sterlite Industries (India) Ltd.	Metal, Metal Products and Mining
Sun Pharmaceuticals Industries Ltd.	Healthcare

Tata Consultancy Services Limited	Information Technology
Tata Motors Ltd.	Transport Equipments
Tata Power Company Ltd.	Power
Tata Steel Ltd.	Metal, Metal Products and Mining
Wipro Ltd.	Information Technology

*As companies in the Index and their weights are revised periodically, readers are advised to obtain the latest position from the internet.

NSE NIFTY

The S&P CNX Nifty, nicknamed Nifty 50 or Nifty, is the leading stock index of large companies on the National Stock Exchange of India. The Nifty which represents over 20 sectors of the economy and contains 50 diverse stocks, is the flagship index of NSE, the 3rd largest stock exchange in the world in terms of number of transactions (Stock Futures). Some of its purposes include benchmarking fund portfolios, index-based derivatives and index funds.[7]

The Nifty Index is based upon solid economic research. It is internationally respected and recognised as a pioneering effort in providing simpler understanding of stock market complexities. Managed by India Index Services and Products, who have a consulting and licensing agreement with Standard and Poor's, they are the first specialised company focused on the index as a core product in India. A weighted average is used to calculate the index so changes in the share prices of larger companies have a larger effect.

Some important points regarding Nifty are given below.

- Nifty index can be used by individuals to track market movements and compare performance of individual companies' *vis-à-vis* market performance.
- Shareholders' evaluation of management decisions — performance of a company *vis-à-vis* the market generally reflects the perception of the investor.
- Assist traders and market intermediaries to evaluate performance and sentiments across the market.
- Index funds can replicate Nifty indices to earn market returns.
- Derivative trading — Investors can use Nifty indices for hedging their exposures in the equity markets.
- Benchmarking NAV performances — Nifty is the benchmark for performance of open-ended and close-ended funds.
- It is a simplified tool that helps investors and ordinary people alike, to understand what is happening in the stock market and by extension, the economy. If the Nifty Index performs well, it is a signal that companies in India are performing well and consequently that the country is doing well.

Nifty stocks represented nearly 60 per cent of the total market capitalisation as on March 31, 2008 and the traded value for the last six months of all Nifty stocks is approximately 55 per cent of the traded value of all stocks on the NSE.

TABLE 25.A.2: THE COMPOSITION OF THE NIFTY 50 AS OF NOVEMBER 17th, 2008*
(LISTED IN THE DECENDING ORDER OF TENTATIVE MARKET CAP)

Company Name	*Industry*
ABB Limited (ABB.BO)	Capital Goods
ACC Limited (ACC-BY)	Cement
Ambuja Cements Ltd.	Cement
Bharat Heavy Electricals Limited (500103-BY)	Capital Goods
Bharat Petroleum Corporation Ltd.	Oil Marketing
Bharti Airtel Ltd. (BHARTIARTL-BY)	Telecommunication
Cairn Energy	Oil and Gas Drilling and Exploration
Cipla Ltd.	Pharmaceuticals
DLF Ltd.	Real Estate Development
GAIL (India) Ltd.	Oil and Gas Refining
Grasim Industries Ltd. (GRASIM-SL)	Conglomerates
HCL Technologies	Information Technology Services
HDFC (HODFI-BY)	Real Estate
HDFC Bank (HDB)	Banking
Hero Honda Motors Ltd.	Auto Makers
Hindalco Industries Ltd. (HINDALCOSL-BY)	Metals and Mining Industry
Hindustan Unilever Ltd. (HUL-BY)	Fast Moving Consumer Goods (FMCG)
ICICI Bank (ICICIBANK-BY)	Banking
Idea Cellular	Telecommunications
Infosys Technologies (INFOSYS-BY)	Information Technology Services
ITC Ltd. (ITCSL-BY)	Fast Moving Consumer Goods (FMCG)
Larsen & Toubro Ltd. (LNT-BY)	Capital Goods
Mahindra & Mahindra Ltd. (MNM-BY)	Auto Makers
Maruti Suzuki India Ltd. (532500-BY)	Auto Makers
National Aluminium Co. Ltd.	Metals and Mining Industry
National Thermal Power Corporation Ltd. (NTPC-BY)	Energy
Oil and Natural Gas Corporation (ONGCSL-BY)	Oil and Gas Drilling and Exploration
Power Grid Corporation of India	Energy
Punjab National Bank	Banking
Ranbaxy Laboratories Ltd. (RANBAXY-BY)	Pharmaceuticals
Reliance Communications (532712-BY)	Telecommunications
Reliance Industries Limited (RELIANCE-IN)	Conglomerates
Reliance Infrastructure Ltd. (RELINFRA-BY)	Energy
Reliance Petroleum (532743-BY)	Oil and Gas Refining
Reliance Power	Energy
Satyam Computer Services (SAY)	Information Technology Services
Siemens AG (SI)	Capital Goods
State Bank of India (SBI-BY)	Banking
Steel Authority of India Limited (500113-BY)	Metals and Mining Industry
Sterlite Industries (India) Ltd. (STERLITEIND-BY)	Metals and Mining Industry
Sun Pharmaceutical Industries Ltd.	Pharmaceuticals

Suzlon Energy Limited (532667-BY)	Hybrid and Alternative Energy Technology
Tata Consultancy Services (TCS-BY)	Information Technology Services
Tata Motors (TTM)	Auto Makers
Tata Power Company Ltd. (TATAPOWERSL-BY)	Energy
Tata Steel Limited (TATASTL-BY)	Metals and Mining Industry
Unitech	Real Estate Development
Videsh Sanchar Nigam (VSL) (now renamed to Tata Communications Ltd.)	Telecommunications
Wipro Limited (WIPRO-BY)	Information Technology Services
Zee Telefilms Ltd.	Media & Entertainment

** It was announced that the National Stock Exchange, NSE will make changes in the constituents of S&P CNX Nifty Index, CNX Nifty Junior Index and CNX 100 Index w.e.f. June 17, 2009. Accordingly while Reliance Petroleum will be excluded from S&P CNX Nifty Jindal Steel and Power will be included. Jindal Steel and Power will be excluded from CNX Nifty Junior Index and Hindustan Petroleum Corporation will be included. While Reliance Petroleum will be excluded from CNX 100 Index, Hindustan Petroleum Corporation will be included.*

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3. ***Ibid.***
4. **Sanjiv Agarwal, *Manual of Indian Capital Market*, Bharat Law House, New Delhi, 1997, pp. 484-5.**
5. **Adopted from the website of Stock Exchange, Mumbai.**
6. ***Ibid.***
7. **Mostly adopted from the website of NSE.**

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Chapter 26

INDUSTRIAL FINANCE

Structure

Types of Industrial Finance

Corporate Securities

New Issues – Marketing of Securities

Internal Financing

Public Deposits

Summary

References

Annexure 26.1: Leasing

TYPES OF INDUSTRIAL FINANCE

Finance, which has been aptly described as the "lifeblood" of industry, is a prerequisite for the mobilisation of real resources to organise production and marketing. Depending upon the nature of the activity to be financed, business requires short-term, medium-term and long-term finance.

Short-term Finance

Short-term finance usually refers to the funds required for a period of less than one year. Short-term finance is usually required to meet variable, seasonal or temporary working capital requirements.

Borrowing from banks is a very important source of short-term finance. Other important sources of short-term finance are trade credit, installment credit and customer advances.

Medium-term Finance

The period of one year to five years may be regarded as a medium-term. Medium-term finance is usually required for permanent working capital, small expansions, replacements, modifications, etc.

Medium-term finance may be raised by:

(i) Issue of shares

(ii) Issue of debentures

(iii) Borrowing from banks and other financial institutions

(iv) Ploughing back of profits

Although medium-term financial requirement may be met by issue of shares, this source is of long-term nature.

Long-term Finance

Periods exceeding 5 years are usually regarded as long-term. Long-term finance is required for procuring fixed assets, the establishment of a new business, substantial expansion of existing business, modernisation, etc.

The important sources of long-term finance are:

(i) Issue of shares

(ii) Issue of debentures

(iii) Loans from financial institutions

(iv) Ploughing back of profits

CORPORATE SECURITIES

Corporate securities are instruments by which capital is raised by joint stock companies. There are two classes of corporate securities, namely,

- Ownership securities
- Creditorship securities

OWNERSHIP SECURITIES

Ownership securities are the shares by which the owned capital (also known as risk capital and venture capital) is raised.

Kinds of Shares

The paid-up capital of a company comes from ownership securities.

The shares of a company may be broadly divided into:

1. Preference Shares
2. Equity Shares

Preference Shares

Preference shares are those which have preferential right to the payment of dividend during the lifetime of the company, and a preferential right to the return of capital when the company is wound up.

Preference shares have the following characteristics.

1. The dividend on them is fixed by the Articles of the company.
2. Preference shareholders get their fixed rate of dividend before any dividend is distributed among the other class of shareholders.
3. At the time of winding up the company, the preference shareholders must be paid back their capital before anything is paid to ordinary shareholders.

Kinds of Preference Shares

Cumulative Preference Shares: The cumulative preference shares are entitled to fixed dividends whether there are profits or no profits. If profits are not sufficient to pay dividends in a particular year, the dividends are accumulated and paid in the succeeding year(s) as profits become available for distribution.

Convertible Cumulative Preference Shares: In 1985, Government of India introduced a new type of preference share namely convertible cumulative preference (CCP) share. The entire issue of the CCP shares shall be converted to equity any time between the third and fifth years of the issue. Since the conversion to the equity is compulsory, the CCP shares cannot be redeemed at any stage. The CCP shareholders enjoy the same voting rights as the cumulative preference shareholders. For calculation of debt-equity ratio, CCP shares are treated as part of equity. However, for calculation of preference-equity ratio, CCP shares are totally excluded from both categories.

Non-cumulative Preference Shares: Unlike the cumulative preference shares, these shares cannot claim arrears of dividends of any year out of the profits of subsequent years.

Participating Preference Shares: In the case of the participating preference shares, shareholders receive a fixed rate of dividend in priority to ordinary shares and, further, the right to participate in the balance of profit in an agreed proportion together with ordinary shareholders.

Non-participating Preference Shares: These shares are entitled to only a fixed rate of dividend; they have no claim in the surplus profit which belongs to ordinary shareholders.

Redeemable Preference Shares: These are shares which can be purchased back by the company. The company reserves its right to call back or purchase these shares at any time, subject to the provisions of its Articles.

Irredeemable Preference Shares: These are shares that cannot be purchased back by the company.

Equity Shares

All shares which are not preference shares are equity shares, also called ordinary shares. Unlike the preference share, equity shares do not have a fixed rate of dividend. Equity shareholders are entitled to dividends only after the dividend claims of the preference shareholders have been met. Similarly, at the time of the winding up of the company, equity shareholders get back their capital only after the capital of the preference shareholders has been paid back. Equity shares are always irredeemable and their holders have normal voting rights.

The Companies Act refers to two types of equity shares, *viz.,* equity share capital –

- With voting rights
- With differential rights as to dividend, voting or otherwise in accordance with such rules and subject to conditions as may be prescribed.

The second type of equity capital mentioned above was included in the Act by the Companies (Amendment) Act, 2000.

The Companies Act provides that a limited company can, if permitted by its Articles of Association, alter its share capital in any of the following ways.

1. It may increase its share capital by the issue of new shares.
2. It may consolidate and divide all or any part of its share capital into shares of a larger amount.
3. It may convert all or any of its fully paid-up shares into stock or reconvert that stock into fully paid-up shares.
4. It may subdivide the existing shares into shares of lower denomination.
5. It may cancel those shares which have not been taken up and reduce its capital accordingly.

A limited company can alter its share capital if permitted by its Articles of Association by passing a resolution in the general meeting.

Any of the above alternations can be effected by passing a resolution in the general meeting of the company and requires no confirmation by the court. However, the company shall give notice of any such alterations to the Registrar within thirty days after doing so.

CREDITORSHIP SECURITIES

Creditorship securities, which consist of debentures and bonds, are credit instruments which are widely used by companies to raise funds. The capital raised through creditorship securities is known as borrowed capital or debt capital.

Debentures

The term *debenture is* defined as "a document under the company's seal which provides for the payment of a principal sum and interest thereon at regular intervals which is usually secured by a fixed or floating charge on the company's property or undertaking which acknowledges a loan to the company."

Classes of Debentures

1. ***Redeemable and Irredeemable:*** From the point of view of redemption, debentures are classified into redeemable and irredeemable. Redeemable debentures are those that will be repaid by the company at the end of a specified period, or on demand, or by installments. Irredeemable debentures are those that are not repayable during the lifetime of the company. Irredeemable debentures are also called perpetual debentures.

2. ***Mortgage and Simple:*** From the point of view of security, debentures are classified into mortgage and simple or naked debentures. Mortgage debentures, also called secured debentures, are those which are secured by a charge on the assets or property of the company, whereas simple debentures are those that are not secured by any charge on the assets of the company.

3. ***Registered and Bearer:*** From the point of view of records, debentures may be classified into registered and bearer debentures. Registered debentures are those in respect of which the names, addresses and particulars of the holdings of debenture-holders are entered in the Register of Debenture-holders. The transfer of a registered debenture cannot be effected without the execution of a regular transfer deed. As against this, the company keeps no such records of bearer debenture-holders. Bearer debentures are negotiable by mere delivery of the document.

4. ***Convertible and Unconvertible:*** In case of convertible debentures, the holders have the option to convert their debenture holdings into equity shares of the company at a specified rate after a specified period.

NEW ISSUES — MARKETING OF SECURITIES

The securities market may be divided into: *(i)* New Issues Market; and *(ii)* Stock Exchange.

The new issues market is concerned with the floatation of new issues of securities either by new corporations or by existing business concerns. The stock exchange is an organised market where the ownership of existing shares can be transferred from one person or institution to another.

Experience indicates that the public is very discriminate to new issues, with issues of reputed companies getting overwhelming response.

The important methods of the marketing of securities are the following:

Issue to the Public: A public limited company may mobilise funds by selling securities directly to the public as per the provisions of the Companies Act.

The direct placing of the securities is appropriate for companies with a good reputation. It may also be successful if the promoters themselves enjoy a very good reputation.

This method has, however, certain limitations. For a new company with promoters who are not popular and reputed, this method is not advisable because the public may be reluctant to take the risk of investing in such a venture. If the company fails to generate sufficient public response to the issue, its plans may flop.

Private Placement: The term *private placement* refers to the sale of an entire issue of securities by a company directly to one or a few investors, usually financial institutions. Here, the appeal to subscribe to or purchase the securities is made to the investors either directly or through brokers. Insurance companies, investment companies, trust accounts, pension and provident funds, etc., resuitable institutions with whom the securities can be directly placed for subscription. The growth of institutional investors has increased the scope of private placing.

An important advantage of private placement is the absence of the risk of uncertainty in raising the capital. Moreover, the cost of raising the capital is very low because the commission

and other charges are either nil or comparatively low, and no expenditure has to be incurred on issuing a prospectus. The cost of promotion, in general, is very low.

Offer to Special Classes: An established company may raise additional capital by any of the following methods:

Rights Issue: The rights issue is an offer with a pre-emption right to the existing shareholders of the company to further contribute to its share capital. Under the rights issue, new shares are offered to the existing shareholders in certain proportion to their existing share ownership. However, the rights themselves are transferable and saleable in the market.

Issue of Bonus Shares: A company may capitalise its profits or free reserves by the issue of bonus shares to shareholders. Bonus shares are allotted to shareholders in proportion to their respective shareholding.

Offer to the Employees: The issue of shares may be offered to employees. This promotes better industrial relations and higher productivity. *Employees stock option schemes*/issue of *sweat equity* have become very popular in recent years.

Offer to the Customers: This is popular with public utilities. Shareholdings by customers gives them some say in the affairs and functioning of the concern.

Offer to the Creditors: At the time of reorganisation of the capital structure, creditors may be requested to purchase the shares in full settlement of their loans or advances.

Underwriting: The marketing of securities with the support of, or by, underwriting is very popular because this method ensures that the subscription to or sale of the whole of the securities is underwritten.

UNDERWRITING OF SECURITIES

The marketing of securities is greatly facilitated by underwriting. An underwriting agreement is defined as "an agreement entered into before the shares are brought before the public that, in the event of the public not taking up the whole of them or the number mentioned in the agreement, the underwriter will, for an agreed commission, take an allotment of such part of the shares as the public has not applied for."

Underwriting is an important source of support to public issues.

From the point of view of the issuing company, underwriting insures the risk of the public not taking up the required amount of securities. Needless to say, the facility of underwriting enables the company to raise the required capital; for if the public does not take up the whole of the issue, the balance left is taken up by the underwriter.

Methods of Underwriting

An underwriting agreement may take any of the following three forms.

1. ***Standing Behind the Issue:*** Under this method, the underwriter guarantees the sale of a specified number of shares within a specified period. If the public does not take up the whole of the specified amount of the issue, the underwriters standing behind the issue purchase the balance.

2. ***Outright Purchase:*** Under this method, the underwriters purchase the issue outright and resell the securities to the investors. The purchase price may be negotiated between the issuer and the underwriter, or may be determined by competitive bidding.

3. ***The Consortium Method:*** Under consortium method, also known as the syndicated method, as the name indicates, underwriting is jointly done by a group of underwriters who form

a syndicate for this purpose. This method is usually adopted for large issues. The underwriting of large issues by a consortium enables the spread of the risk among the members of the syndicate—no single underwriter bears the entire risk.

Importance and Advantages of Underwriting

Industrial development is fostered, among other things, by the development of the securities market. A good securities market is one of the prerequisites for the growth of joint stock companies. The marketing of securities is necessary for raising the owned capital. Underwriting, therefore, assumes great significance.

A public company will have to secure the minimum subscription within the stipulated time after the issue of the prospectus without which the allotment of shares cannot be made; and without the declaration that it has received the stipulated minimum subscription, the company will not be able to obtain the certificate from the Registrar of Companies to commence business. Underwriters are of great help in ensuring that the company raises the required share capital. Underwriting, thus, plays a very important role in the development of the capital market and in fostering industrial development. It may be mentioned here that the growth of the underwriting business has been one of the important factors that have contributed to the development of the Indian capital market in the post-independence period.

The underwriting business offers the following advantages to the corporate sector.

Underwriters are helpful in different ways.

1. Underwriting relieves the issuer of the risk of not being able to find buyers for all the issues offered to the public. Thus, the company can be reasonably sure of raising adequate share capital.
2. Underwriters help the company to fulfil the statutory regulations, like securing the prescribed minimum subscription within the stipulated period.
3. Underwriters relieve the issuer of the burden of undertaking the highly specialised function of distributing securities.
4. Underwriters, having expert knowledge of the capital market conditions, can render expert advice to the company on the timing of security issues, the size and type of securities to be issued, the value at which they may be offered, etc.
5. Underwriting business is of enormous assistance in the mobilisation of funds in the capital market because public confidence is enhanced by the underwriting of issues by reputed underwriters.
6. The activities of underwriters help stabilise capital market conditions.

Underwriting offer is similar to insurance business, where the insurer is exposed to risk to the extent of amount insured, but the only gain is the insurance commission. In underwriting, the compensation is underwriting commission.[1]

Underwriting in India

Professional underwriting service has developed in India from the mid-1950s. The Industrial Credit and Investment Corporation (ICICI), established in 1955, has played an important role in the development of professional underwriting service.

A number of factors were responsible for the relative underdevelopment of the underwriting business in the past. Underwriting grows along with the growth of the capital market and industrialisation, and it could not, therefore, grow significantly because of the poor state of the industrialisation and capital market. The conservative attitude of the Indian commercial banks,

the absence of specialised institutions like issue houses, investment institutions, financial syndicates as found in Western countries, the preponderance of the *managing agents* who played a multi-faceted role as promoters, financiers, underwriters, managers, etc., of the companies under their group, affected the development of the underwriting business in India.

Underwriting has, however, been developing in the country, particularly after the establishment of the ICICI in 1955. Public sector financial institutions, such as the IFCI, ICICI, IDBI, SFCs, UTI, LIC; commercial banks; investment companies and stock brokers—all have played an important role in developing the underwriting service.

In India, underwriting commission is regulated by statute at a maximum of 2.5 per cent. Similarly, the entry into this business is also regulated by SEBI whereby only SEBI registered agencies can act as underwriters.

According to SEBI Guidelines on Investor Protection and Disclosure dated 11-6-92, underwriting was mandatory for the full it for each issue of capital to the public. This has since been relaxed in view of involved and now the underwriting is optional.

To avoid disputes between the underwriters and issuer company, SEBI has formulated a model underwriting agreement which seeks to standardise the legal relationship between the two parties. It provides clear guidelines for resolving the issues of disputes. It stipulates several norms for the interest of both the parties including the time limit within which the issue should open from the date of the agreement. It indicates that the time is the essence of agreement. Any failure on the part of any party to adhere to the time limits shall discharge the other party of his obligations. If the prospectus contains untrue statements, the underwriter can terminate the contract prior to the opening of the issue.[2]

The model underwriting agreement formulated by the SEBI seeks to make very clear and standardise the terms and conditions.

INTERNAL FINANCING

Ploughing Back of Profits

An important source for fixed and working capital requirements of established companies is the savings generated internally in the form of retained earnings by the process of ploughing back of profits. A profitable company may retain with it a part of the net profits as undistributed profits to strengthen its financial position, or to meet some of the present or future financial requirements. The reserves thus built up over the years by ploughing back profits may be utilised for the following purpose:

1. Expansion of the undertaking.
2. Replacement of obsolete assets and modernisation.
3. Meeting permanent (regular) or special working capital requirements.
4. Redemption of old debts.

Benefits to the Company

The important advantages of retained profit from the point of view of the company are:

1. It enables the company to withstand difficult situations—*for example*, a depression or recession, period of credit squeeze etc.
2. It enables the company to adopt a stable dividend policy. Sufficient retained earnings enable the company to pay the normal rate of dividend even if, in a particular year, the profit is very little, or the company incurs a loss.

3. Modernisation and expansion programmes will not suffer for want of finance if a company has large retained earnings.
4. Retained earnings can be made use of to set right any shorfalls in the provision for depreciation, bad and doubtful debts, and similar contingencies.
5. The reserves built up out of undistributed profits may be made use of to retire bonds and debentures, to build up sinking funds, and to redeem debts.
6. Regular or permanent working capital requirements may be met by the surplus retained with the company.
7. It increases the creditworthiness of the company.
8. It may help increase the sales of the company because, as funds cause no problem, it can expand credit sales to a reasonable extent.
9. It reduces the dependence on external sources of finance.

Ploughing back of profits benefits the company, shareholders and society.

Benefits to the Shareholders

Though the policy of ploughing back part of the profit limits the dividends, from the long-term point of view, it may benefit the shareholders.

The main advantages from the point of view of the shareholders are:

1. It provides a reasonable assurance to shareholders of a stable rate of dividend.
2. The soundness of the company and its stable dividends help appreciate share values.
3. Shareholders stand to benefit from the modernisation and expansion financed by retained earnings.
4. The redemption of debts may also benefit the shareholders.
5. Shareholders will further benefit from the better performance of the company because of its ability to withstand difficult situations and to carry out timely replacements and improvements.

Benefits to Society

Society, too, may, derive certain benefits if companies favour ploughing back of profits.

1. Modernisation and expansion financed by internal funds benefit society because they improve the supply position and may even reduce the cost of production, for expansion leads to economies of scale and modernisation increases productivity.
2. The increase in corporate investment increases employment opportunities.
3. Internal financing reduces the demand for funds in the capital market. It would, thus, increase the availability of funds for other investors.
4. Society benefits from the stability accorded to the industrial sector by the internal availability of funds.

Dangers of Ploughing Back Profits

Some dangers are associated with indiscriminate policy of ploughing back profits. Some of the possible dangers are:

1. It may lead to concentration of economic power because large retained earnings enable companies to enlarge their business easily by a continual reinvestment of the profits.
2. It gives scope for manipulation. The controlling powers of the company may depress share prices by keeping the dividend rate very low by ploughing back a substantial part of the profit so that they might purchase the shares at low prices and later benefit from a higher dividend and appreciation of the share value due to the rise in the rate of dividends.
3. The top brass of the management may misuse the funds by locking them up in their pet concerns or companies under the same management against the overall interest of the shareholders.
4. It may lead to overcapitalisation if the reserves are capitalised by issuing bonus shares or bonus issues.
5. The ploughing back of profits interferes with the rights and freedom of shareholders. If shareholders get higher dividends, they will be at liberty to distribute their investments as they like, whereas they, especially the small shareholders, do not have any significant say in the investment or utilisation of retained earnings.
6. From the above point of view, it follows that excessive ploughing back of profits may hinder the natural growth of the capital market.

Indiscriminate ploughing back of profits could be detrimental to the shareholders and the capital market.

Determinants of Retained Earnings

The following are the three important determinants of retained earning:

Profits: Obviously, the question of the ploughing back of profits does not arise if a company does not earn profits. Normally, a company has to declare a reasonable rate of dividend to satisfy the shareholders and to prevent a depreciation of share values. Hence, only what is left over after paying a reasonable dividend can be ploughed back. Thus, the amount of net profits is an important determinant of internal savings.

Taxation: The rate of corporate taxation is an important determinant of net profits. A high rate of corporate tax imposes limitations on the building up of internal savings.

Dividend Policy: The dividend policy is an important determinant of retained profits. A conservative dividend policy is regarded as necessary to build up internal savings. Some people advocate a statutory ceiling on dividends to facilitate a greater ploughing back of profits. At times, the Government imposed ceilings on dividends.

PUBLIC DEPOSITS

Public deposits is an important source of finance for companies (here, the reference is to deposits with non-financial joint stock companies). Public deposits played an important role in industrial finance in the past as well. For instance, in the 1930s, it was an important source for the textile mills of Ahmedabad, Bombay, Solapur, Bengal and the Punjab. The tea gardens of Bengal and Assam also depended on this source of finance.

Reasons for Popularity

The increasing popularity of public deposits has been mainly due to the following reasons:

1. The rate of interest the companies have to pay on deposits from the public is lower than the interest on bank loans.
2. As the rate of interest offered by the companies have been significantly higher than the rates offered by banks for the same periods, there has been a good public response.
3. Public deposit has been an easier method of mobilising funds than from banks, especially during periods of credit squeeze.
4. To obtain credit from a commercial bank, the company has to satisfy the creditworthiness of the purpose for which the loan is sought; but in the case of public deposits, there is no such need.
5. It follows from this that public deposits may form a source to finance business activities for which bank finance is not available.
6. A further attractiveness of public deposits from the point of view of the companies is that they are unsecured.
7. Some public sector undertakings have also been drawing upon this source of finance.

Public deposits could be an important source of finance when money market conditions are difficult.

Limitations

Public deposits, however, have certain demerits from the point of view of society.

1. As public deposits are unsecured, depositors bear the risk of loss of money in the event of the failure of the company.
2. Public deposits with companies may cause a diversion of resources into non-priority and undesirable areas.
3. Public deposits tend to defeat the objectives of monetary policy, especially a dear money policy. They also distort the planned interest rate structure in the economy.
4. It has been argued by some people that public deposits adversely affect bank deposits. But this argument has been countered by pointing out that if public deposits activate the idle resources in the economy, they would help increase the deposits with commercial banks.

Regulation of Public Deposits

Acceptance of public deposits by companies needs to be regulated in the interest of the depositing public, the efficacy of the monetary policy and resource utilisation. From time to time, the Reserve Bank has issued directives regulating public deposits.

These regulations pertain to the ratio of deposits to the paid-up capital and free reserves; the maximum period of deposits; obligation to invest a specified percentage of the deposit in a current or other account with a scheduled bank free from any charge or lien, or in approved securities which shall be used only for the repayment of deposits; filing of periodical returns with the RBI, giving the required information about public deposits/loans; and furnishing of certain specified information on its financial position and its working while issuing advertisements and application forms soliciting deposits.

A Section (58AA) was added by the Companies (Amendment) Act, 2000, with a view to protect the interest of small investors (a small depositor means a depositor who has deposited in

a financial year a sum not exceeding twenty thousand rupees in a company and includes his successors, nominees and legal representatives) requires every company, which accepts deposits from small depositors to intimate to the Company Law Board any default made by it in repayment of any such deposits or interest on deposits. No company shall, at any time, accept further deposits from small depositors, unless each small depositor, whose deposit has matured, had been paid the amount of the deposit and the interest accrued thereupon, barring certain exceptions (like a deposit which has been renewed by the small depositor voluntarily).

Further, every company, which has on any occasion made a default in the repayment of a deposit or part thereof or any interest thereupon to a small depositor, shall state, in every future advertisement and application form inviting deposits from the public, the total number of small depositors and amount due to them in respect of which such default has been made.

There is penalty for non-compliance with the provisions relating to the protection of small depositors.

This provision, thus, serves the cause of small depositors and puts the defaulting companies in a clear disadvantageous position. Provision should also have been made in the Act to make public any default in the repayment of the money of other depositors.

SUMMARY

Business enterprises may require short-term, medium-term and long-term capital for different purposes. Table 26.1 indicates the important sources of industrial finance.

TABLE 26.1 : SOURCES OF FINANCE

Short-term	*Medium-term*	*Long-term*
1. Bank Credit 2. Trade Credit 3. Installment Credit 4. Customer advances	1. Issue of shares 2. Issue of debentures 3. Loans from banks and other financial institutions 4. Public deposits (for existing concerns) 5. Ploughing back of profits (for existing concerns)	1. Issue of shares 2. Issue of debentures 3. Loans from banks and other financial institutions 4. Ploughing back of profits (for existing concerns)

Corporate securities are instruments by which a large part of the capital is raised by joint stock companies. There are two classes of corporate securities, namely, ownership securities and creditorship securities.

Ownership securities are the shares by which the owned capital (also known as risk capital and venture capital) is raised. The shares of a company may be broadly divided into equity shares and preference shares. Preference shares are those which have preferential right to the payment of dividend during the lifetime of the company, and a preferential right to the return of capital when the company is wound up. All shares which are not preference shares are equity shares, also called ordinary shares. Table 26.2 lists the different types of securities.

Creditorship securities, which consist of debentures and bonds, are credit instruments which are widely used by companies to raise funds. The capital raised through creditorship securities is known as borrowed capital or debt capital.

TABLE 26.2 : TYPES OF CORPORATE SECURITIES

<table>
<tr><th colspan="3">CORPORATE SECURITIES</th></tr>
<tr><th colspan="2">Ownership Securities</th><th>Creditorship Securities</th></tr>
<tr><th>Equity Shares</th><th>Preference Shares</th><th>Debentures</th></tr>
<tr><td>• With voting rights
• With differential rights as to dividend, voting or otherwise in accordance with such rules and subject to conditions as may be prescribed.</td><td>• Cumulative Preference Shares
• Convertible Cumulative Preference Shares
• Non-cumulative Preference Shares
• Participating Preference Shares
• Non-participating Preference Shares
• Redeemable Preference Shares
• Irredeemable Preference Shares</td><td>• Redeemable and Irredeemable
• Mortgage and Simple
• Registered and Bearer
• Convertible and Unconvertible</td></tr>
</table>

Companies also meet their financial requirements by ploughing back of profits. A profitable company may retain with it a part of the net profits as undistributed profits to strengthen its financial position, or to meet some of the present or future financial requirements.

Public deposits as a source finance is popular with companies with good credit rating. It is often cheap finance.

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1. **Sanjiv Agarwal, *Manual of Indian Capital Market*, Bharat Law House, New Delhi, 1977, p. 1200.**
2. ***Ibid.*, p. 1201.**

ANNEXURE 26.1

Leasing

Leasing which is an alternative to selling capital goods is a common thing in business marketing. Basically, leasing is an arrangement between the leasing company or the *lessor* and the user or the *lessee*, the former arranging to buy the capital equipment for the use of the latter. The lessee has to pay the lessor in the form of rentals and the lessor remains owner of the equipment during the specified period.

There are four types of leases, *viz.,*

1. Operating lease
2. Financial lease
3. Sale and lease back transaction
4. Leveraged lease

Operating Lease refers to a short-term lease of an asset for an hour, a day, etc.

The financial lease is for a basic term during which the lease is non-cancellable. The length of this basic period is determined primarily by the economic life of the asset, and is usually shorter than the expected life. This arrangement provides some means by which the company may continue to use the asset after the expiry of the basic lease period, or alternatively a market purchase price is negotiated on the lease termination.

The sale and lease back transaction provides for an arrangement by which an entity that owns a given asset may sell it to the leasing company, and lease it back. This enables the lessee to immediately defreeze the money that it had locked into the original asset, which becomes available to it for working capital or further expansion.

In case of very large assets, a single lessor may not be capable of acquiring it or may not be willing to shoulder the whole risk associated with. Hence, two or more lessors may jointly acquire the asset and lease it to the lessee. Such an arrangement is known as leveraged lease. The leveraged lease is, thus, similar to consortium financing.[1]

Leasing companies claim the following principal advantages for the lessee.[2]

1. Leasing conserves cash flow by providing hundred per cent finance and enables the companies to employ their funds for working capital requirements.
2. Lease obligations are not reported as company's liabilities, whereas loan obligations must be recorded. Consequently, by financing the asset acquisitions with lease, rather than borrowing, a company can report a better debt-equity ratio.
3. Leasing facilities provide certainty and cash flow forecasts as well as budget controls can be more accurate.
4. Leasing, although a firm commitment, is a revenue expense and lease rental, is an allowable expenditure under the Income-tax Act.
5. Leasing also offers additional cost recovery for such contracts which allow recovery of rent, but not interest costs.
6. Formalities to be gone through for obtaining the lease financing are much less than bank or institutional financing arrangements.

7. Leasing facilities are more flexible. Adjustments to rentals schedule can be made to accommodate the special needs of leases.

Haas points out that leasing has the following disadvantages.[3]

In the long run, leasing usually requires a greater outlay of capital than debt financing does. Thus, the customer may pay more for the same equipment. In addition, although the customer may view lease payments as operating expenses, they are fixed payments that must be met. Lease agreements can be hazardous if the customer is not careful.

Leasing as a financial alternative to equity capital or bank term finance was introduced to the modern world by the United States of America where it became effective during the 1940s and 1950s. In some of the industrially advanced countries, leasing today plays a very important role in the acquisition of capital goods. It is estimated that in the USA, leasing industry finances about 25 per cent of capital goods acquisition and in the United Kingdom it accounts for about 15 per cent. The leasing industry has taken great strides in the United States.

In India, the leasing industry took roots with the establishment of the First Leasing Company of India Ltd., in Madras, which started functioning in 1973-74. "The Indian leasing industry grew disjointedly with the First leasing Company of India Limited operating alone for almost seven years, followed thereafter by several other companies in the late seventies after which a mini entrepreneurial revolution took place."[4] Several public sector institutions like the ICICI, IFCI, State Bank of India, Canara Bank, some SIDCs, etc. have also entered the leasing business, either directly or indirectly.

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1. **Farouk Irani, "Leasing Companies and Banks", *Commerce*, May 28, 1983.**
2. **These are mentioned in the feature on Leasing Industry, *Commerce*, May 28, 1983.**
3. **Robert W. Haas, *Business Marketing* (Boston: PWS-KENT Publishing Company, 1992), p. 634.**
4. **Farouk Irani, "Bright Days Ahead", *The Economic Times*, April 28, 1986.**

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INDUSTRIAL FINANCIAL INSTITUTIONS

Chapter 27

Structure

Industrial Development Bank of India
Industrial Finance Corporation of India
ICICI Bank
Industrial Investment Bank of India
Discount and Finance House of India
State Financial Corporations
State Industrial Development/Investment Corporations
Investment Institutions
Institutions for Small Industry
Commercial Banks
Summary
Reference
Annexure 27.1: Merchant Banking, Mutual Funds and Venture Capital

Finance is a prerequisite to mobilise real resources for organising production. In a developing economy, however, lack of finance is not the only deterrent to economic development. Even when finance is available, other important factors like imperfections in the information flow and dearth of entrepreneurship may come in the way of industrial and economic development. Hence, it is necessary to make finance and other development assistances in a package to take the dormant and developing economies to the take-off stage. Many developing countries, in particular, therefore, set up *Development Banks* rather than institutions which merely provide finance.

A number of development financial institutions established by the Central and State governments have played a great role in the industrial development, particularly when the capital market was underdeveloped.

"A Development Bank is a multipurpose institution which shares entrepreneurial risk, changes its approach in tune with the industrial climate and encourages new industrial projects to bring about speedier economic growth. The concept of development banking is based on the assumption that mere provision of finance will not help to bring about entrepreneurial development. Successful entrepreneurial banking should include the discovery of investment projects, undertaking the preparation of project reports, provision of technical advice and management services and finally assisting the management of industrial units."[1]

After Independence, starting with the establishment of the Industrial Finance Corporation of India in 1948, a number of development banks have been set up at all-India and State levels for assisting the development of large, medium and small industries by providing financial and various other promotional assistances.

Types of Institutions

The most important all-India Development Financial Institutions (DFIs) are Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI) and Industrial Credit and Investment Corporation of India (ICICI). The Industrial Reconstruction Corporation of India (IRCI) established in 1971 with the main objective of revival and rehabilitation of viable sick units was converted into the Industrial Reconstruction Bank of India (IRBI) in 1985 with more powers and this was again transformed to new institution called Industrial Investment Bank of India (IIBI).

Besides the above, the All-India Financial Institutions (AIFIs) providing industrial finance also include some investment institutions like the Unit Trust of India (UTI), Life Insurance Corporation India (LIC), and the General Insurance Corporation of India (GIC) and its subsidiaries. (These institutions are termed as investment institutions here exclusively from the point of view of their industrial finance function).

The all-India institutions, except those specifically meant for the SMEs, assist large-scale enterprises and the state level institutions assist SMEs.

Development banks have been established at the State level too. There is a State Financial Corporations (SFCs) and State Industrial Investment/Development Corporation (SIICs/SIDCs) in most of the States.

Financial assistance is provided, directly or indirectly, to the small-scale sector also by National Small Industries Corporation (NSIC), State Small Industries Development Corporations (SSIDCs) and Khadi and Village Industries Commission (KVIC), although financing is only an ancillary function of these organisations.

The Small Industries Development Bank of India (SIDBI), a wholly owned subsidiary of the IDBI, is an apex institution for promotion, financing and development of industries in the small-scale sector and for coordinating the functions of other institutions engaged in similar activities.

The IDBI is the apex institution which coordinates the activities of various institutions.

A very important source of industrial finance is commercial banks.

Types of Assistance

Provision of rupee and foreign currency loans, subscription to shares and debentures, underwriting of shares and debentures, guaranteeing of deferred payments and loans are the important types of financial assistance provided by these institutions (some of the institutions do not provide some of these assistances).

Development activities of the DFIs include identifying industrial potentials of different areas; development of entrepreneurship through training and motivation; assistance in project identification, feasibility studies and preparation of project reports; technical and managerial consultancy; seed/risk capital assistance, etc.

The development financial institutions provide different funded and non-funded assistances.

Direct assistance from the all-India development banks is normally confined to large projects. Various state level institutions and certain specialised institutions like the National Small Industries Corporation (NSIC), State Small Industries Development Corporations (SSIDCs), Khadi and Village Industries Commission (KVIC), SIDBI and banks assist small-scale (including khadi and village) units and medium-scale units.

Projects involving very large investment are assisted by the all-India financial institutions through *consortium financing* (*i.e.,* the project is jointly financed by a group of financial institutions). In consortium financing, one of the institutions plays the lead role.

The DFIs have sponsored a number of technical consultancy organisations (TCs) and some institutes for entrepreneurial/management development and imparting education/research in capital market.

INDUSTRIAL DEVELOPMENT BANK OF INDIA

The Industrial Development Bank of India (IDBI) was established in 1964 by the Indian Government under an act of the Indian Parliament, the Industrial Development Bank of India Act, 1964.

The creation of IDBI in particular, and Financial Institutions (FIs) in general, was a considered response to the emergence of broad-based industrial development as an imperative of national policy. This found expression in the gradual evolution, since 1948, of FIs, both at central and state levels, largely as government-owned specialised institutions. These were set up with the principal objective of providing term finance for fixed asset formation in industry. IDBI was entrusted with the additional responsibility of acting as the principal financial institution for coordinating the activities of institutions engaged in the financing, promotion or development of industry.

IDBI was initially established as a wholly owned subsidiary of Reserve Bank of India. In 1976, the ownership of IDBI was transferred to the Government of India (GoI). The IDBI Act was amended in October 1994 to, *inter alia,* permit IDBI to raise equity from the public, subject to the holding of GoI not falling below 51 per cent of the issued capital.

According to the Bank's Corporate Mission "IDBI's strategic objective is to position itself as India's premier wholesale bank through a full range of wholesale products – lending, capital markets, advisory and risk management – through an integrated group structure."

According to IDBI sources, its strengths lie in:

- Diversified portfolio across different industries, regions and sectors.
- Long-standing business relationships with all major industrial houses.
- Proven core competence in project financing.

IDBI is the most important industrial development bank of India.

- Large balance sheet and sound financials.
- Capacity to take large single party exposure.
- Capacity to leverage.
- Sizeable stock of cost-effective, long-term funds.
- Fairly good retail network with a large investor base.
- Lean organisation with a sizeable pool of qualified, experienced professionals.

Subsidiary Organisations

IDBI has set up a host of subsidiaries and associates with a view to expand the functional reach of the IDBI Group and take advantage of opportunities in a liberalised market economy.

SIDBI: To give focussed attention to the needs of small-scale industry, IDBI had set up the Small Industries Development Bank of India (SIDBI) in 1990 as a wholly owned subsidiary. The SIDBI Act was amended in March 2000, enabling, among other things, the transfer of IDBI shareholding to a maximum 51 per cent from IDBI.

IDBI Capital: A stock broking company, IDBI Capital Market Services Limited (IDBI Capital) was set up in 1993 to provide a range of capital market related services. It commenced operation as a Primary Dealer in November 1999. In the private placement market, it acts as arranger for several institutional and corporate users. IDBI Capital markets public issues of securities through its strong network of agents. As a depository participant, the company offers institutional and retail clients the facility to maintain their investments and securities in electronic form. It also acts as a portfolio manager and manages the investment portfolios of several provident and pension funds. IDBI Capital is one of the primary dealers accredited by RBI to act as a market maker in government securities.

IDBI Bank: Consequent upon opening up of commercial banking to the private sector, IDBI set up a commercial bank, IDBI Bank Limited in 1994. IDBI Bank offers high technology based top-of-the-line branded products, which have been well received by the market. It is also a leading player in Depository Participation services enabling customers to hold and trade shares electronically. The IDBI Bank was merged with IDBI Ltd. in 2005, making IDBI a *Universal* Bank.

The deepening and widening the scope of IDBI's business have been facilitated by the establishment of different subsidiaries.

INTECH: To take advantage of the emerging business prospects of the IT sector, IDBI set up IDBI Intech Limited (INTECH) in March 2000 to undertake IT-related activities. With the domain knowledge in the financial sector, acquired by its professional staff over the year, and their experience in the development of software for the financial sector, INTECH would capitalise on the business and IT knowledge to offer the IT-related products and services to the IDBI Group and the other organisations in the financial sector. INTECH is also in the process of identifying an appropriate overseas partner to have access to the export market segment. To realise its goals, INTECH will operate in multi-dimensional framework — as advisor, software developer, systems integrator and implementer, provider of shares services, specialist training and development and also as a forum for ideas on digital economy solutions.

ITSL: Consequent to amendment of the Debenture Trustee Regulation, 1993, requiring arms length relationship to be maintained between the issuer and the trustee, IDBI set up IDBI Trusteeship Services Ltd. (ITSL) under the Companies Act, 1956 in March 2001. It proposes to induct an international strategic partner into this venture in due course. The new company would be technology-driven to provide safety, up-to-date information and professional services to the subscribers and issuers of debentures.

Products

The important products (schemes of assistance) of IDBI are the following.

IDBI has a host of products to meet the different requirements of the corporate sector.

Project Finance: The objective of this product is to provide long-term finance (Rupee and Foreign Currency Loan) for new projects and expansion, diversification and modernisation of existing projects.

Term loan, underwriting, direct subscription to equity capital and deferred payment guarantee are the types of assistance under scheme.

Equipment Finance: Equipment finance is available for acquiring specific machinery/equipment to financially sound companies which have been in operation for a minimum period of 5 years, consistently profit making for last 3 years and dividend paying capacity of not less than two years. Rupee and Foreign Currency Loans are available.

Assistance under the scheme will not be available for acquisition of second hand equipment/ machinery, in-house fabrication of equipment/machinery, reimbursement of the cost of the equipment/machinery purchased more than 90 days prior to the date of application; and grass-root projects or major expansion/diversification, which would call for detailed appraisal.

Asset Credit: The objective of this product is to help companies to acquire new machinery/ equipment. Financially sound companies which have been in operation for a minimum period of 5 years, consistently profit making for last 3 years and good track record are eligible for assistance under this scheme.

Corporate Loan: This product has been designed to provide for capital expenditure and long-term working capital to financially sound companies with net worth of not less than ₹ 10 crore, having been in commercial operation for 5 years and making profit consistently for last 3 years, besides satisfying certain criteria. Rupee and foreign currency loans are available under this scheme.

Working Capital Loan: The purpose of this scheme is to provide loan component of working capital finance to companies already assisted by IDBI, which are financially sound having a net worth of not less than ₹ 15 crore. Both rupee and foreign currency loans are available under this scheme.

Direct Discounting of Bills: Financially sound companies which have been in operation for at least 3 years and having no defaults to financial institutions can avail this facility for selling machinery/equipment. Assistance up to 100 per cent of the total value (including insurance, taxes and freight) may be provided.

Equipment Lease: Financially-sound companies are eligible for financial lease facility for purchase of equipment on lease basis. However, sale and lease back transactions are normally excluded from this facility.

Venture Capital Fund: This has been established to encourage commercial applications of indigenous technologies or adaptation of imported technologies, development of innovative products and services, holding substantial potential for growth and bankable ventures involving higher risk including those in the information technology (IT) sector.

Finance for Medium-scale Industries: IDBI provides Line of Credit (LoC) to all SFCs/SIDCs to finance medium-scale industrial units. SSI units are not considered under this scheme.

Bills Rediscounting: The objective of this scheme is to cover or promote sale of indigenous machinery/equipment to commercial establishment or institutions.

Services: IDBI also provides some very important services to promote and develop industries. These include, merchant banking (See the *Annexure* for details), debenture trusteeship and foreign exchange services.

INDUSTRIAL FINANCE CORPORATION OF INDIA

The Industrial Finance Corporation of India was established in 1948 under the IFCI Act, with the object of making medium- and long-term credit more readily available to industrial concerns in India. IFCI was corporatised in 1993 as a part of the financial sector reforms and an initial public offer was made in the same year. Following the successful public issue, IFCI's business volume as well as profits went up significantly as did its share of fresh sanctions.

IFCI, established in 1948, is the first development bank of India.

Principal Activities

IFCI's financial operations principally include Project Financing, Financial Services, and Comprehensive corporate advisory services.

Project Financing: Project financing is the core business of IFCI. Financial assistance is provided by way of medium-/long-term credit for:

- Setting up new projects
- Expansion/Diversification schemes
- Modernisation/Balancing schemes of existing projects.

Financial Services: IFCI provides assistance tailor-made to meet specific needs of corporates through various specially designed schemes:

- Equipment finance
- Equipment credit, Equipment leasing
- Supplier's/buyer's credit
- Leasing and hire purchase concerns
- Corporate loans, Short-term loans
- Working capital term loans.

Financial assistance is provided by way of: Rupee loans, Loans in foreign currencies, Underwriting of/Direct subscription to shares and debentures, Providing guarantee for deferred payments and foreign loans.

Lending Policies

While overall viability of the project and safety of assistance extended are the fundamental criteria for investment decisions, the board norms followed by IFCI in project financing are given below. However, IFCI adopts a flexible and pragmatic approach in applying these norms, wherever adequate justification exists.

During the 5 years following corporatisation in 1993-94, there was a surge in business volumes and net profits. However, from 1998-99, a decline set in: its sanctions, disbursements and profits began falling, which in turn adversely impacted on its financial ratios. During this period, IFCI witnessed a sharp increase in the quantum of its non-performing assets.

Problems

In April, 2000, the Board of Directors of IFCI Ltd. constituted an Expert Committee, under the chairmanship of D. Basu, to formulate a medium- to long-term strategic plan for the future of IFCI. The focus of the Committee's deliberations was to be on the future course of action, taking into account the current portfolio of IFCI, its assets and liability mix, the financials of the company and the recovery framework and the emerging opportunities as a result of the reforms in the financial sector.

According to the Report of the Committee, after a period of rapid growth in business from 1993-94 to 1997-98 immediately following corporatisation and a maiden public issue, IFCI's operations suffered a sharp setback due to:

1. Rising level of NPAs (fresh NPAs as well as newly recognised NPAs).
2. Downgrades in credit ratings.
3. Consequent rise in borrowing costs and difficulties in raising fresh borrowings.
4. A resultant decline in new sanctions and disbursements in respect of project finance; the new short-term financing programme could not also be launched due to resource constraints.

The Committee has looked into the major factors which have led to the sudden and sharp downturn in IFCI's performance after 1997-98 and is of the view that the following are the main contributory factors:

1. Immediately following its corporatisation and its initial public offering in 1993, IFCI embarked upon a programme of rapid expansion of business. This was at a time when the traditional consortium mode of lending in which all major financial institutions participated as per a set pattern of sharing was breaking down in a milieu of financial sector liberalisation, thereby introducing a competitive relationship among financial institutions. This resulted in IFCI taking relatively large exposures in several greenfield projects (notably in Steel and Oil sectors) which suffered from cost and time overruns. Such exposures were often not commensurate with IFCI's net owned funds.

2. In many cases, the financing plan for the projects included raising equity from the capital market or from internal generation of group companies. However, due to prolonged, depressed conditions in the capital market and the industrial recession in the aftermath of the South-East Asian crisis of 1997, the promoters were unable to raise such resources as planned which led to time and cost overruns and a number of projects remaining incomplete, resulting in loans becoming non-performing.

3. IFCI's loan portfolio was heavily weighted towards traditional commodity sectors such as iron and steel, textiles, synthetic fibres, cement, sugar, basic chemicals, synthetic resins, plastics, etc. These traditional sectors were significantly more exposed to demand recession and price fluctuations which affected viability. Some of these sectors were particularly affected by the abolition of import controls and the gradual reduction of tariffs.

4. Unlike other financial institutions, IFCI has not diversified into other types of businesses. Project finance still accounts for 94 per cent of IFCI's business assets. As a result, the impact of NPAs arising from delayed completion of projects has been more pronounced in the case of IFCI than in the case of other institutions.

5. The sharp rise of IFCI's gross NPA level in 1998-99 (₹ 5,783.56 crore as against ₹ 4,159.84 crore in the previous year) was partly the result of falling in line with the mandatory RBI guidelines for classifying non-performing assets. As a result, certain loans, particularly those

relating to projects under implementation, which had been treated as performing assets in earlier years, had to be classified as non-performing.

6. During the years immediately following corporatisation, when IFCI was rapidly scaling up the volume of business, it increasingly raised resources from the debt markets. This was at a time when interest rates were relatively high. In order to cover the high cost borrowings, the institution also went in for high yielding loan assets. As interest rates eased over time, such high cost borrowings frequently proved unviable for the concerned customers and this again contributed to the relatively high level of NPAs for IFCI. In fact, the Committee has noted that despite a Board-level decision in 1996 initiating a drive for attracting prime quality borrowers as recommended by consultants, Arthur Andersen & Associates, hardly any new customer in this category could be brought to the books of IFCI.

7. As credit rating agencies started taking note of IFCI's deteriorating loan book quality, they lowered credit ratings. This in turn affected IFCI's standing in the debt market, making resource raising increasingly difficult.

8. Constraints in resource raising in turn led to cutbacks in disbursements and new business with an inevitable impact on earnings, thus completing the cycle of downward spiral.

9. In this context, the Committee would like to observe that some of the factors referred to above such as impact of trade policy liberalisation and tariff reduction, recessionary conditions in the late nineties, depressed conditions in the capital market, etc. affected other DFIs and banks as well. However, the impact was particularly pronounced in the case of IFCI as concentration of risk relative to net worth was much higher in the case of IFCI. Also, as already stated, other DFIs had started diversifying into non-project-related lending and business.

Recommendations for Improvement

In light of the foregoing analyses and observations, the Committee wishes to make the following recommendations:

1. IFCI should transform itself into a fully licensed Term Credit Bank over a period of time. IFCI has had long experience in project finance and has built-up wide-ranging corporate relationships.

2. IFCI should endeavour to reduce the proportion of project finance in their books and diversify into post-project and short-term financing business, as well as enter fee-based services.

It should also increase its share of financing of brownfield projects (expansion of capacity as well as modernisation at existing locations of established companies with good track record) as financing of such projects involve lesser risks.

3. There is a growing basket of newer forms of corporate finance business, particularly in the advisory, business restructuring and M&A areas and IFCI should equip itself to get a share of the business.

4. IFCI need not enter the retail financial market for the present.

5. Despite corporatisation, IFCI still functions as a government entity rather than a vibrant business organisation and the contemplated distancing from government has not yet taken place. A new culture has to be established within the organisation that encourages aggressive business development with adequate risk monitoring and control. In keeping with the increasingly dynamic business environment, there must be an internal willingness and capability to deal with rapid changes. As such a transition for IFCI would be a sweeping one and to facilitate this transition, it might be best to seek a strategic partnership with another institution in similar business. Such a strategic partner should be financially strong, and with demonstrated skills in.

6. IFCI needs to develop quickly a range of new products and services even before transformation into a bank to make up for the reduced proportion of project finance business in its overall portfolio. Product innovation and development will thus become a critical function. In the early stages, IFCI may consider seeking outside experts' help in giving a thrust to this activity.

7. IFCI should consider building up a portfolio of selected highly-rated corporate bonds with appropriate maturities. Such a portfolio (comprising bonds rated AAA, AA+ and to a limited extent AA) can provide a relatively high-quality asset portfolio, which are marketable compared with loans even though the spread will be finer. This portfolio can be partly funded by short-term resources and can partly fill up the gap in business assets resulting from reduced project financing.

8. IFCI should activate its treasury operations and view it as an important profit centre. IFCI may seek necessary expert advice from a consultant to organise its treasury operations (particularly in risk management areas) as has been done by several banks and institutions.

9. IFCI should deepen its expertise and research of industries that it finances.

10. Asset Reconstruction Company (ARC) should be set up by DFIs. ARC shall buy out selected NPAs (priority being given to NPAs of common borrowers) from the participating DFIs, including IFCI. The ARC should have its own Board and management and be free to draw its personnel either through open recruitment or by way of secondment of staff from DFIs and Banks. The capital for ARC will need to be provided by the concerned DFIs to the extent necessary. The possibility of attracting private sector entities as investors should also be explored. The ARC can buy out selected NPAs from DFIs based on independent valuation, the methodologies for which should be mutually agreed upon in advance. The ARC would need to raise resources from the market by issuing bonds, which would need to be guaranteed by Government. It must be recognised that without such a guarantee being available for its bonds, no ARC can really take off.

The Committee also recommended several measures of organisational restructuring.

ICICI BANK

The Industrial Credit and Investment Corporation of India Limited (ICICI), which was merged with the ICICI Bank in 2001, was founded by the World Bank, the Government of India and representatives of private industry on January 5, 1955 to encourage and assist industrial development and investment in India. The main objectives of ICICI were the following.

Objectives and Functions

1. Providing assistance in the creation, expansion and modernisation of industrial enterprises;
2. Encouraging and promoting the participation of private capital, both internal and external in such enterprises; and
3. Encouraging and promoting industrial investment and the expansion of investment markets.

ICICI's principal business activities include:

1. Medium-term and long-term project financing for the infrastructure and manufacturing sectors,

Over the years, ICICI has evolved into a diversified financial institution.

2. Corporate finance to meet the treasury requirements of Indian companies
3. Lease finance
4. A comprehensive range of financial and advisory services.

Diversifications

The liberalisation of the Indian economy in the 1990s offered ICICI an opportunity to provide a wider range of financial services. For regulatory and strategic reasons, ICICI set up specialised subsidiaries in the areas of commercial banking, investment banking, non-banking finance, investor servicing, broking, venture capital financing and state-level infrastructure financing.

ICICI Venture Funds Management Company Limited: With the recent spurt in entrepreneurship in the country, venture capital and private equity capital financing are fast attaining a role of prominence. ICICI, therefore, established the ICICI Venture Funds as a wholly owned subsidiary. According to ICICI sources, strong parentage and affiliates provide ICICI Venture with access to a broad spectrum of financial and analytical resources.

ICICI Venture seeks to invest in opportunities where its network through ICICI and TCW can create value for all involved.

The Venture's primary investment objective is capital investment through investments by way of equity or equity-related securities in unlisted companies with significant growth potential.

Its investments span a broad spectrum of industries and stages of development. Its main areas of investment are Information Technology; Biotechnology and Life Sciences; Media and entertainment; and Retail Services. ICICI Venture backs companies with a sustainable competitive edge.

ICICI Venture backs companies with a sustainable competitive edge, principally in India, and selectively in cross-border investment opportunities, across all the stages of a company's life cycle.

ICICI Securities and Finance Company Limited: Formed in 1993 when ICICI's Merchant Banking Division was spun off into a new company, i-SEC today is India's leading Investment Bank and one of the most significant players in the Indian capital markets.

i-SEC endeavours to offer its clients what are probably the widest, most in-depth range of services in the market, with the highest standards of professionalism.

Backed by a strong distribution network, i-SEC is at the forefront of new developments in the Indian debt market. i-SEC Research Reports, Compendia, Updates, I-BEX and Sovereign Bond Index, are sought after by finance, business and reputed publications alike.

The Project Finance Group has helped take strategic projects from the drawing board to financial closure, leveraging the expertise of parent organisations. i-SEC has also executed several assignments in M&A, including business valuations, spin-offs and mergers, for both domestic and overseas clients.

The range of products offered by i-SEC includes: *(i)* Corporate Finance – Mergers and Acquisitions, Equity, Bidding (especially for Telecom Projects); *(ii)* Fixed Income – Primary Dealership, Debt Research; *(iii)* Equities – Lead Management, Underwriting, Syndication, Private Equity Placement, Sales, Trading, Broking, Sectoral and Company Research.

ICICI Brokerage Services Limited: Set up in March 1995, ICICI Brokerage Services is a 100 per cent subsidiary of I-SEC. It commenced its securities brokerage activities in February 1996 and is registered with the National Stock Exchange of India Limited and The Stock Exchange, Mumbai.

ICIC has set up several subsidiaries for promoting the diversified growth of its business.

ICICI Personal Financial Services Limited (ICICI PFS): Formerly *ICICI-Credit*, was one of the first four companies to obtain registration as a Non-banking Financial Company (NBFC) from the Reserve Bank of India (RBI) in 1997.

During the year 1998-99, there was a significant shift in the company's operations from leasing and hire purchase to distribution and servicing of all retail products for the ICICI Group. It is now a focal point for marketing and distribution of all retail asset products for ICICI, including auto loans, consumer durable finance and other financial products. The company has thus become a critical part of ICICI's retail strategy aimed at offering a comprehensive range of products and services to retail customers. In view of this reorientation of the business, the name of the company was changed from ICICI Credit Corporation Limited to ICICI Personal Financial Services Limited (ICICI PFS) effective from March 22, 1999.

ICICI Capital Services Limited: ICICI Capital Services Ltd. was incorporated in the name of SCICI Securities Ltd., on September 24, 1994 as a wholly owned subsidiary of erstwhile SCICI Ltd., with the objective of providing stock broking services to the institutional clients and undertaking activities such as underwriting, primary market placements and distribution industry and company research etc. After the amalgamation of SCICI with ICICI, it became a wholly owned subsidiary of ICICI effective from April 1, 1996 resulting in the change of name.

The company is mandated, under review by ICICI, to carry out on its behalf the retail resource-raising activities and to provide front-office services related to all retail and semi-retail liability products of ICICI. The company also operates the network of ICICI centres being set up by ICICI. As on date, the company has set up 91 centres across the country.

The company was earlier involved in distribution of bond product (in the brand name of Safety Bonds) and private placement treasury products from ICICI. However, from December 1999 onwards, the company has focussed on being a provider of a comprehensive range of financial products and services, being a ONE-STOP SHOP for various financial products like ICICI Bonds, ICICI Fixed Deposits, Mutual Funds, IPOS, e-invest Accounts, Depository services, select IPOs, investment consulting and all set for the forthcoming product of insurance.

The widespread geographical locations of centres, which are well equipped with the necessary infrastructure, have provided the company with strategic distribution initiatives so as to become one of the top distribution houses in the country. The company has also strengthened its distribution network by effectively managing over 11000 agents.

The company now proposes to focus on furthering its product base by expanding the product range.

ICICI Bank: ICICI Bank, the commercial banking outfit of the ICICI Group, was established in 1994. In October 2001, the ICICI and two of its retail finance subsidiaries – ICICI PFs and ICICI Capital Services Ltd. – were merged with the ICICI Bank. It is now India's second largest bank.

INDUSTRIAL INVESTMENT BANK OF INDIA

In 1971, the Government of India established an institution, namely, Industrial Reconstruction Corporation of India (IRCI), with the main objective of reconstruction and rehabilitation of industrial units which were closed down or were facing the risk of closure but which could be made viable with suitable assistance.

The need for a more powerful institution to deal with the problem of industrial sickness was felt and on March 20, 1985, the Industrial Reconstruction Bank of India (IRBI) was established

as per the provisions of the Industrial Reconstruction Bank of India Act, 1984, and the erstwhile Industrial Reconstruction Corporation of India was vested and transferred to the IRBI on that date.

In 1997, IRBI was converted into a company and transformed it into a full-fledged financial institution known as Industrial Investment Bank of India Ltd. (IIBI). The Bank has moved into business-oriented activities from simple revival of sick units.

DISCOUNT AND FINANCE HOUSE OF INDIA

The Reserve Bank of India, together with public sector banks and financial institutions, has recently set up a company called the Discount and Finance House of India Limited (DFHI), to deal in short-term assets in order to provide liquidity in the money market.

STATE FINANCIAL CORPORATIONS

The SFCs are meant to finance small- and medium-scale industries.

The State Financial Corporations Act, 1951, has enabled the State Governments to set up State Financial Corporations (SFCs) to function as regional development banks, making a significant contribution to the industrial advancement of their respective States.

Apart from their share capital, the SFCs depend for financial resources on repayment of loans and income from investments, issue of bonds, refinancing of loans from the IDBI and to a limited extent on borrowings from the RBI, deposits from the public and occasionally loans from the State.

Types of Assistance

Financial assistance from State Financial Corporations takes the following forms:

1. Granting of loans or advances and subscribing to the debentures of industrial concerns.
2. Guaranteeing loans raised by industrial concerns in the capital market or from scheduled banks or state cooperative banks.
3. Guaranteeing deferred payments due from any industrial concern in connection with its purchase of capital goods within India.
4. Underwriting the issues of stocks, shares, bonds or debentures by industrial concerns.
5. Subscribing to the stocks, bonds or debentures of an industrial concern out of the funds representing the special class of share capital subscribed by the State Government and the IDBI in accordance with the provisions of Section 4A of the SFCs Act, 1951.

The SFCs grant loans mainly for the acquisition of fixed assets like land, buildings and plant and machinery.

Sometimes, they also provide loans for working capital margin in combination with loans for acquisition of fixed assets.

SFCs are also providing foreign currency loans to small- and medium-scale industrial units for import of plant and machinery and/or technical know-how under IDA-World Bank credits to IDBI.

STATE INDUSTRIAL DEVELOPMENT/INVESTMENT CORPORATIONS

Since 1960, many States and Union Territories have set up State Industrial Development Corporations (SIDCs)/State Industrial Investment Corporations (SIICs), with the main object of accelerating the industrial development of the respective States and Union Territories.

For efficiently carrying out the functions of promotion, improvement and development of industries, these Corporations are empowered to plan, formulate and execute industrial undertaking, project or enterprise which is likely to accelerate industrial development. Further, they promote medium/large industrial ventures as joint sector units in collaboration with private entrepreneurs, or as wholly owned subsidiaries and provide risk capital to new generation entrepreneurs. Various incentive schemes of Central/State Governments are also administered through them.

The SIDCs/SIICs have been promoted as promotional bodies entrusted with the major task of promoting industries and ensuring balanced regional growth within each State/UT.

Functions

These Corporations undertake a wide range of functions. The important functions are:

1. Grant of financial assistance to industrial concerns in the form of:
   (a) Direct investment
   (b) Loans
   (c) Extension of guarantee for loans and deferred payments
   (d) Underwriting and subscriptions to the issue of shares, bonds and debentures
2. Promotion and management of industrial concerns
3. Provision of industrial sheds/plots: and
4. Promotional activities such as identification of project ideas, selection and training of entrepreneurs, provision of technical assistance during project implementation, etc.

The Corporations in States like Karnataka and Bihar are empowered to undertake special activities like establishing and managing industrial estates, development of industrial areas, generation, transmission and sale of electricity etc.

INVESTMENT INSTITUTIONS

Unit Trust of India

The Unit Trust of India (UTI), a public sector Mutual Fund was established in 1964. The share capital of the UTI was subscribed by the IDBI, LIC, SBI and its subsidiaries and other scheduled banks and financial institutions.

Sale of units and other savings schemes are the main sources of funds for the Trust.

The main objective of the UTI is to mobilise the savings of the community and channelise them into productive corporate investments so as to provide for growth and diversification of the economy. It is at the same time intended to provide the facility for an equity type of investment to the large and growing number of investors in the small and medium income groups.

The UTI mobilises funds from the public through a number of schemes. The savings thus mobilised is channelled into productive activities by the Trust by investing them in the shares and debentures of industrial concerns.

It is one of the main intentions of the UTI to provide opportunity to investors belonging to small and medium income groups to indirectly participate in the ownership of shares and debentures of joint stock companies.

For small investors, the UTI has been expected to offer the advantages of: *(i)* considerably reduced risk since funds are invested in a balanced and well distribute portfolio; *(ii)* the benefit of expert management; *(iii)* a steady income: and *(iv)* liquidity.

The management and performance of the UTI for some time has been so bad that in by mid-2001 the financial crisis of the Trust became public and it has virtually betrayed the trust of millions of investors.

Life Insurance Corporation of India

Consequent to the decision to nationalise the life insurance business, the Life Insurance Corporation of India was established in 1956 as a wholly owned corporation of Government of India in order to carry on the business of life insurance and deploy the savings to the best advantage of the policyholders and the community as a whole.

A large part of the funds of LIC is deployed as loans to assist the development of social overheads like housing, rural electrification, water supply and sewerage schemes.

However, LIC provides substantial assistance to the industrial sector.

Besides normal investment operations by way of sale and purchase of securities in stock markets and investment in government securities, the Corporation has been anticipating with other all-India institutions in extending direct assistance to industries in the form of loan and direct subscription to shares and debentures of industrial concerns.

LIC extends resource support to the term lending institutions by way of subscription to their bonds and thus contributes to industrial financing in an indirect manner.

The Corporation has also helped small and medium industries by granting loans for setting up of industrial estates.

General Insurance Corporation of India

As a member of the consortium of all-India Financial Institutions, the General Insurance Corporation of India and its four subsidiaries (The United India Insurance Co. Ltd., Oriental Fire and General Insurance Co. Ltd., National Insurance Co. Ltd., and New India Assurance Co. Ltd.) provide assistance to industries in the form of loans, underwriting and direct subscriptions to shares and debentures, placement of short-term deposits with companies, etc.

Besides taking right entitlement and underwriting of debenture issues, GIC, along with LIC and UTI, buys back debentures tendered by individual holders back to companies for encashment after a stipulated period and thus provides liquidity to such long-term financial assets.

INSTITUTIONS FOR SMALL INDUSTRY

There are several institutions specifically to assist the development of the small and village industries.

SIDBI

The Small Industries Development Bank of India Act, 1989, under which SIDBI was established on April 2, 1990, envisages SIDBI to be "the principal financial institution for the promotion, financing and development of industry in the small-scale sector and to coordinate the functions of the institutions engaged in the promotion and financing or developing industry in the small-scale sector and for matters connected therewith or incidental thereto".

SIDBI is an apex institution for the development of the small-scale sector.

As an apex institution, SIDBI makes use of the network of the banks and state level financial institutions, which have retail outlets. SIDBI supplements the efforts of existing institutions through its direct assistance schemes to reach financial assistance to the ultimate borrowers in the small-scale sector. Refinancing, bills rediscounting, lines of credit and resource support mechanisms have evolved over the period of time to route SIDBI's assistance through the network of other retail institutions in the financial system. Improved levels of coordination for development of the small-scale sector is also achieved through a system of dialogue and obtaining feedback from the representatives of institutions of small-scale industries who are on the SIDBI's National Advisory Committee and Regional Advisory Committees.

Business Domain

The business domain of SIDBI consists of small-scale industrial units, which contribute significantly to the national economy in terms of production, employment and exports. In addition, SIDBI's assistance flows to the transport, health care and tourism sectors and also to the professional and self-employed persons setting up small-sized professional ventures.

Objectives

Four basic objectives are set out in the SIDBI Charter. They are:

- Financing
- Promotion
- Development
- Coordination

For orderly growth of industry in the small-scale sector. The Charter has provided SIDBI considerable flexibility in adopting appropriate operational strategies to meet these objectives. The activities of SIDBI, as they have evolved over the period of time, now meet almost all the requirements of small-scale industries which fall into a wide spectrum constituting modern and technologically superior units at one end and traditional units at the other.

The scope of SIDBI's role encompass the multifarious development needs of the small-scale sector.

Operational Emphasis

SIDBI, in its operational strategy, emphasises:

- Enhancement in the flow of financial assistance to SSIs.
- Enhancement in the capabilities of SSIs at all levels, with focus on adoption of improved and modern technology.

The small industries sector in India is dominated by a large number of small units. These micro-enterprises require special nurturing. SIDBI has been operating schemes like Single Window Scheme and Composite Loan Scheme.

To ensure that financial assistance is made available to such units on easy terms and with hassle-free procedures. It has been a matter of policy in SIDBI to identify the areas of gaps in credit delivery system and fill them through devising appropriate new schemes and implementing them.

Financial Assistance

SIDBI's assistance now covers:

- Equity
- Term loan (domestic and foreign currency)
- Working capital for inventory, for raw material, through finance against bills receivables and for intangibles.

The purposes for which SIDBI's assistance is provided include new projects, expansion, diversification, technology upgradation, modernisation, quality improvement, environmental management, marketing (domestic and international) and rehabilitation of sick SSIs.

Promotional Orientation

Besides financing, SIDBI provides developmental and support services to SSIs under its *Promotional and Developmental (P&D) schemes*. The focus of such assistance is to ensure:

- Enterprise Promotion
- Human Resource Development
- Technology Upgradation
- Environmental and Quality Management
- Information Dissemination and
- Market Promotion

The P&D initiatives of SIDBI have crystallised over the years and are now oriented to serve rural entrepreneurs and youth, particularly women through programmes to empower them and motivate them to undertake entrepreneurial ventures.

As an apex financial institution for promotion, financing and development of industry in the small-scale sector, SIDBI meets the varied developmental needs of the Indian SSI sector by its wide-ranging Promotional and Developmental (P&D) activities.

P&D initiatives of the bank aim at improving the inherent strength of small-scale sector on one hand as also economic development of poor through promotion of micro-enterprises.

In pursuance of its multifaceted P&D activity, synergistic with its business activities aimed at development of the small industries, SIDBI looks forward to a partnership with NGOs, associate financial institutions, corporate bodies, R&D laboratories, marketing agencies, etc., for national level programmes.

SIDBI has identified the following thrust areas of P&D activities, which are being undertaken in partnership with various institutions, agencies, and NGOs.

SIDBI Foundation for Micro Credit: The SIDBI, an apex financial institution for promotion, financing and development of small-scale industries in India, has launched a major project christened "SIDBI Foundation for Micro Credit" (SFMC) as a proactive step to facilitate accelerated and orderly growth of the microfinance sector in India. SFMC is envisaged to emerge as the apex wholesaler for microfinance in India providing a complete range of financial and non-financial services such as loan funds, grant support, equity and institution building support to the retailing Microfinance Institutions (MFIs) so as to facilitate their development into financially sustainable entities, besides developing a network of service providers for the sector. SFMC is also poised to play a significant role in advocating appropriate policies and regulations and to act as a platform for exchange of information across the sector. Operations of SFMC in the next few years, are expected to contribute significantly towards development of a more formal, extensive and effective microfinance sector serving the poor in India.

SIDBI plays an important role in the field of micro financing.

Mahila Vikas Nidhi: A trained and skilled woman can earn her livelihood and effectively contribute to the national income. SIDBI operationalises this concept under its Mahila Vikas Nidhi (MVN) programme by assisting accredited NGOs to create training and marketing infrastructure.

Mahila Vikas Nidhi (MVN) is SIDBI's specially designed Fund for economic development of women, especially the rural poor, by providing them avenues for training and employment opportunities.

A judicious mix of loan and grant is extended to accredited NGOs for creation of training and other infrastructural facilities. The basic activity involves setting up of Training-cum-Production Centres (TPCs) by the assisted NGOs to ensure that women are provided with training and employment opportunities.

In addition, activities like vocational training, strengthening of marketing set up for the products of the beneficiary group, arrangements for supply of improved inputs, production and technology improvement are also covered under the MVN scheme. Assistance is given mainly towards capital expenditure and support of a recurring nature is discouraged.

NGOs that have been in existence for at least 5 years, should be registered with properly constituted bye-laws, memorandum and articles of association, governing body, broad-based management and properly maintained accounts and having good track records are eligible for this programme.

Rural Industries Programme: A unique approach for rural industrialisation where the emphasis is on stimulating and helping the potential entrepreneurs to set up small enterprises through consultancy outfit positioned by SIDBI.

Development of viable and self-sustaining enterprises in rural and semi-urban areas has been identified for an intensive thrust by the Bank with a view to addressing problems such as rural unemployment, urban migration, underutilisation of physical resources and skills of rural areas.

The Rural Industries Programme (RIP) of the Bank provides a cohesive and integrated package of basic inputs like information, motivation, training and credit, backed by appropriate technology and market linkages for the purpose of enterprise promotion.

SIDBI has initiated several specific focus initiatives.

Implementing agencies such as NGOs, development professionals, Technical Consultancy Organisations etc. are identified and assigned the task of developing RIP. The implementing agency either by itself or by networking with the appropriate agencies, provides the following professional services: identification and motivation of potential entrepreneurs in the rural areas; identifying potential investment opportunities for these entrepreneurs; facilitating skill upgradation; assistance in securing finance from banks and other lending institutions; helping entrepreneurs in selection, sourcing, installation and operation of machinery; arranging market support wherever necessary; and guiding entrepreneurs till their units commence commercial production.

SIDBI is encouraging a sub-sectoral approach under RIP to provide necessary technology and marketing linkages as relevant to specific industrial segment and rural clusters.

SIDBI meets part of the manpower cost of the implementing agency, mainly in the form of a performance fee. The fee is linked to units actually grounded by the identified rural entrepreneurs. In deserving cases, the Bank even provides some start-up expenses to the implementing agencies apart from the performance fee.

Entrepreneurship Development Programmes: Entrepreneurship can be developed by training. Towards this end and also to make the Entrepreneurship Development Programmes (EDPs) result-oriented, SIDBI has been supporting suitable agencies to train and guide potential entrepreneurs to set up enterprises.

EDPs aim at training various target groups in entrepreneurial traits so that they obtain adequate information, motivation and guidance in setting up their own enterprises. In order to maintain a homogeneous nature of participating groups, EDPs focus on rural entrepreneurs, women and SC/ST.

The EDPs are normally of 6 weeks' duration coupled with proper practical training inputs. Training Agencies specialising in conducting EDPs, Non-governmental Organisations (NGOs) and specialised technical institutes are extended assistance for conduct of product-specific EDPs.

In an effort to attract more professional and result-oriented institutions into the EDP fold, the Bank has made the scheme more performance-oriented by extending reasonable support towards training cost and encouraging the institutions to earn performance fee by grounding units.

Management Development Programmes: Management Development in SSIs has been identified as a crucial area of intervention for the viability, competitiveness and profitability of SSI units especially in the context of present economic transition when the market barriers are gradually being removed. SIDBI took initiative to remedy the shortcoming of HRD in SSI sector by launching two programmes namely Small Industries Management Programme (SIMAP) targeted at qualified unemployed as well as industry sponsored candidates to provide low cost and competent managers to SSI units and Skill-cum-Technology Upgradation Programme (STUP) for owners/managers of SSIs.

Quality Management: SIDBI is also giving due emphasis to creating awareness in the SSI sector regarding the need for quality and environment management. Suitable agencies are appointed to create awareness and assist in implementation of unit specific plan.

As the small-scale sector has been slow to respond to the importance of quality, the Bank launched a major campaign to organise participative workshops all over the country to sensitise the SSI units about the issue and to create awareness about concepts such as 'Total Quality Management' and 'ISO 9000' as also to assist the SSI units in acquiring ISO-9000 certification by making available to them all the major inputs which are required, *viz.,* expert guidance, escort services and finance.

Environment Management: The environment management initiative of the Bank has been launched with the objective to make the SSI units aware of environmental issues and to assist them to acquire a green image by finding solutions to their pollution problems.

The two-pronged approach aims at increasing awareness on the important issues of environment management and supporting the setting up of demonstration projects in homogeneous cluster of SSI units.

The conduct of awareness programmes is entrusted to professional agencies. These agencies conduct interactive and focused programmes, which endeavour to provide solutions to the multifarious problems afflicting SSI units. The objective of this exercise was to educate the SSI units about the environmental regulations, which need to be adhered to, and the steps, which need to be adopted to operate within prescribed norms.

Demonstration projects are implemented by professional agencies by providing select units in homogeneous clusters with escort services. The agency helps in setting up projects which not only reduce pollution levels but also bring in benefits like improved quality, reduced processing time and material conservation.

NSIC

The National Small Industries Corporation Ltd., which is wholly owned by the Government of India and meant exclusively for the development of small-scale industries, was established in 1956. The NSCI with its head office at Delhi has regional/sub-offices in several places. The main functions of the Corporation are the following:

NSIC helps in the supply of machinery and raw materials for small enterprises and in the marketing of products of SSIs.

1. Supply of machinery, both indigenous and imported, on hire purchase to help setting up of new small ancillary units and to modernise existing ones.
2. The Corporation's Prototype Development and Training Centres, the subcentres and the demonstration-cum-training centre at different places develop prototypes which may be transferred along with know-how to manufacturing units for commercial production, and/or renders training in various engineering trades.
3. Under the Raw Materials Assistance Scheme, small-scale units are supplied raw materials — imported and scarce indigenous ones — on a continuing basis, giving them also the benefit of bulk purchases.
4. NSIC helps the marketing of products of small-scale units under the Government Stores Purchase Programme as well as under its Internal Marketing Programme through consortia approach. In the field of export marketing, the Corporation has adopted a 'Single Window' assistance programme.
5. Further, with a view to creating facilities for regular display of products of the small-scale sector. NSIC has set up showrooms-cum-marketing development centres in a number of places in the country.
6. NSIC undertakes small industries projects on turnkey basis and provides total services from feasibility studies to installation and commissioning of plant.

SSIDCs

State Small Industries Development Corporations have been set up to serve the needs of small-scale industries in the respective States/Union Territories. The SSIDCs have been incorporated under the Companies Act so as to lend them the desired operational flexibility to undertake a variety of activities for the benefit of small-scale industries.

SSIDCs have manifold functions for the development of SSIs.

The specific activities undertaken by the SSIDCs include:

1. procurement and distribution of raw materials;
2. supply of machinery to small entrepreneurs on hire purchase basis;
3. management assistance to production units;
4. operation of seed capital scheme on behalf of the State governments;
5. construction and management of industrial estates;
6. participating with other institutions in setting up of technical consultancy organisations; and
7. undertaking marketing activities.

In addition to the above, SSIDCs have been providing infrastructural facilities like sheds, godowns and common production facilities, technical and consultancy services, particularly to the unemployed, like preparation of feasibility reports, formulation of project reports and planning for modernisation/diversification of existing product range and implementation of projects. Some SSIDCs have also sponsored industrial potential surveys in some districts to identify viable small-scale projects to be based mainly on locally available raw materials and local demand conditions.

SSIDCs also arrange for marketing of finished products of small industrial units both in domestic as well as international markets under their Marketing Assistance Scheme.

Many SSIDCs are actively associated with the setting up of emporia to assist small-scale units in marketing their products. Such emporia have been set up in metropolitan cities and also places of tourist importance. The showrooms established are consumer goods oriented and are aimed at ensuring reasonable prices to both the producers and the consumers. Further, SSIDCs also organise and participate in exhibitions in various markets. The products involved are mainly handicrafts, handlooms, ready-made garments, sports goods and the like.

KVIC

The Khadi and Village Industries Commission, established as a statutory organisation under the Khadi and Village Industries Commission Act, 1956, provides various schemes of assistance which cover extension of finance right from the stage of procurement of raw materials, tools and implements to the production of goods and their marketing.

For more information about KVIC, see the chapter on *Village and Small Industries*.

COMMERCIAL BANKS

Commercial banks are a very important source of finance for all categories and types of business.

Commercial Banks are a very important source of finance for the industry. The industrial sector is getting around 50 per cent of the total banks' credit.

Particularly since the major bank nationalisation of 1969, there has been a substantial expansion of the bank branch network and a substantial growth of the bank deposits and credits.

Commercial banks in India had been following the orthodox British line of disfavouring term loans to industries. However, there has been a change in their attitude.

In respect of term finance, the commercial banks, besides providing term credit and subscribing to shares and debentures, indirectly participate in term finance by subscribing to the

shares and debentures of financial institutions. Commercial banks also do underwriting of shares and debentures. Some of the banks have merchant banking divisions. Scheduled banks have been permitted to hold in their own investment portfolio shares and debentures of the private corporate sector devolving on them through their underwriting and merchant banking commitments.

The shift in favour of the 'priority sectors' led to a decline in the share of the industrial sector in the total bank credit. Today, the industrial sector accounts for about half of the total bank credit compared to over-two-thirds prior to the nationalisation of 1969. This decline in the share has been confined to the medium and large sectors. Small industry is a priority sector and there has been a very significant increase in the proportion of the credit flow to this sector.

SUMMARY

There are a number of institutions at all-India and State levels for assisting the development of large, medium and small industries by providing financial and various other promotional assistances.

The most important all-India Development Financial Institutions (DFIs) are Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI) and Industrial Investment Bank of India (IIBI). The IDBI is the apex institution which coordinates the activities of various institutions.

Besides the above, national level institutions providing industrial finance also include some investment institutions like the Unit Trust of India (UTI), Life Insurance Corporation India (LIC), and the General Insurance Corporation of India (GIC) and its subsidiaries.

Development banks have been established at the State level too. There are State Financial Corporations (SFCs) and Industrial Investment/Development Corporation (SIICs/SIDCs) in most of the States.

The Small Industries Development Bank of India (SIDBI), a wholly owned subsidiary of the IDBI, is an apex institution for promotion, financing and development of industries in the small-scale sector and for coordinating the functions of other institutions engaged in similar activities. Financial assistance is provided, directly or indirectly, to the small-scale sector also by National Small Industries Corporation (NSIC), State Small Industries Development Corporations (SSIDCs) and Khadi and Village Industries Commission (KVIC), although financing is only an ancillary function of these organisations.s

A very important source of industrial finance is commercial banks.

TABLE 27.1 : INDUSTRIAL DEVELOPMENT/FINANCIAL INSTITUTIONS

All-India Institutions (For large and medium industries)	*State Level Institutions (For medium and small industries)*	*Institutions for Small-scale Sector*	*Others*
Industrial Development Bank of India (IDBI) Industrial Finance Corporation of India (IFCI) Industrial Credit and Investment Corporation of India (ICICI) Industrial Investment Bank of India (IIBI) Investment Institutions (UTI, LIC, GIC and subsidiaries)	State Finance Corporations (SFCs) State Industrial Development/ Investment Corporations (SIDCs/ SIICs)	Small Industries Development Bank of India (SIDBI) National Small Industries Corporation (NSIC) State Small Industries Development Corporations (SSIDCs) Khadi and Village Industries Commission (KVIC)	Commercial Banks, Cooperative Banks, Venture Capital Funds etc.

Provision of rupee and foreign currency loans, subscription to shares and debentures, underwriting of shares and debentures, guaranteeing of deferred payments and loans are the important types of financial assistance provided by these institutions (some of the institutions do not provide some of these assistances).

Development activities of the DFIs include identifying industrial potentials of different areas; development of entrepreneurship through training and motivation; assistance in project identification, feasibility studies and preparation of project reports; technical and managerial consultancy; seed/risk capital assistance, etc. The IDBI is the apex institution which coordinates the activities of various institutions.

The DFIs have sponsored a number of technical consultancy organisations (TCs) and some institutes for entrepreneurial/management development and imparting education/research in capital market.

As a percentage of GDP, disbursements by financial institutions to industry rose from as low as 0.5 per cent in the first-half of the seventies to 1.4 per cent in the first-half of the eighties, to 2.9 per cent in the first-half of the nineties and further to 3.3 per cent in the second-half of the nineties.

REFERENCE

1. **K.V. Prabhakar, "Development Banks — New Trends", *Financial Express,* June 18 and 19, 1981.**

ANNEXURE 27.1*

Merchant Banking, Mutual Funds and Venture Capital

Merchant Banking

"Merchant banks are issue houses rendering such services to industrial projects or corporate units as floatation of new ventures and new companies, preparation, planning and execution of new projects, consultancy and advice in technical, financial, managerial and organisational fields. A number of other functions such as restructuring, revaluation of assets, mergers, takeovers, acquisitions, etc. are also undertaken by them.

A major function of merchant banking is the issue management. The issue can be public issue through prospectus, offer of sale, or private placements, etc."[1]

According to a notification of the Ministry of Finance, a merchant banker is any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management".

Merchant Banking Services

According to the SEBI Guidelines for Merchant Bankers, the authorised merchant banking activities are the following.

1. Issue management, which will *inter alia* consist of preparation of prospectus and other information relating to the issues, determining financing structure, tie-up of financiers and final allotment and/or refund of subscription.
2. Corporate adviser services relating to the issue.
3. Underwriting.
4. Portfolio management services.
5. Managers, consultants or advisers in the issue.

The list of merchant banking services provided by the IDBI, given below, would give an idea of the services rendered by merchant banks.

Corporate Finance

- Project Advisory Services which include:
  - Review of feasibility, key contracts/structures
  - Advice on key project contracts
  - Identifying foreign partners/investors and assistance in evaluation and negotiations
  - Structuring financing plan and advise on financing options
  - Financial modelling and sensitivity analysis
  - Risk analysis and risk allocation

* This Annexure is intended only to explain/illustrate the meaning of *Merchant Banking*, *Mutual Funds* and *Venture Capital*. Those who are interested in the details are advised to refer other publications like *Manual of Indian Capital Market* by Sanjiv Agarwal.

- – Preparation of project information memorandum
- – Documentation agency services
- – Structuring of credit enhancement mechanism

- Policy formulation and evaluation of infrastructure projects
- Project appraisal
- Placement of equity with banks, FIIs, high net worth investors, mutual funds, institutional investors and private equity funds.
- Placement of preference shares and debentures with domestic investors
- Structuring and syndication of bought-out deals
- Coordinating the financial participation of multilateral agencies and international banks
- Arranging buyers' line of credit/suppliers' line of credit/guarantee assistance
- Loan syndication – Rupee and foreign currency from Indian financial institutions, banks, multilateral agencies, foreign commercial banks, export credit agencies
- Syndication of structured debt instruments, ECBs and commercial papers
- Advice on resolution of inter-creditor issues of offshore lenders (including ECA lenders) and domestic lenders
- Advice on commercial issues of loan/Guarantee documentation, Sponsor documentation, Security documentation

Issue Management

- Management of public/rights issues of equity, preference shares, convertible, partly convertible and non-convertible debentures including:
  - – Structuring of instruments
  - – Preparation of offer document
  - – Obtaining statutory and other clearances required in connection with the issue
  - – Tying up underwriting and placement through book-building process
  - – Assistance in selection of bankers, brokers, registrars, printers, advertisement agency and other intermediaries
  - – Marketing of the issue
  - – Post-issue activities including finalisation of basis of allotment/refund and listing
  - – Advice on the management of Euro issues
  - – Advice on Buyback of securities and management of tender offer
  - – Open Offer Management under SEBI Takeover Code

Corporate Advisory Services

- – Equity and Business Valuation
- – Advice on Mergers, Acquisition and Divestitures

– Advice on Business and Financial Restructuring
– Privatisation advice
– Restructuring/rehabilitation advice for weak units
– Advice on Asset Sale and hive-offs

Merchant Banking in India

Merchant banking was introduced in India by foreign banks. It was only in the 1970s that Indian banks entered this field.

The following are some of the reasons why specialist merchant banks have a crucial role to play in India.[2]

1. Growing industrialisation and increase of technologically advanced industries.
2. Need for encouragement of small and medium industrialists, who require specialist services.
3. Growing complexity in rules and procedures of the Government.
4. Need to develop backward areas and states which require different criteria.

Institutions engaged in merchant banking, either by themselves or through subsidiaries, in India fall into the following categories.

– Financial institutions like IDBI, IFCI and ICICI.
– Commercial banks – Foreign and Indian (Public sector and Private sector)
– Private merchant bankers like DSP, Kotak etc.

Any person or body proposing to engage in the business of merchant bailing would need authorisation by the (SEBI) in their prescribed format.

All merchant bankers are expected to perform with high standards of integrity and fairness in all their dealings. A code of conduct for merchant bankers will be prescribed by SEBI. Within this context, SEBI's authorisation criteria would take into account mainly the following: professional competence; personnel, their adequacy and quality, and other infrastructure; capital adequacy; and past track record, experience, general reputation and fairness in all their transactions.

MUTUAL FUNDS

A Mutual fund is an agency that mobilises investible resources of, mostly, individuals and invests them in a diversified portfolio of financial assets so as to balance maximisation of returns and minimisation of risks.

Small investors, particularly, may not have the knowledge, expertise and sufficiency of resources to make prudent, profitable and risk spreading investments. The mutual funds with their intimate knowledge of the investment opportunities and analytical and fund management expertise are therefore, expected to be of great service to the small investors. As James L. Pierce observes, a mutual fund, thus, is "a non-depository, non-banking financial intermediary which acts as an important vehicle for bringing wealth holders and deficit units together indirectly."

According to the SEBI Regulations of Mutual Funds brought out in 1993, a mutual fund is "a fund established in the form of a trust by a sponsor, to raise monies by the trustees by the sale of units to the public, under one or more schemes, for investing in securities in accordance with these regulations."[3] In other words, a Mutual Fund (called Unit Trusts in the UK) collects money from the public by sale of units and invests them in financial assets like shares, bonds etc.

Traditionally, the *open-ended* type of mutual fund has been very popular. In the case of the open-ended fund, an investor can buy or redeem (*i.e.,* sell back) units any time. Open-ended schemes, thus, combine, theoretically, return on investment and almost perfect liquidity. In a *close-ended* mutual fund, the corpus of the fund and the duration of the fund are predetermined. An investor cannot redeem his investment directly from the Fund before the scheme matures. They, may however, be traded in the capital market.

The net asset value (NAV) of a fund indicates the worth of the investments made of the fund. The NAV per unit is computed by dividing the net assets of the fund by the number of units outstanding. A NAV more than the face value indicates capital appreciation and *vice versa*.

The public sector Unit Trust of India (UTI), established in 1964 is the first Mutual Fund in India. The main objective of the UTI is to mobilise the savings of the community and channelise them into productive corporate investments so as to provide for growth and diversification of the economy. It is at the same time intended to provide the facility for an equity type of investment to the large and growing number of investors in the small and medium income groups. For small investors, the UTI has been expected to offer the advantages of: *(i)* considerably reduced risk since funds are invested in a balanced and well distributed portfolio; *(ii)* the benefit of expert management; *(iii)* a steady income: and *(iv)* liquidity.

The UTI has grown substantially, launching attractive products suitable to different segments. Its first product, the US-64, an open-ended scheme of the UTI, was very popular because of the fairly high returns and liquidity it offered. However, in 2000, it served a severe blow to the confidence of the small investors, particularly, not only in the UTI but also in the public sector financial institutions and the Government itself when it suspended for some time the repurchase of the units due to financial crises and the fall in the NAV below the face value. Investments, allegedly, with vested interests and mismanagement led to such a flight.

The Amendment to the Banking Regulation Act in 1993, which empowered the Reserve Bank to permit banks to carry on non-banking businesses such as leasing, mutual funds etc. gave a fillip to the growth of Mutual Funds. Besides banks, a number of non-banking financial intermediaries (NBFIs), like Jardine Fleming, Birla Mutual Fund, Alliance Mutual Fund, Kothari Pioneer Mutual Fund etc. are also in the Mutual Fund business in India now.

Resources mobilised by mutual funds (UTI was the only mutual fund until 1987-88) grew at a steady rate until 1992-93; since then they showed some variations. Resources mobilised by mutual funds which was just 0.04 per cent of GDP during the period 1970-71 to 1974-75 increased to 1.59 per cent during 1990-91 to 1992-93. Total resources mobilised as proportion of GDP declined to 1.12 per cent by 1994-95 but nevertheless remained. This ratio stood at 1.13 per cent during 1999-2000.

VENTURE CAPITAL

Development of entrepreneurship demands combination of three vital factors:

- Innovative ideas
- Competency in project preparation and implementation
- Project financing

There may be a many people with good project ideas. These ideas, however, do not get translated into commercially viable practical projects in the absence of the other two factors. Many young technocrats and others with innovative ideas suffer because of this. It is in this context that the Venture Capital can play a crucial role in the industrial development by providing the two missing links.

Venture Capital (VC) has played an important role in the industrial development of USA. The development of the Silicon Valley, in particular, owes a lot the VCs.

Innovative projects, albeit potentially very profitable, are often very risky and, therefore, financiers tend to shy away from such projects. As the VC firms venture into such risky projects, venture capital is also known as *risk capital*.

Venture capital activities have been pioneered in India by AIFIs like ICICI, IDBI and IFCI by setting up Venture Capital divisions or subsidiaries. Venture capital funds have been established by State level institutions, commercial banks and private forms also.

The details of the Venture Capital Fund of the IDBI given in Box 27.2 would give some exposure to the characteristics of VC.

BOX 27.1 : VENTURE CAPITAL FUND, IDBI

Objective	*To encourage commercial applications of indigenous technologies or adaptation of imported technologies, development of innovative products and services, holding substantial potential for growth and bankable ventures involving higher risk including those in the Information Technology (IT) Sector.*
Eligibility	*All industrial concerns defined in Section 2(c) of IDBI Act, 1964.* • *Ventures, which may not be first in the technology but would be one of the first few offering potential for substantial return* • *Venture should normally have innovation content* • *Ventures, which deliver traditional products/services in emerging sectors and have sustainable competitive advantage* • *Overriding criteria for eligibility will be potential for substantial long-term capital gains*
Target Sectors	*IDBI shall target investments in high growth and profitable industry sectors and will exclude mature industries, commodity-type products and highly competitive sectors. The main criteria will be high growth prospects, potential for capital appreciation and clear-cut exit route within a time frame of 3-5 years*
Nature of Assistance	*Equity* *Term Loan* *Convertible debt*
Extent of Assistance	*Finance for capital expenditure, start-up working capital and selectively for core current assets during commercial operation. Maximum up to 80 per cent of the project cost. IDBI's exposure to be restricted to ₹ 20 crore in each venture*
Project Cost	*No upper limit on the cost of the venture*
Promoters'	*Minimum 20 per cent of the cost of the venture, with core promoters' contribution being not less than 10 per cent.*

REFERENCES

1. **V.A. Avadhani, *Investment and Securities Markets in India*, Himalaya Publishing House, Bombay, 1992, p. 151.**
2. ***Ibid.*, p. 157.**
3. **Sanjiv Agarwal, *Manual of Indian Capital Market*, Bharat Law House, New Delhi, 1997, p. 1419.**

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Part 5

LABOUR ENVIRONMENT

The labour environment is one of the most important factors affecting business. Labour standards has emerged as an important issue in international business.

The labour environment sometimes affects the profitability and fate of a business. It is one of the important considerations in the location of business. There are several cases of the labour environment causing migration of industry.

Even when there are national legislations pertaining to labour, the real regulatory environment of labour could be different in different States or localities because of differences in the attitude of the State governments or the social environment.

Most Indian labour laws are very old; several of them were formulated long before the Independence. The situation that prevails now is very different from what prevailed at the time they were drawn up, indicating that reform of the labour laws is overdue. The Union Finance Minister in his Budget Speech, 2001-2002, which was hailed as one initiating the second generation of reforms, indicated the need for reform of several laws.

This *Part* provides a bird's eye view of labour legislation in India and deals with certain topics like Trade Union Movement, Workers' Participation in Management, Quality Circles and Exit Policy.

Chapter 28

LABOUR LEGISLATION

Structure

Classification of Labour Legislation

Unorganised Sector

Summary

References

Annexure 28.1: Second National Commission on Labour on Rationalisation of Labour Laws

The labour environment is an important determinant of business location and functioning. Factors such as the availability of labour of different skill levels, productivity and cost of labour, flexibility of labour, attitude and behaviour patterns of labour, nature of trade unionism, labour legislation and the effectiveness of their implementation etc. are important to business. Labour standards, which encompass issues such as child labour, working conditions and labour welfare, wage levels, labour legislation and their implementation, have emerged as an important concern in international business.

Labour legislation should provide a framework for protection of rights and interests of employers as well as employees and industrial relations.

Labour legislation is a very important factor that shapes the labour environment. Protection of the interests of labour was long held as one of the important responsibilities of the State in the democratic countries. However, some recent developments indicate that the Government should intervene to prevent the legitimate rights of consumers, the general public, and employers from being denied by the militant might of organised labour. But many a time, there is a tendency to ignore the latter aspect. In the global environment, the cost of such negligence could very high.

The *Directive Principles* in the Constitution of India places a lot responsibility on the State in respect of labour. The Constitution directs the State to provide work to every citizen who is willing and able to work. Article 42 requires the state to make provision for securing just and humane conditions of work and for maternity relief. Article 43, which is described as the *Magna Carta* of the Indian worker, imposes upon the state the obligation, inter alia, to secure, by suitable legislation or economic organisation or in any other way, to all workers, agricultural, industrial or otherwise, work, a living wage, conditions of work ensuring a decent standard of life, full enjoyment of leisure, and social and cultural opportunities.

BOX 28.1 : SECOND NATIONAL COMMISSION ON LABOUR

The Second National Commission on Labour, appointed by Government of India in October 1999, under the chairmanship of Mr. Ravindra Varma, submitted its Report in 2002, i.e., 35 years after the Report of the first National Commission on Labour.

The Terms of References of the Commission were: (i) "to suggest rationalisation of existing laws relating to labour in the organised sector;" and (ii) "to suggest an Umbrella Legislation for ensuring a minimum level of protection to the workers in the unorganised sector."

One of the criticisms of the terms of references to the Commission was that the terms of reference talk of 'rationalisation' of existing laws. The Report of the Commission points out that some critics have tried to create an impression that the word 'rationalisation' means the retrenchment of workers or cutting down the labour force engaged in an industry or plant, and, therefore, indicates an attempt to sanctify 'retrenchment.' According to the Commission, "this is an unwarranted interpretation. In our understanding, rationalisation in this context, means only making laws more consistent with the context, more consistent with each other, less cumbersome, simpler and more transparent."

One of the two main tasks that have been entrusted to the Commission is to suggest Umbrella Legislation for ensuring a minimum level of protection to the workers in the unorganised sector. When the Commission is asked to review legislation and structures that exist in the organised sector and also to make recommendations for legislation and structures in the unorganised sector, it means that the Commission is expected to suggest measures that will cover the problems and needs of the entire workforce in the country.

It was suggested that while conducting the studies, drawing conclusions and formulating the suggestions, the Commission took into account various factors that contributed to the creation of the context in which the Government deemed it necessary to appoint the Commission. The Resolution appointing the Commission itself identified some of these factors as the emerging economic environment: the globalisation of the economy and liberalisation of trade and industry; the rapid changes in technology and their consequences and ramifications; the effects that these changes were likely to have on the nature and structure of industry, on methods and places of production, on employment and the skills necessary to retain employability and mobility; and the responses that are necessary to acquire and retain economic efficiency and international competitiveness. The Resolution also desired that while considering the demands of international competitiveness, the Commission took into

account the need to ensure a minimum level of protection and welfare to labour, to improve the effectiveness of measures relating to social security, safety at places of work and occupational health hazards; to pay special attention to the problems of women workers, minimum wages, evolving a healthy relation between wages and productivity; and to improve the efficiency of the basic institutional framework necessary to ensure the protection and welfare of labour.

Another set of factors sharpening the need for an urgent review of the existing laws in the organised sector and of the inadequacy of laws and structures in the unorganised sector, arose from the experiences that all social partners – entrepreneurs, workers and the State and Central Governments – have had, of the way the existing laws have worked during the last few decades. All three partners have complained that the laws, as they exist, are unsatisfactory. All three wanted a comprehensive review, and a comprehensive reformulation of the legal framework, the administrative framework and the institutional structures in the field of social security. Demands for basic reforms had been voiced in the Labour Conferences for many years, and the Government had assured the tripartite conferences that it would take early steps for review and reform.

Labour legislation is regarded as "a most dynamic institution. From a simple restraint on child labour in 1881, labour legislation in India has become an important agency of the State for the regulation of working and living conditions of workers, as indicated by the rising number and variety of labour Acts. This rapid development of labour legislation is an integral part of the modern social organisation."[1] "Like slave labour in ancient times, serf relics of all of which are still to be found in many backward countries, free labour is the direct result of growing industrialism and democracy, and labour legislation is the institution through which the State protects the interest, ameliorates the moral and material conditions, of the working classes."[2]

Labour is an item included in the Concurrent List in the Constitution, which implies that both Union and State governments can legislate on this matter. However, State legislature cannot enact a law which is repugnant to an Act passed by the Parliament. The National Commission on Labour has observed that, in practice, however, the working of the Constitutional provisions have not created any difficulty in labour matters even at the time when Union-State relationship in other aspects of their respective functions had to undergo a severe strain.

BOX 28.2 : ILO DECLARATION ON FUNDAMENTAL PRINCIPLES AND RIGHTS AT WORK

The ILO declaration on Fundamental Principles and Rights at Work, adopted by the International Labour Conference in June 1998, declares inter alia that all Member States have an obligation to respect, to promote and to realise the principles concerning the fundamental rights which are the subject of those conventions, namely;

(a) freedom of association and the effective recognition of the right to collective bargaining;

(b) the elimination of all forms of forced or compulsory labour;

(c) the effective abolition of child labour; and

(d) the elimination of discrimination in respect of employment and occupation.

The primary goal of the ILO today is to promote opportunities for women and men to obtain decent and productive work in conditions of freedom, equity, security and human dignity. The goal is not just the creation of jobs but the creation of jobs, of acceptable quality.

Government of India ratified Convention 122 on Employment and Social Policy in 1998. Article 1 of the Convention lays down:

1. With a view to stimulating economic growth and development, raising levels of living, meeting manpower requirements, and overcoming unemployment and underemployment, each Member shall declare and pursue, as a major goal an active policy designed to promote full, productive and freely chosen employment.

2. The said policy shall aim at ensuring that:

(a) There is work for all who are available for and seeking work.

(b) Such work is as productive as possible

(c) There is freedom of choice of the employment and the fullest possible opportunity for each worker to qualify for, and to use skill and the endowments in a job for which he is well suited, irrespective of race, colour, sex, religion, political opinion, national extraction or social origin.

3. The said policy shall take due account of the state and the level of economic development and mutual relationships between employment objectives and other economic and social objectives, and shall be pursued by methods that are appropriate to national conditions and practices."

This convention was ratified by India. From the commitments of the Government of India, it can be deduced that the following rights of workers have been recognised as inalienable and must, therefore, accrue to every worker under any system of labour laws and labour policy. These are:

(a) Right to work of one`s choice

(b) Right against discrimination

(c) Prohibition of child labour

(d) Just and humane conditions of work

(e) Right to social security

(f) Protection of wages including right to guaranteed wages

(g) Right to redress of grievances

(h) Right to organise and form trade unions and Right to collective bargaining, and

(i) Right to participation in management.

The second NCL has observed regarding the above that one cannot overlook the fact that rights are also related to duties.

Principles of Labour Legislation

Labour legislation should confirm to the socio-economic realities of the nation and ILO principles.

There are some cardinal principles of labour legislation.

Social Justice: The principle of social justice demands that the State should afford protection to workers against harmful effects to their health, safety and morality, of their working conditions, as well as ensure a reasonable wage. But what is not sufficiently recognised and emphasised is that organised workers shall not be allowed to exercise their might to meet socially unjustifiable rights and hold public life at ransom.

Social Equity: The principle of social equity demands that the changes in the socio-economic and political conditions and environment should be appropriately absorbed into labour legislation from time to time.

International Uniformity: The International Labour Organisation (ILO) has been playing a very important role in ensuring uniformity in the labour legislation of different countries. The ILO helps in providing a common platform for men engaged in the field or industrial relations to study and understand the norms of social justice and social equity, applied to labour matters in different countries, and adapt them intelligently in their respective countries, with due regard for their own national economy. Most labour legislation in India is based on this principle.

National Economy: While formulating labour laws in respect of wages, working conditions, welfare, social security, etc., it is very important to bear in mind the general economic situation of the country.

BOX 28.3 : POSTULATES AND EVOLUTION OF LABOUR POLICY IN INDIA

The main postulates of labour policy operating in the country could be summed up as follows:

1. *Recognition of the State, the custodian of the interests of the community, as the catalyst of 'change' and welfare programmes.*
2. *Recognition of the right of workers to peaceful direct action if justice is denied to them.*
3. *Encouragement to mutual settlement, collective bargaining and voluntary arbitration.*
4. *Intervention by the State in favour of the weaker party to ensure fair treatment to all concerned.*
5. *Primacy to maintenance of industrial peace.*
6. *Evolving partnership between the employer and employees in a constructive endeavour to promote the satisfaction of the economic needs of the community in the best possible manner.*
7. *Ensuring fair wage standards and provision of social security.*
8. *Cooperation for augmenting production and increasing 'productivity'.*
9. *Adequate enforcement of legislation.*
10. *Enhancing the status of the worker in industry.*
11. *Tripartite consultation.*

The First Plan adumbrated these principles and they were reaffirmed in successive Plans.

In giving effect to them in practice, the accent has been on reciprocity and mutuality of obligations and recognition of workers' contribution to production and productivity. A subtle change in emphasis with regard to modes of settlement of disputes in successive Plans is also discernible. Legalistic approach is gradually yielding place to voluntary bilateral arrangements. Strengthening of trade unions to secure better labour-management relations has also been a part of this approach.

Courtesy: *Report of the National Commission on Labour*

CLASSIFICATION OF LABOUR LEGISLATION

V.V. Giri (a veteran trade union leader who also adorned such positions as Union Minister of Labour and President of India), in his well-known book *Labour Problems in Indian Industry*, has classified the labour legislation in India under the following broad heads.[3]

I. *Laws Relating to Weaker Sections*
   1. Children
   2. Women

II. *Laws Relating to Specific Industries*
   1. Factories and workshops
   2. Mines and minerals
   3. Plantations
   4. Transport, namely *(a)* Railways; *(b)* Seamen; *(c)* Ports and Docks; *(d)* Inland water transport; *(e)* Motor transport; and *(f)* Air transport
   5. Shops and commercial establishments
   6. Contract labour
   7. Construction workers
   8. Working journalists

There are a host of labour laws related to different sections of the labour population, different sectors of economy, labour welfare and social security, specific labour matters and trade unions and industrial relations.

III. *Laws Relating to Specific Matters*

1. Wages
2. Indebtedness
3. Social security: *(a)* Workmen's compensation; *(b)* maternity benefits; *(c)* retrenchment benefits; *(d)* provident fund and bonus schemes.
4. Bonus
5. Forced labour

IV. *Laws Relating to*

1. Trade unions
2. Industrial relations

Laws Relating to Weaker Sections

Laws relating to weaker sections cover conditions of employment of children and women.

The important legislative provisions with a bearing on the employment of children relate to minimum age of employment, working hours, health certification, employment on dangerous machines and the like. The Factories Act, 1948; the Mines Act, 1952; the Plantation Labour Act, 1951; the Employment of Children Act, 1938; the Shops and Establishments Act of Various States, etc. regulate the minimum age of employment. To ensure the physical fitness of children, the Factories Act provides that children up to the age of 18 will be employed on the production of a health certificate which will be valid for one year only. The Factories Act, the Mines Act, the Plantation Labour Act, the Shops and Establishments Acts, etc., prescribe the maximum hours of work allowed to be assigned to children. The Child Labour (Prohibition and Regulation) Act, 1986 is limited in scope. It does not cover all occupations and processes where children are working. The Act covers only some hazardous occupations and processes. It excludes children working in family based enterprises.

There are several laws to take care of problems/special needs of women and children in employment.

The legislative provisions for the protection and welfare of women workers are largely inspired by the ILO Conventions on:

1. Maternity Protection, 1919
2. Night Work, 1919
3. Underground Work, 1935
4. Equal Remuneration, 1951
5. Discrimination (Employment and Occupation), 1958

However, the actual wording of the enactments in India in which the protection is written draws heavily on the Indian experience. Maternity benefits are provided under the Employees' State Insurance Act and the Maternity Benefit Act, 1961. The other legislative measure for women relates to certain restriction on the lifting of weight, employment in hazardous occupations, provision for separate toilet facilities, rest rooms, creches, etc.

Laws Relating to Specific Industries

***Factories and Workshops*:** The Factories Act, 1948, which provides for the licensing, registration and inspection of factories, is meant to protect the interests of workmen, to ensure for them better conditions of work, and to prevent the employers from taking advantage of their weak bargaining

power. It regulates the conditions of the employment of young persons and females, and provides for safe and healthy working conditions inside the factories.

The Industrial Employment (Standing) Orders Act, 1946, defines the rights and obligations of the employer and the workers in respect of recruitment, discharge, disciplinary action, holiday and leave, etc., with a view to reducing the friction between management and workers in industrial undertakings. The Act provides for the framing of standing orders in all industrial establishments (including factories, mines, railways, docks and plantations) employing 100 or more workers.

***Mines and Minerals*:** According to the definition of the term "mine" under the Indian Mines (Amendment) Act, 1959, mine includes all borings, bore holes, oil wells, shafts, quarries, open cast workings, railways, aerial ropeways, conveyors, tramways, slidings, workshops, power stations; etc., or any premises connected with mining operations and near or in the mining area. The Mines Act prohibits the employment of persons in a mine when its owner fails to comply with the notice of the Mines Inspectorate for remedying any matter connected with a mine which is dangerous to human life, limb or safety.

The Coal Mines (Conservation and Safety) Act, 1952, authorises the Central Government to take such measures as it deems proper or necessary for the maintenance of safety in coal mines or for the conservation of coal.

Other important laws in the field of mines and minerals are the Iron Ore Mines Labour Welfare Cess Act, 1961, Coal Mines Labour Fund Act, 1947, and Coal Mines Provident Fund and Bonus Schemes Act, 1948.

Plantations: The Plantation Labour Act, 1951 regulates the conditions of work of plantation workers and provides for their welfare. The Act, which applies to tea, coffee, rubber and cinchona plantations, may be applied by State Governments to other plantations also. The Act, amended in 1981, provided for compulsory registration of plantations.

***Transport*:** The working and service conditions of the employees of different transports are regulated by various laws, such as the Indian Railways Act, 1930; the Indian Merchant Shipping Act, 1973; the Indian Dock Labourers' Act, 1934; the Dock Workers (Regulation of Employment) Act, 1984; Marketing of Heavy Packages Act, 1951; Motor Vehicles Act, 1939; and Motor Transport Workers Act, 1961.

***Shops and Commercial Establishments*:** State Acts on shops and establishments broadly cover wage earners employed in shops, commercial establishments (including insurance and banking firms), restaurants, theatres, cinemas, and other places of public amusement. These Acts contain provisions related to opening and closing hours, hours of work, rest intervals, spread over, overtime rates and weekly holidays.

There are several laws pertaining to labour in specific segments/types of employment.

Contract Labour: Contract labour is generally employed for casual, seasonal or irregular work. The Contract Labour (Regulations and Abolition) Act, 1970, seeks to abolish the contract labour system in perennial operations and regulates it where the system cannot be abolished. The Act is implemented both by the Centre and States. In the Central sphere, contract labour has been prohibited for certain specified operations in coal, iron ore, limestone, dolomite and manganese mines, and in buildings owned or occupied by establishments under the Central Government.

The Act applies to every establishment which employs 20 or more workmen, and to every contractor who employs not less than 20 workers. The 2nd NCL has observed that this Act has many loopholes and as it does not apply to who does not employ less than 20 workers, if leads to manipulations.

In his Budget (2001-2002) speech, the Union Finance Minister observed that rigidities inherent in the existing legislation regarding Contract labour inhibit growth in employment in many service activities. Section 10 of the existing Act envisages prohibition of contract labour in work/ process/operation if the conditions set therein like perennial nature of job etc. are fulfilled. Section 10 enables the contract labour engaged in prohibited jobs to become direct employees of the principal employer. To overcome this difficulty and at the same time to ensure the protection labour, it is proposed to bring an amendment to facilitate outsourcing of activities without any restrictions as well as to offer contract appointments. It would not differentiate between core and non-core activities, and provide protection to labour engaged in outsourcing activities in terms of their health, safety, welfare, social security, etc. It would also provide for larger compensation based on last drawn wages as retrenchment compensation for every year of service. This proposal raised a lot of opposition.

Construction Labour: To a limited extent, the Workmen's Compensation Act, 1923; the Minimum Wages Act 1948; the Employees State Insurance Act, 1948; the Contract Labour (Abolition and Regulation) Act, 1970, and Standing Instructions relating to casual labour applicable to the employing agencies apply to construction labour as well. It has, however, been noticed that these legislative enactments and standing orders do not cover safety at work and social security.

Working Journalists: The Working Journalists and Other Newspaper Employees (Conditions of Service) and Miscellaneous Provisions Act, 1955, regulates the conditions of service of working journalists and other persons employed in newspaper establishment. By a specific provision of this Act, the provisions of the Industrial Disputes Act with certain modifications have been applied to working journalists.

Laws Relating to Specific Matters

Wages: The two important enactments for wages are the Payment of Wages Act, 1936, and the Minimum Wages Act, 1948.

The Payment of Wages Act, 1936, ensures that industrial workers receive payment of their wages at regular intervals and that no unauthorised deductions are made from their wages. This Act was amended in 2005 for enhancing the wage ceiling to ₹ 6,500 per month for applicability of the Act.

The Minimum Wages Act empowers the appropriate Government to fix the minimum rate of wages payable to workers employed in all scheduled employments, which include employments in any woollen, carpet-making or shawl-weaving establishment, rice mill, flour mill, dal mill, oil mill as well as employment under any local authority.

Bonus: In the past, bonus was regarded as an ex-gratia payment made by the employer to his workers to provide a stimulus for extra effort by them in the production process. Sometimes, it represented the desire of the employer to share with his workers the surplus generated by common endeavour and enterprise. However, later, bonus began to be looked upon as a "deferred wages" and the Payment of Bonus Act, 1965, by imposing a statutory liability upon the employer to pay bonus to the employees, has in effect accorded recognition to this view.

The Payment of Bonus Act applies to every factory as defined in the Factories Act, and to every other establishment in which 20 or more persons are employed on any day during an accounting year. Bonus is payable to employees drawing up to ₹ 3,500 per month. The second National Commission on Labour has recommended to raise the ceiling to ₹ 10,000.

Bonded Labour: The bonded labour system was abolished all over the country by the Bonded Labour System (Abolition) Act, 1976. Under the Act, every bonded labourer stands freed and discharged from any obligation to render any bonded labour.

Laws Relating to Trade Unions and Industrial Relations

The law relating to the registration of trade unions and certain other matters is contained in the Trade Unions Act, 1926. The Act lays down the procedure for the registration of trade unions and defines very clearly their rights and liabilities. It specifies the objects on which trade union may spend its general funds and provides for the constitution of a separate fund for political purposes. Members of bonafide registered trade unions have been granted protection against various civil and criminal liabilities which they are likely to incur in promoting and safeguarding their legitimate interests. More information is provided in the chapter on *Trade Unions*.

The various matters connected with industrial disputes are dealt with by the Industrial Disputes Act, 1947. The main objects of the Act are to secure industrial peace by preventing and settling disputes and to ameliorate the conditions of workmen in industry.

The Act specifies all those cases when a strike or a lock-out shall be illegal and lays down the conditions necessary for the validity of lay-off and retrenchment of workers. It provides for the appointment of various conciliations authorities. The rights and powers of these authorities, the procedure of conciliation for the validity of settlements and awards have also been laid down by the Act. For details, see the chapter on *Industrial Relations*.

The Trade Unions Act, 1926, the Industrial Disputes Act, 1947, and Industrial Employment (Standing Orders) Act, 1946, are the most important pieces of legislation covering employer-employee relations.

UNORGANISED SECTOR

The term 'unorganised labour' is defined as those workers who have not been able to organise themselves to pursue their common interests due to certain constraints like casual nature of employment, ignorance and illiteracy, small and scattered size of establishments etc.

As per the survey carried out by the National Sample Survey Organisation in the year 2004-05, of the total employment of 45.9 crore, around 2.6 crore (less 6 per cent) was in the organised sector and the balance 43.3 crore (nearly 95 per cent) workers in the unorganised sector. Out of 43.3 crore workers in the unorganised sector, 26.8 crore workers (about 62 per cent) were employed in agricultural sector, about 2.6 crore in construction work (about 6 per cent) and remaining in manufacturing and service.

Nearly 95 per cent of the employment in India is in the unorganised sector, more than 60 per cent of it being in the agricultural sector.

In order to take care of the social security and welfare of unorganised workers, two-pronged strategy, *i.e.,* legislative measures, and, implementation of welfare schemes and programmes have been followed so far. The legislative measures include the Minimum Wages Act, 1948, the Workmen's Compensation Act, 1923, the Maternity Benefit Act, 1961, the Bonded Labour System (Abolition) Act, 1970, the Contract Labour (Regulation and Abolition) Act, 1970, the Inter-State Migrant Workmen (Regulation of Employment and Conditions of Service) Act, 1979, the Building and Other Construction Workers (Regulation of Employment and Conditions of Service) Act, 1996, etc. Mention about some of these laws have already been made in the preceding sections/ chapter.

The Government has set up Welfare Funds for providing welfare measures to the beedi, non-coal mine and cine workers. The Funds are used to provide the financial assistance to these workers for education of their children, recreation, medical and health facilities, construction of houses, etc. The Building and Other Construction Workers (Regulation of Employment and Conditions of Service) Act, 1996 also has provision for setting up of welfare Board/Fund by every State Government to provide welfare/social security measures to the construction workers. Some States, like Kerala, have constituted welfare funds for specific categories of workers in the unorganised sector.

BOX 28.4 : LABOUR REGULATIONS AND RIGIDITIES IN THE LABOUR MARKET

Almost all countries have labour laws and regulations to protect workers. These fall into five categories:

- *Establishment and protection of workers' rights, including the right to associate and organise, the right to bargain collectively, and the right to engage in industrial action.*
- *Protection for vulnerable groups, including minimum working age requirements, equality of wages, and employment opportunities and special provisions for women.*
- *Establishment of minimum compensation for work, including minimum wages, minimum nonwage benefits, and overtime pay.*
- *Assurance of decent working conditions, including occupational health and safety provisions and maximum hours of work.*
- *Provision of income security, including social security, job security, severance pay, and public works.*

World Development Report 1995 provides a detailed analysis of labour legislation and its effects and shows that not all labour laws achieve their intended objectives. The Report has suggested that labour laws in developing countries be simplified and focused on basic human rights and safety issues.

In developing countries excessively restrictive labour laws sometimes have the effect of benefiting a group of relatively well-off workers at the cost of limiting the employment of others (sometimes the majority) in the formal sector. In some countries, labour laws have introduced significant rigidities into the labour market, with adverse consequences for production and growth.

An example is India, with 165 pieces of labour legislation (World Bank, 2000, Zegha, 1998). Indian labour laws provide for a wide scope for initiating industrial disputes, long procedures for settlement of industrial disputes, inflexible provisions on change in conditions of service, and provisions enabling government interventions in areas such as layoff, retrenchment, and closures. The proliferation of labour laws is made worse by definitional complexities, making their interpretation even more difficult. There are 11 different ways of defining "wages", and the meaning of "worker", "employee", and "employed person" changes depending on the piece of legislation.

Lack of clarity about the rights and obligations of employers and employees, litigiousness, and delays in settling disputes have consequently become key features in the application of India's labour laws. Most disputes take more than 1 year to settle, and 20 years is not infrequent. This legislative framework has impeded large-scale industrial restructuring, relocation, or exit—and hence entry into the formal sector—and even the relocation of labour within an enterprise and often even in the same city or town.

Courtesy: *World Bank, World Development Report 2002.*

SUMMARY

The nature of labour laws and the effectiveness of their implementation are an important dimension of the business environment.

Labour legislation should be based on the principle of social justice, social equity, international uniformity and national economy.

V.V. Giri has classified the labour legislation in India under the following broad heads.

1. ***Laws Relating to Weaker Sections:*** These laws cover conditions of employment of children and women.
2. ***Laws Relating to Specific Industries:*** These laws deal with conditions of employment in factories and workshops; mines and minerals; plantations; shops and commercial establishments; and transport, namely railways, seaman, ports and docks, inland water transport; motor transport and air transport. There are also laws pertaining to contract labour, construction workers, and working journalists.

3. ***Laws Relating to Specific Matters:*** This category of legislations include those dealing with payment of wages and minimum wages, indebtedness, bonus, bonded labour, and social security covering matters like workmen's compensation, maternity benefits, retrenchment benefits, provident fund and bonus schemes.

4. ***Laws Relating to Trade Unions and Industrial Relations:*** The Trade Unions Act lays down the procedure for the registration of trade unions and defines their rights and responsibilities. The various matters connected with industrial disputes are dealt with by the Industrial Disputes Act, 1947.

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2. R.K. Das, *Principles and Problems of Indian Labour Legislation*, p. 1 (cited by Kuchhal, *ibid.*, p. 445.)
3. V.V. Giri, *Labour Problems in Indian Industry*, Mumbai: Asia Publishing House, 1972, p. 137.

ANNEXURE 28.1

Second National Commission on Labour on Rationalisation of Labour Laws

According to the Second National Commission on Labour, existing set of labour laws should be broadly grouped into four or five groups of laws pertaining to: *(i)* industrial relations, *(ii)* wages, *(iii)* social security, *(iv)* safety and *(v)* welfare and working conditions and so on. While the ultimate object must be to incorporate all such provisions in a comprehensive code, such a codification may have to be done in stages.

The Commission is of the view that the coverage as well as the definition of the term 'worker' should be the same in all groups of laws, subject to the stipulation that social security benefits must be available to all employees including administrative, managerial, supervisory and others excluded from the category of workmen and others not treated as workmen or excluded from the category of workmen.

The Commission observed that it is necessary to provide a minimum level of protection to managerial and other (excluded) employees too, against unfair dismissals or removals. This has to be through adjudication by labour court or Labour Relations Commission or arbitration.

Central laws relating to the subject of Labour Relations are currently the Industrial Disputes Act 1947, the Trade Unions Act 1926 and the Industrial Employment (Standing Orders) Act, 1946. Mention must also be made of the Sales Promotion Employees (Conditions of Service) Act 1976 and other specific Acts governing industrial relations in particular trades or employments. There are state level legislations too on the subject. We recommend that the provisions of all these laws be judiciously consolidated into a single law called the Labour Management Relations Law or the Law on Labour Management Relations. However, we would carve out a section of those workers who are employed in establishments with an employment size of 19 and below, for a different kind of dispensation. In view of our approach, we recommend the repeal of the Sales Promotion Employees (Conditions of Service) Act, 1976 and other specific Acts governing industrial relations in particular trades or employments and also specific laws governing wage fixation in particular trades or employments, in the light of what we recommend later in respect of the law on wages. The general law on industrial relations and wages will apply to them.

The Commission recommend the enactment of a special law for small-scale units. We have come to the conclusion that the reasonable threshold limit will be 19 workers. Any establishment with workers above that number cannot be regarded as small. The composite law suggested by us for small enterprises has provisions for registration of establishments, (provisions pertaining to) securing safety, health and welfare of the workers, hours of work, leave, payment of wages, payment of bonus, compensation in case of lay-off, retrenchment and closure, resolution of individual and collective disputes of workers, etc. The law suggested by us also has provisions pertaining to social security. We are of the view that a composite law will not only protect the interests of the workers in these enterprises but will make it easier for the small enterprises to comply with the same.

The Commission adopted certain approaches in drafting the Law on Labour Management Relations.

Firstly, the Commission would prefer the gender neutral expression 'worker' instead of the currently used word 'workman' that we find in the Industrial Disputes Act and some other Acts.

Secondly, the law will apply uniformly to all such establishments.

Thirdly, we recognise that today the extent of unionisation is low and even this low level is being eroded, and that it is time that this trend was reversed and collective negotiations encouraged. Where agreements and understanding between the two parties is not possible, there, recourse to the assistance of a third party should as far as possible be through arbitration or where adjudication is the preferred mode, through labour courts and labour relations commissions of the type we propose later in this regard, and not Governmental intervention. A settlement entered into with a recognised negotiating agent must be binding on all workers.

Fourthly, we consider that provisions must be made in the law for determining negotiating agents, particularly on behalf of workers.

Fifthly, the law must provide for authorities to identify the negotiating agent, to adjudicate disputes and so on, and these must be provided in the shape of labour courts and labour relations commissions at the state, central and national levels.

Sixthly, the Commission is of the view that changes in the labour laws be accompanied by a well-defined social security package that will benefit all workers, be they in the 'organised' or 'unorganised' sector and should also cover those in the administrative, managerial and other categories which have been excluded from the purview of the term worker.

One of the most important steps that one needs to take in rationalising and simplifying the existing labour laws is in the area of simple common definitions of terms that are in constant use; such terms include 'worker', 'wages' and 'establishment'. By making the law applicable to establishments employing 20 or more workers, irrespective of the nature of the activity in which the establishment is engaged, we have avoided the need to define 'industry'. After examining all aspects of the question, we have come to the conclusion that the persons engaged in domestic service are better covered under the proposed type of umbrella legislation, particularly in regard to wages, hours of work, working conditions, safety and social security.

Likewise, the Commission defined establishment as a place or places where some activity is carried on with the help and cooperation of workers.

It is desirable to define two terms, 'wages' and 'remuneration', the former to include only basic wages and dearness allowance and no other for the purpose of contribution to social security and for calculations of bonus and gratuity and all other payments including other allowances as well as overtime payment together with wages as defined above will be 'remuneration'.

The Commission also discussed the question whether any distinction should be made between 'strike' and 'work stoppage' and came to the conclusion that the existing definition of 'strike' in the Industrial Disputes Act 1947 may stand, "Go slow" and "work to rule" are forms of action which must be regarded as misconduct. Standing Orders and Provisions relating to unfair labour practices already include them and provide for action both in the case of "go slow" and "work to rule".

Term 'retrenchment' should be defined precisely to cover only termination of employment arising out of reduction of surplus workers in an establishment, such surplus having arisen out of one or more of several reasons.

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Chapter 29

LABOUR WELFARE AND SOCIAL SECURITY

Structure

Labour Welfare
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Summary
References

LABOUR WELFARE

The National Commission on Labour observes that the concept of "welfare" is necessarily dynamic, bearing a different interpretation from country to country and from time to time, and even in the same country, according to its value system, social institutions, degree of industrialisation and general level of social and economic development.[1] The Directive Principles of State Policy in our Constitution refer generally to the promotion of the welfare of the people. In its specific application to the working class, securing just and humane conditions of work has been highlighted, but what these actually imply cannot be specified in rigid terms for all times.

The ILO has defined broadly the scope of labour welfare.

In its Resolution of 1947, the ILO defined Labour Welfare as "such services, facilities and amenities as adequate canteens, rest and recreation facilities, arrangements for travel to and from their houses, and such other services amenities and facilities as contribute to improvements in the conditions under workers are employed".[2]

The Governing Body of the ILO (Geneva, May-June, 1953) considered the subject and urged that it was essential to define precisely and closely the scope of labour welfare in view of the fact that it was a very wide subject, covered a very broad field and was not limited to any one industry or occupation. The ILO Recommendation No. 102 concerning the welfare for workers refers to:

- Facilities for food and meals in or near the undertaking;
- Rest and recreation facilities provided by the undertaking (excluding holiday facilities); and
- Transportation facilities to and from the place of work where ordinary public transport is inadequate or impractivable.[3]

The study team appointed by the Government of India in 1959 to examine the labour welfare activities then existing divided the entire range of these activities into three groups, *viz.*,

Labour welfare encompasses measures to ensure certain standards of basic comforts and working conditions.

1. Welfare within the precincts of an establishment; medical aid; creches, canteens, supply of drinking water;
2. Welfare outside the establishment: provision for indoor and outdoor recreation, housing, adult education, visual instructions; and
3. Social security.

The Committee of Experts on Welfare Facilities for Industrial Workers convened by the ILO in 1963 divided welfare services into two groups – *(a)* within the precincts of the establishment and *(b)* outside the establishment – but the total content of the activities was the same as that included in the three groups mentioned above.[4]

The classification adopted by the ILO is given below.[5]

Welfare and Amenities within the Establishment

Minimum standards have been set by legislation in respect of working conditions.

1. Latrines and urinals
2. Washing and bathing facilities
3. Creches
4. Rest shelters and canteens
5. Arrangements for drinking water
6. Arrangements for prevention of fatigue
7. Health service including occupational safety

8. Administrative arrangements within a plant to look after welfare
9. Uniforms and protective clothing
10. Shift allowance.

It is the employer's responsibility to provide facilities within the precincts of an establishment, as they form a part of working conditions. For many components of such welfare, legislation in the country has set certain minimum standards. Improvements upon them have been left to the employers.

The facilities within the precincts of the establishment are regulated by the Factories Act, 1948; the Plantation Labour Act, 1951; and the Mines Act, 1952.

The Factories Act makes it obligatory on the employer to provide:

1. Cool and clean drinking water; latrines and urinals; and washing and bathing facilities.
2. One first-aid box for every 150 employees.
3. Canteen in establishments which employ more than 250 workers.
4. Rest shelters or rest rooms and a suitable lunch room in all establishments employing 150 workers or more.
5. Creches in factory establishments employing more than 50 women.

The Factories Act also requires the factories employing 500 or more workers to appoint a Labour Welfare Officer to look after the welfare of the workers.

State Governments have been empowered to frame rules to prescribe standards and to grant exemptions, wherever considered necessary. They have laid down elaborate standards for all welfare amenities, keeping in view mainly the requirements of all workers.

The Mines Act, 1952, has laid down provisions for drinking water, conservancy, first aid (including a first-aid room in every mine, wherein more than 150 persons are employed) and creche (in every mine employing women). The Mines Rules provide that:

1. An ambulance room shall have to be maintained under the charge of a qualified medical practitioner assisted by qualified staff on every mine employing 500 or more persons;
2. A shelter shall be constructed for taking food and rest at every mine employing 150 or more persons on any one day of the previous calendar year, as also near loading places, workshops or open cast workings in mines employing 25 or more persons; and
3. A canteen is to be provided in every mine employing 250 or more persons.

Drinking water, conservancy, medical facilities, canteen, creche, recreational facilities, and provision of umbrellas, blankets and raincoats have been made statutory by the Plantations Labour Act, 1951. A canteen has to be set up on plantations with 150 workers or more and a creche where 50 or more women are employed.

Certain welfare facilities are provided to workers in ports and docks under the Dock Workers (Safety, Health and Welfare) Scheme, 1961, which applies to all major ports and docks in the country. Housing, education and recreation facilities are provided for port workers by the Port Trusts with the Port Trust Employees' Welfare Funds. All the Dock Labour Boards have constituted Labour Welfare Funds to provide amenities, including medical and recreation facilities, for dock workers. Welfare facilities for workers employed in the workshop located in port areas are provided under the Factories Act, 1948.

The Motor Transport Workers Act, 1961 provides for the welfare of motor transport workers and for the regulation of their working conditions. The various schemes in operation include canteens, restrooms, uniform hours of work and leave. The Act is administered by State Governments which have framed rules for its enforcement.

The bidi and cigar workers under the Bidi and Cigar Workers (Conditions of Employment) Act, 1966, and contract labour under the Contract Labour (Regulation and Abolition) Act, 1970, have also been provided with many of the facilities mentioned in the foregoing paragraphs.

Welfare Outside the Establishment

1. Maternity benefits
2. Social insurance measures, including gratuity, pension, provident fund and rehabilitation
3. Benevolent funds
4. Medical facilities, including programmes for physical fitness and efficiency, family planning and child welfare
5. Education facilities including adult education
6. Housing facilities
7. Recreation facilities, including sports, cultural activities, library and reading room
8. Holiday homes and leave travel facilities
9. Workers' cooperatives, including consumers' cooperative stores, fair price shops and cooperative thrift and credit societies
10. Vocational training for dependants of workers
11. Other programmes for the welfare of women, youth and children
12. Transport to and from the place of work

Welfare and amenities within the establishment are essential conditions and those outside the establishment are supplementary ones for improving labour welfare.

Welfare amenities outside the precincts of the establishment, such as medical, educational, recreational, housing and other facilities, are non-statutory in many cases. However, in plantations, the provisions of some of them is obligatory on the employer.

Large establishments now pay attention to the above facilities. A number of large industrial enterprises also provide transportation facilities to their employees.

The Government have been trying to see that all industrial establishments employing more than 300 workers set up consumers' cooperative stores and fair shops for their workers. A large number of industrial establishments have set up their own consumers' cooperative stores and fair price shops.

The importance of workers' education has been duly recognised by the Government. The Central Board for Workers' Education (CBWE), set up in 1958, is a tripartite body, consisting of representatives of Central and State Governments organisations of employers and workers and educationists. It is a registered society for the implementation of workers' education schemes with the following objectives.

1. To equip all sections of workers for their intelligent participation in the socio-economic development of the nation.
2. To promote among workers a greater understanding of the problems of their socio-economic environment, their responsibilities towards family and their rights and obligations as citizens, as workers in industry and as members and officials of their trade unions.

3. To develop leadership from among the rank and file of workers themselves.
4. To create strong, united and more responsible trade unions through enlightened members and better trained officials.
5. To strengthen democratic processes and traditions in the trade union movement.
6. To enable trade unions themselves to take over ultimately the functions of workers' education.

The scheme of workers' education needs improvement and strengthening.

The CBWE, a tripartite society registered under the Societies Registration Act, 1860, implements the workers' education programmes at national, regional and unit/village levels. The focus of the education programmes is to create awareness among all sections of the working class about their rights and obligations for their effective participation in the socio-economic development of the country. The Board undertakes training programmes which cover workers from organised, unorganised, rural and informal sectors. Supervisory and managerial cadres are also covered through joint education programmes.

With headquarters at Nagpur, the Board has a network of regional and sub-regional centres spread throughout the country. It also has four zonal directorates at Delhi, Calcutta, Mumbai and Chennai monitor the activities of the regional centres. The Indian Institute of Workers Education at Mumbai was set up by the Board to conduct national level training programmes.

The V.V. Giri National Labour Institute (earlier known as National Labour Institute), an autonomous body under the Ministry of Labour, Government of India, is engaged in research pertaining to labour and training of labour administrators, trade unions, public sector managers and other government functionaries concerned with labour. The Institute now pays attention on child labour also.

The National Safety Council was set up in March 1966. Its main function is to conduct seminars, organise film shows in factories, and distribute posters on the subject of safety.

Various schemes for the grant of National Safety Awards to factories, covered by the Factories Act, 1948, and ports have been instituted for good safety records. Each scheme consists of cash prizes and certificates of merit.

SOCIAL SECURITY

Modern Welfare States are expected to take care of the citizens from the "cradle to the grave". Resource constraints, however, do not permit many of them to completely accomplish this task. They, therefore, endeavour to look after the welfare of the individuals according to their capability. The Constitution of India, for instance, lays down that the State shall, within the limits of its economic capacity and development, make effective provisions for securing public assistance in the event of unemployment, old age, sickness, and disablement.

As the International Labour Organisation (ILO) states, social security envisages that the members of a community shall be protected by collective action against social risks causing undue hardship and privation to individuals whose private resources can seldom be adequate to meet them. It covers, through an appropriate organisation, certain risks to which a person is exposed. These risks are such that an individual of small means cannot effectively provide for them by his own ability or foresight alone or even private combination with his colleagues.[6]

In the words of V.V. Giri, "social security measures have a twofold significance for every developing country. They constitute an important step towards the goal of a Welfare State, by

improving living and working conditions and affording the people protection against the uncertainties of the future. These measures are also important for every industrialisation plan, for not only do they enable workers to become more efficient but they also reduce the wastage arising from industrial disputes. The man-days lost on account of sickness and disability also constitute a heavy drain on the slender resources of the worker and on the industrial output of the country. Lack of social security impedes production and prevents the formation of a stable and efficient labour force. Social security is, therefore, not a burden, but a wise investment in the long run."[7]

Giri observes that "in modern times, the active participation of the State in social security has resulted in two distinct methods of solving the problem. The first method is that of social assistance, where the State or the local bodies step in to ameliorate the distress caused by these contingencies to the population in general. In this method, there are generally no contributory conditions. In concrete terms, social assistance includes non-contributory benefits towards the maintenance of children, mothers, invalids, the aged, the disabled and others. It also includes unemployment assistance. Social assistance can, therefore, be defined as a device for providing benefits, like exemption from taxation or general revenues, to persons of small means in amounts sufficient to meet a minimum standard of needs. The second method is that of social insurance, to which the persons concerned, their employers and the State, make contributions and mainly out of these contributions, benefits necessary to prevent want during unemployment, sickness, old age and other contingencies are given as a right, subject to certain qualifying conditions. In other words, social insurance can be defined as a device to provide benefits as of right for persons of small earnings, in amounts which combine the contributive efforts of the insured with subsidies from the employer and the State.

"The social insurance approach has grown from the system of friendly societies, which developed in Western countries and particularly in the United Kingdom during the last three centuries. The social assistance approach is the outcome of the Poor Laws, which also developed in these countries at the same time. In fact, in the United Kingdom, where social security is available to the entire population from the cradle to the grave, the main approach is that of social insurance, and persons are entitled to benefits by virtue of compulsory contributions. Those who are qualified or can no longer get such benefits, are looked after by measures of social assistance.

"Present-day developments show that social insurance and social assistance are moving closer to one another. In fact, they even meet and combine as, *for example*, in New Zealand and Denmark, where it is difficult to say whether social insurance or social assistance predominates. Such countries have adopted a national system of social securities.

"To be equitable, measures of social assistance should provide for the population as a whole. The extent to which this can be done will depend on the level of national income; and in a developing country, this cannot be adequate. Measures of social insurance, on the other hand, depend very much more on the capacity of the individual industry. As such, it can be introduced in phases; first in more prosperous industries and later in less prosperous ones. In a country like India, where it is impossible at present to provide social security for the whole population, the main approach has to be that of insurance".[8]

Legislative Enactments

There are some important legislative enactments in India for the provision of social security. These enactments may be broadly classified into two categories:

- Acts that provide security in cases of employment injury, maternity and sickness.
- Acts that cover the risks of old age and unemployment.

According to the 2nd NCL, social security should be considered as a fundamental human right and the commission recommend a system in which the State bears the responsibility for providing and ensuring an elementary or basic level of security, and leaves room for partly or wholly contributory schemes. This will mean that the responsibility to provide a floor will be primarily that of the State, and it will be left to individual citizens to acquire higher levels of security through assumption of responsibility and contributory participation.

The following three Acts come under the first category:

1. The Workmen's Compensation Act, 1923.
2. The Maternity Benefits Act, 1961.
3. The Employees' State Insurance Act, 1948.

The Acts that come under the second category are:

1. The Employees' Provident Fund and Miscellaneous Provisions Act, 1952.
2. The Coal Mines Provident Fund, Family Pension and Bonus Act, 1948.
3. The Payment of Gratuity Act, 1972.
4. The Industrial Disputes Act, 1947.

Workmen's Compensation

The 2nd NCL has recommended that the Workmen's Compensation Act should be converted from an employers' liability scheme to a social insurance scheme, its coverage should be progressively extended to more employments and classes of employees, and the restrictive clauses in Schedule II of the Act should be removed.

The Workmen's Compensation Act, 1923, amended several times, applies to workmen who are employed in factories, mines, plantations, transport and construction work, railways and certain hazardous occupations. The Central and State Governments are empowered to extend the scope of the Act to any class of persons whose occupations are considered hazardous. Workers covered by the Employees' State Insurance Scheme are not entitled to benefits under the Workmen's Compensation Act.

The Act provides for the payment of compensation by employers to workmen and their dependents for personal injury caused by accidents arising out of and in the course of employment and for death or disablement as a result of contracting certain occupational diseases. The amount of compensation depends on the nature of the injury and the average monthly wages and age of the workmen. Compensation for death is payable to the dependents of workmen. The minimum and maximum rates of compensation payable for death and disablement have been fixed and is subject to revision from time to time. The Act is administered by State Governments through Commissioners for Workmen's Compensation. The Commissioners are entrusted with the settling of disputed claims, the disposal of claims for injuries resulting in death; and the revision of the periodic payments.

Maternity Benefits

The Maternity Benefit Act, 1961, enacted with a view to achieving uniformity in matters relating to maternity protection, applies to all factories, mines and plantations, except to those to whom the Employees' State Insurance Act applies.

The 2nd NCL has recommended that so far as the organised sector is concerned, the existing provisions for maternity benefit should be extended so as to be applicable to all women workers.

The Maternity Benefit Acts provide for the payment of cash maternity benefit for certain periods before and after confinement, and grant of leave and other facilities to women employees, on conditions prescribed in these Acts. The qualifying period of service shall be eighty days during a span of 12 months. The benefit is payable for a maximum period of 12 weeks. Apart from the Central Maternity Benefit Act, 1961, which permits the payment of a medical bonus, some State Acts include additional benefits, such as free medical aid, maternity bonus, provision of creches and additional rest intervals. In order to safeguard the interests of pregnant women workers, both the Central and State Acts provide that such women shall not be dismissed; nor can a woman worker be discharged during the period of maternity leave.

The administration of the Acts in all the States is the responsibility of factory inspectorates. Whereas in the Coal Mines, the Coal Mines Welfare Commissioner is in charge of it, the Director General of Mines Safety is in charge of mines other than coal.

Employees' State Insurance Scheme

The Employees' State Insurance Act, 1948, applies in the first instance to all non-seasonal factories run with power and employing 10 or more persons and factories run without power and employing 20 or more persons. Under the enabling provisions contained in the Act, the Act is being extended by the State governments to new classes of establishments, namely shops, hotels, restaurants, cinemas, including preview theatres, road motor transport undertakings, and newspaper establishments employing 20 or more persons.

The ESI scheme applies only to persons whose aggregate remuneration does not exceed ₹ 6,500 per month.

An insured person, entitled to benefits under this scheme, is not eligible to claim similar benefits under the Workmen's Compensation Act and the State Maternity Benefit Act.

The benefits provided by the ESI scheme are:

1. Free medical treatment (including specialised services such as cardiological and pathological services) in cases of sickness and employment injury.
2. Free maternity care for women employees. The maternity benefit is admissible for 12 weeks, of which not more than 6 weeks may precede the expected date of confinement.
3. In the case of employment injury disabling the employee for more than seven days, a cash disablement benefit, which is roughly half the employee's wages for the duration of the disability, is allowed.
4. In the case of total permanent disablement, a life pension equal to about half the employee's wages, and in the case of partial but permanent disablement, a proportion of the amount that may fall due as life pension.
5. If the injury proves fatal, the half-wage benefit takes the form of a pension for the family or dependants of the deceased.

The scheme is financed out of a fund built from contributions collected from employees and employers and grants from the Central and State Governments.

The Act is administered by a Corporation in which employers, employees, the medical profession, the Central and State Governments and Parliament are represented. A Medical Benefit Council functions in an advisory capacity. A standing committee of the Corporation is responsible for general supervision, but executive responsibility at headquarters lies with the Director-General.

To secure cooperation of all levels, regional boards and local committees have been set up, on which are representatives of labour, employers, State Governments and the Corporation. In order to settle disputes speedily, the Act provides for the setting up of Employees' Insurance Courts by State Governments.

Provident Fund

While provident fund schemes were common in some government employments and with enlightened employers, the first legislative measure to cover industrial workers was the Coal Mines Provident Fund and Bonus Schemes Act, 1948. Though in the initial years the Act ran into opposition, both from employers and workers, after some time the misgivings on both sides were dispelled, and the Act got off to a good start.

The 2nd NCL has recommended that the PF Act be made applicable to all classes of establishments, subject to necessary exceptions and that the employment threshold should be brought down to 10 immediately, to 5 during the next 3-5 years, and to one within a short time-frame thereafter.

Encouraged by the success of the Coal Mines Provident Fund Scheme and faced with the persistent demand made to the Central Government for the extension of similar benefits to workers employed in other industries, the Employees' Provident Fund and Miscellaneous Provisions Act was passed in 1952. (Since 1971, it is known as the Provident Funds and Family Pension Fund Act).

The Act provides insurance against old age, retirement, discharge, retrenchment or death of the workers. It is against these risks that the schemes guarantee the necessary protection to workers and their dependants. The Act and the scheme extend to the whole of India. It applies to factories and establishments falling under any notified industry employing 20 or more persons.

To become eligible for membership of the Fund, a worker must have completed one year's continuous service, or worked for 240 days during a period of 12 months.

The employees have to contribute at the rate 6¼ per cent of the basic wage, dearness allowance and retaining allowances, if any, including the cash value of food concessions given to them. The employers too, have to contribute at the same rate. Workers, if they so desire, can contribute more, subject to a maximum of 8¼ per cent. With effect from January 1, 1963, the statutory rate of provident fund contribution has been raised to 8 per cent in respect of certain industries/classes of establishments employing 50 or more persons in a few specified industries.

The scheme is administered by a Central Board of Trustees, consisting of the representatives of the Central and State Governments, employers and workers. There are a number of regional offices, each under a regional commissioner. There are also regional committees, whose function is to advise the Central Board.

Lay-off and Retrenchment Compensation

The Industrial Disputes Act of 1947 was amended several times, provide for the payment of compensation in the event of lay-off, retrenchment, closure and transfer of undertakings.

Workers, employed in any factory, mine or plantation having an average daily employment of 50 or more where the work done is not of an intermittent or seasonal character, are entitled to compensation for lay-off, provided that they have put in the prescribed qualifying service in the preceding twelve calendar months.

A workman laid off is entitled to get compensation according to the following rules:

1. A workman laid off will be paid compensation by the employer for all the days during which he is so laid off except for such weekly holidays as may intervene.
2. The rate of compensation shall be equal to fifty per cent of the total basic wages and dearness allowance that would have been payable to him had he not been so laid off.
3. A workman laid off shall be entitled to compensation only when he is not a badli workman or a casual workman. Badli workman means a workman who is employed in an industrial establishment in the place of another workman whose name is borne on the muster rolls of the establishment. A badli workman shall cease to be regarded as such on the completion of one year of continuous service in the establishment.

Unlike the lay-off provision, the benefits of retrenchment compensation are applicable to all the workmen covered by the Act. No workman, who has been in continuous service in any industry for not less than one year, can be retrenched by an employer until one month's notice (or wages in lieu thereof) has been given to him in writing, indicating the reasons for the retrenchment. If the establishment employs not less than one hundred workers, the notice period shall be three months or wages for the period of notice. Retrenchment compensation is payable at the rate of 15 days' average pay for every completed year of service or any part thereof in

excess of six months. In the event of bonafide closures or transfer of undertakings, compensation shall be payable to workers who loose employment in consequence of such closure or transfer. In the event of a change of ownership, such workers as have been re-employed on the terms and conditions which are not less favourable to them shall not be entitled to compensation.

Gratuity Scheme

The Payment of Gratuity Act, 1972 is applicable to factories, mines, oil fields, plantations, ports, railways, motor transport undertakings, companies, shops and other establishments. The Act provides for payment of gratuity at the rate of 15 days' wages for each completed year of service subject to a maximum of ₹ 3,50,000. In the case of seasonal establishment, gratuity is payable at the rate of seven days' wages for each season. The Act does not affect the right of an employee to receive better terms of gratuity under any award or agreement or contract with the employer.

In case of misconduct of the employee, which involves financial loss to the management, an amount equal to the loss directly suffered by the employer by reason of such misconduct is liable to be forfeited from the gratuity due to the employee. The Act also provides for the punishment of the employer who fails to pay gratuity to an employee. Thus, gratuity has now become a statutory service condition, and its quantum has no bearing on the size of the profit of the organisation or similar extraneous consideration.

The 2nd NCL has recommended that the Payment of Gratuity Act may be integrated with the EPF Act and converted into a social insurance scheme. This will ensure automatic extension of the Payment of Gratuity Act to all establishments to which the EPF Act applies.

Employees' Pension Scheme

This scheme was introduced for the industrial workers with effect from 16 November, 1995. Under the Scheme, pension at the rate of 50 per cent pay is payable to the employees on retirement/superannuation on completion of 33 years' contributory service. A minimum 10 years' service is required for entitlement to pension. Depending upon the salary and service of the employee at the time of death, the scheme also provides for grant of family pension ranging from ₹ 450 per month to ₹ 2,500 per month. In addition, children pension at the rate of 25 per cent of widow pension subject to a minimum of ₹ 115 per child is also payable up to two children.

The schemes are financed by diverting a portion of the employers' and employees' contribution to the Employees' Provident Funds with an additional contribution by the Central Government.

SUMMARY

According to the ILO, *labour welfare* refers to "such services, facilities and amenities as adequate canteens, rest and recreation facilities, arrangements for travel to and from their houses, and such other services amenities and facilities as contribute to improvements in the conditions under workers are employed".

The labour welfare services may be divided into two groups – *(a)* within the precincts of the establishment and *(b)* outside the establishment.

Welfare and amenities within the establishment include latrines, urinals and washing and bathing facilities; crèches; rest shelters and canteens; arrangements for drinking water; arrangements for prevention of fatigue; health service including occupational safety; administrative arrangements within a plant to look after welfare; uniforms and protective clothing; and shift allowance.

It is the employer's responsibility to provide facilities within the precincts of an establishment, as they form a part of working conditions. For many components of such welfare, legislation in the country has set certain minimum standards. Improvements upon them have been left to the employers.

The facilities within the precincts of the establishment are regulated by the Factories Act, 1948; the Plantation Labour Act, 1951; and the Mines Act, 1952.

Welfare outside the establishment include maternity benefits; social insurance measure; benevolent funds; medical facilities; education facilities including adult education; housing facilities; recreation facilities, including sports, cultural activities, library and reading room; holiday homes and leave travel facilities; workers' cooperatives; vocational training for dependants of workers; other programmes for the welfare of women, youth and children; transport to and from the place of work.

Welfare amenities outside the precincts of the establishment, such as medical, educational, recreational, housing and other facilities, are non-statutory in many cases. However, in plantations, the provisions of some of them is obligatory on the employer.

Social security is also a component of labour welfare. Social security envisages that the members of a community shall be protected by collective action against social risks causing undue hardship and privation to individuals whose private resources can seldom be adequate to meet them. The Constitution of India lays down that the State shall, within the limits of its economic capacity and development, make effective provisions for securing public assistance in the event of unemployment, old age, sickness, and disablement.

The legislative enactments in India for the provision of social security may be broadly classified into two categories: (1) Acts that provide security in cases of employment injury, maternity and sickness. (2) Acts that cover the risks of old age and unemployment.

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Chapter 30

INDUSTRIAL RELATIONS

Structure

Meaning

Industrial Disputes

Causes of Industrial Disputes

Industrial Disputes in India

Prevention of Industrial Disputes

Settlement of Disputes

Summary

References

Annexure 30.1: Schedules to the Industrial Disputes Act, 1947

Industrial disputes is a serious problem that many democratic societies face. At a point of time, an industrial relations problem may be confined to one firm, an industry, a sector, a locality/region or the whole nation. Industrial disputes sometimes have a cascading effect. Labour laws, policies and attitudes of political parties, characteristics of labour and trade unionists, policies and attitudes of industrialists and management, government policies and approaches, behaviour of general public etc. all contribute in varying degrees to the industrial relations environment.

The important Central laws relating to the subject of Labour Relations are the Industrial Disputes Act 1947, the Trade Unions Act 1926 and the Industrial Employment (Standing Orders) Act, 1946. There are state level legislations too on the subject. The 2nd NCL has recommended that the provisions of all these laws be judiciously consolidated into a single law called the Labour Management Relations Law or the Law on Labour Management Relations.

MEANING

The term industrial relations is so broad that it is not amenable to a precise definition. We may, however, state that *the core of industrial relations is the various aspects of interactions between employer and employees, employees and employees, employers and employers, and between the state, employers and employees*. Professor Richardson observes: "How people get on together at their work, what difficulties arise between them, how their relations, including wages and working conditions, are regulated, and what organisations are set up for the protection of different interests – these are some of the main problems of industrial relations and indicate the wide scope of the subject."[1] Industrial relations are indeed "an integral aspect of social relations arising out of employer-employee interaction in modern industries, which are regulated by the State in varying degrees, in conjuncture with organised social forces and influenced by the existing institutions. This involves a study of the State, the legal system, and the workers' and employers' organisations at the institutional level; and of patterns of industrial organisation (including management), capital structure (including technology), compensation of the labour force, and a study of market forces – all at the economic level."[2]

Professor J.T. Dunlop of Harvard University views industrial relations in a very broad perspective.[3] According to him, industrial relations should not be taken as one which denotes union-management relations operating within the spectrum of industrial peace or conflict. On the other hand, it should be taken as one which is concerned with the larger subject of an industrial relations system which defines the role, status and the conduct of different groups of people who work together for productive purposes in an economy characterised by its peculiar social and economic conditions prevailing in a given technological, market and power context, giving rise to the creation of a body of rules to govern the interactions of the different groups of people involved therein. To quote him: "An industrial relations system at any one time in development is regarded as comprised of certain actors, certain contents, an ideology which binds the industrial relations system together; and a body of rules created to govern the actors at the workplace and work community."[4]

INDUSTRIAL DISPUTES

Meaning

According to the Industrial Disputes Act, 1947, the term "industrial dispute" means any dispute or difference between employers and employers, or between employers and workmen, or between workmen and workmen, which is connected with the employment or non-employment, or the terms of employment or with the conditions of labour, of any person."

In the literature on industrial relations, the words dispute and conflict are used more or less as synonyms. However, there is a difference between unrest and dispute. Unrest is "psychological in nature and the disputes are concrete evidence of unrest. Disputes constitute open manifestations

of the feeling of dissatisfaction, disputes are the overt expression."[5] Thus, as Dr. Nagaraju observes, industrial unrest "refers to the discontent or dissatisfaction lurking in the disturbed minds of labourers, about certain lapses at the workplace or about their wages or security of employment, etc. Labourers are always hopeful that their causes of discontent or unrest can be eliminated by their collective strength. Hence, they form their own organisation and resort to certain measures with which they try to gain their ends. Since industrial unrest involves questions of right or wrong and also affects every section of society, it thrusts itself upon the attention of the community and becomes a social problem. That is the reason why in all industrial conflicts, the public is viewed as an important factor."[6]

CAUSES OF INDUSTRIAL DISPUTES

There are a number of causes for industrial dispute. A dispute may be caused by any one or more of these many factors. Some of these factors are so intertwined that sometimes it is not possible to segregate and categorise them definitely. The common causes have been adumbrated below.

Conflict of Interests

Industrial disputes arise mostly from the conflicts of interests of employees and employers.

Needless to say, all disputes emerge from one or other type of conflict of interest. Though the employer and employees are integral parts of the same organisation, many a time the goals or strategies of each party are guided by its own vested interests, the interests of one affecting those of the other. As. Nagaraju points out,[7] though there is a large area in which the interests of employers and employees are the same, there are at least three areas in which conflict is certain to occur.

First, there is the conflict of interests over the division of the total product of the industry. For instance, there are a number of instances of industrial disputes caused by the labour's demand for higher bonus on the ground that the enterprise has been making substantial profits. This is one instance of labour and capital coming into conflict on the issue of sharing what the enterprise mops up from the market.

Second, as Srivastava points out, there is the conflict between the humanitarian rights of the workers and the property rights of the employers.[8] Labour wants to have a healthy and pleasant working environment, including good behaviour of the supervisors. But if the employer, in his eagerness to maximise profits, does not care for the human factor, a conflict of interest is bound to arise.

Third, as Butler observes, there is a continuing conflict between the efficiency aspirations of the management and the security aspirations of the workers.[9] For instance, where rationalisation or automation leads to retrenchment of labour, it is likely to cause a dispute.

Economic Causes

In the developing countries, where the monetary rewards for work are meagre, economic causes are the most important source of industrial disputes. We have already hinted at a few of the economic causes under the "Conflict of Interests" dealt with above. We may now more specifically state the important economic causes of industrial disputes.

Wages: The demand for higher wages is one of the most important sources of industrial conflict. An examination of the causes of industrial disputes in India shows that in most of the years, in about one-third of the total number of disputes, the main issue was wages and allowances. The common reasons for a demand for higher wages and allowances are:

1. Workers may feel that their wages do not correspond to their output or the work they do, including the risks involved in the nature of their work.
2. Existing wages are insufficient to provide a reasonable standard of living.
3. Wages and allowances have not increased sufficiently to offset the increase in the cost of living.
4. Wages and allowances may be lower than those of the workers in other comparable enterprises or industries.
5. Differences of income between industrial workers and the property-owning class and the differences in the distribution of wealth.
6. The feeling that the enterprise has the capacity to pay higher wages (even when the wages are comparatively better).

The most common factors behind industrial disputes are monetary, job security, working conditions and labour welfare.

Bonus: Another important issue on which disputes crop up is bonus. Despite the Payment of Bonus Act, disputes over the rate of bonus, etc. have been common. Bonus has been the cause of a significant number of industrial disputes in India.

Economic Insecurity: Sometimes, industrial disputes crop up following the demand of labour for economic security. The most important economic security for the worker is his job. It is, then, natural that labour should try its best to protect the job. It is the feeling of insecurity that leads labour into a strike against retrenchment and dismissals and for a permanent status for temporary workers. Particularly in countries where there is no social safety net, like unemployment insurance, the fear of job loss creates unrest. Industrial disputes are also caused by a demand for social security benefits.

Working Conditions and Labour Welfare

Workers have come to believe that they have a right to good working conditions. Working conditions include the length of the working day, the interval and frequency of leisure, physical work environment, including safety measures.

As stated in a previous chapter, the term labour welfare refers to such services, facilities and amenities, and adequate canteen, rest and recreation facilities, arrangements for travel to and from work and for the accommodation of workers employed at a distance from their houses, and such other services such as amenities and facilities that contribute to improvements in the conditions under which workers are employed.

Personnel Factors

The role of personnel management in preventing dispute is not adequately appreciated.

Poor personnel administration may also cause industrial disputes. In the absence of effective personnel management, grievances and unrest, which can be solved at the incipient stage, may spark off a dispute. V.V. Giri observes: "The services of personnel officers are called for only when a disputes arises, and their role prior to that is lost sight of. While they are useful in solving disputes, they would be far more valuable in preventing the occurrence of a dispute, if their services are properly utilised. By regularly keeping themselves in touch with labour and interpreting to them the policies of the management and also apprising the employers of the possible reactions of labour to their various schemes, personnel officers would be able to restrict, to a great extent, the nature and number of disputes in the industries".[10]

Psychological Factors

As Patterson remarks: "There are human or psychological causes of labour conflict as well as material or market causes. A worker's satisfaction with the job is based only partly on his

wages, hours of work or other conditions of employment. It is also based upon the extent to which he enjoys his work and feels that it is worthwhile."[11] Such psychological factors as denial of opportunity to the worker of satisfying his basic urge for self-expression, personal achievement and betterment may cause unrest and labour problems.

External Factors

External factors refer to those causes which are not directly connected with the industrial establishment. *For example*, if the workers of an establishment strike work in support of, or to express sympathy for, the strikers in some other establishment, it is an external factor.

One of the important external factors is the political factor. Labour may strike work to protest against certain legislative measures or government policies, to support certain social and political movements, or even to change a political regime.

INDUSTRIAL DISPUTES IN INDIA

The total number of man-days lost due to strikes and lock-outs increased from 4.92 million in 1961 to 16.55 million in 1971 and 36.58 million in 1981. In 1982, the number was 77.4 million and 44.3 million in 1983, including the man-days lost due to Bombay textile strike which were estimated at 44.2 million in 1982 and 19.3 million in 1983. In most years, a majority of the man-days were lost because of strikes. The number of man-days lost due to strikes and lock-outs declined in recent years — from 2,71,66,752 in 2007 to 66,71,179 in 2011.

PREVENTION OF INDUSTRIAL DISPUTES

As prevention is better than cure, no effort should be spared to prevent the occurrence of industrial disputes. Preventive measures may be taken at the enterprise level and at the macro level.

Employer-Employee Relations

At the enterprise level, a good personnel management and cordial employer-employee relationship contribute to industrial peace. The participation of labour in management, a good employer-employee communication system, a proper understanding of the situation by both the parties, mutual respect for each other's rights, a proper discharge of the responsibilities by both the parties, etc., are very important if conflicts and disputes are to be avoided. There should be proper procedure for the redressal of individual grievances so that they may not ultimately lead to disputes.

Tripartite Machinery

Certain general measures have been taken to prevent disputes and to promote industrial peace, such as the establishment of a number of tripartite bodies, the adoption of the Code of Discipline, and the Industrial Truce Resolution.

The term tripartite machinery refers to the various bodies, composed of representatives of employers, employees and the Government, set up for the promotion of industrial peace. The important tripartite bodies are the following.

1. The Indian Labour Conference which is concerned with such matters as the promotion of uniformity in labour legislation, in the procedures for the settlement of industrial disputes, etc.
2. The Standing Labour Committee, which considers all those matters referred to it by the Indian Labour Conference (ILC) or by the Central Government, including the suggestions of State Governments, employers and employees bearing on labour affairs.
3. The Industrial Committees, which discuss the specific problems of industries for which they have been set up, and submit their reports to the ILC, which coordinates their activities.
4. The Central Implementation and Evaluation Committees, which are concerned with the effective implementation of labour laws, awards, settlements, etc.
5. The Committee on Conventions, which examines the ILO conventions and recommendations, and explores the possibility or advisability of ratifying them and applying them to Indian conditions.

Code of Discipline and Industrial Truce Resolution

The central organisations of employers and workers adopted the Code of Discipline in 1958. To ensure better discipline in industry, the Code lays down that:

1. There shall be no strike or lock-out without notice.
2. No unilateral action shall be taken in connection with any industrial matter.
3. The existing machinery for the settlement of disputes should be utilised with the utmost expedition.
4. Neither party will have recourse to coercion, intimidation and lock-out.
5. They will avoid litigation, sit-down and stay-in strikes and lock-outs.
6. No deliberate damage shall be done to plant and machinery.
7. Awards and agreements should be speedily implemented.
8. Any action which disturbs cordial industrial relations should be avoided.

The Industrial Truce Resolution, which was adopted in 1962, provides that there should be maximum recourse to voluntary arbitration, and envisages that all complaints pertaining to dismissal, discharge, victimisation and retrenchment of individual workmen, not settled mutually, should be settled by arbitration.

Works Committee

The ID Act lays down that the appropriate government may require the employer of every industrial establishment in which one hundred or more workmen are employed to constitute a Works Committee consisting of representatives of employers and workmen engaged in the establishment. The number of representatives of workmen on the Committee shall not be less than the number of representatives of the employer. The representatives of the workmen shall be chosen in the prescribed manner from among the workmen engaged in the establishment and in consultation with their trade union, if any.

It shall be the duty of the Works Committee to promote measures for securing and preserving amity and good relations between the employer and workmen and, to that end, to comment upon matters of their common interest or concern and endeavour to compose any material

difference of opinion in respect of such matters. The 2nd NCL recommend that the works committee should be substituted by Industrial Relations Committee (IRC) to promote in-house dispute settlement.

SETTLEMENT OF DISPUTES

There are statutory and non-statutory methods for the settlement of industrial disputes.

If the dispute can be settled by non-statutory methods, the employer-employee relations might continue to be cordial. Under statutory methods, the settlement is sometimes imposed rather than willingly accepted.

Sometimes, an amicable settlement may arise out of negotiation and discussion directly between management and employees. When this is not possible, a third party, like a Government representative, may mediate and try to bring the parties to a mutual agreement.

Voluntary Arbitration

V.V. Giri, who regarded compulsory adjudication as Enemy Number One of collective bargaining and industrial peace, had great faith in the virtues of arbitration on voluntary basis. The Code of Discipline adopted by the central organisations of employers and workers in 1958 and the Industrial Truce Resolution of 1962 stressed the significance of voluntary arbitration. The spirit of voluntary arbitration is to settle disputes mutually and without recourse to legal remedies, for "it is essentially the existence of a spirit of give-and-take amongst employers and workers which is a *sine qua non* for the maintenance of peace between the two parties."

The second NCL suggested that arbitration should become the accepted mode of determining disputes which are not settled by the parties.

The merits attributed to voluntary arbitration are:

1. It is less time-consuming.
2. It is less expensive than adjudication.
3. It avoids litigation which so often occurs in adjudication cases.
4. It promotes goodwill and confidence between the parties to the dispute.
5. The award of the voluntary arbitrator is generally accepted with better spirit than under compulsory arbitration.
6. It promotes collective bargaining and the democratic spirit.

SETTLEMENT OF DISPUTES UNDER THE INDUSTRIAL DISPUTES ACT

The statutory machinery for the settlement of industrial disputes has been provided by the Industrial Disputes Act, 1947, amended from time to time (significantly in 1982). The important authorities which constitute the machinery for the settlement of industrial disputes under the Act are described below.

Grievance Settlement Authority

The ID Act provides that every industrial establishment which employs 50 or more workers shall have a Grievance Settlement Authority (GSA) for the settlement of industrial disputes connected with any individual workman employed in the establishment.

When an industrial dispute connected with an individual workman arises in such an establishment, the workman or any trade union of workmen of which such workman is a member, may refer, in such manner as may be prescribed, such dispute to the GSA.

The GSA shall follow the prescribed procedure and complete the proceedings within the prescribed period.

No reference shall be made with respect to any such dispute to any other authority under the Act unless such dispute has been referred to the GSA and the decision of the GSA is not acceptable to either of the parties to the dispute.

Conciliation Officers

The ID Act provides for the appointment of conciliation officers by appropriate Government, charged with the duty of mediating in and promoting the settlement of the industrial dispute. (It may be stated, generally, that in respect of industrial disputes concerning a Central Government establishment, the appropriate government is the Central government, and in most other cases the State government concerned is the appropriate government).

According to the 2nd NCL, to make conciliation effective, it is necessary to improve the status and competence and calibre of conciliation officers through proper recruitment, training and placement. A. Labour and Judicial Service can be formed.

A conciliation officer may be appointed for a specified area, or for specified industries in a specified area, or for one or more specified industries, either permanently or for a limited period.

Where any industrial disputes exists or is apprehended, the conciliation officer may (or where the dispute relates to a public utility service and a notice for strike or lock-out has been given in accordance with the provisions of the Act, the conciliation officer *shall*) hold conciliation proceedings in the prescribed manner.

If a settlement of the dispute or of any of the matters in dispute is arrived at, the conciliation officer shall send a report of it to the appropriate Government (or an officer authorised in this behalf by the appropriate Government), together with a memorandum of the settlement signed by the parties to the dispute.

If no such settlement is arrived at, the conciliation officer shall report the reasons on account of which, in his opinion, a settlement could not be arrived at. If, on a consideration of the such a report by the conciliation officer, the appropriate Government is satisfied that there is a case for reference to a Board of Conciliation, Labour Court, Tribunal or National Tribunal, it may make such a reference. Where the appropriate Government does not make such a reference, it shall record and communicate to the parties concerned its reasons thereof.

Board of Conciliation

The ID Act provides that the appropriate Government may, as occasion arises, constitute a Board of Conciliation to promote the settlement of an industrial dispute.

The Board shall consist of a chairman and two or four other members, as the appropriate Government thinks fit. The chairman shall be an independent person and the other members shall be persons appointed in equal numbers to represent the parties to the dispute, and any person appointed to represent a party shall be appointed on the recommendation of that party. However, if any party fails to make a recommendation as aforesaid within the prescribed time, the appropriate Government shall appoint such persons as it thinks fit to represent that party.

Where a dispute has been referred to a Board, it shall, without delay, investigate the dispute do all such things as it thinks fit for the purpose of inducing the parties to come to a fair and amicable settlement of the dispute.

If the settlement of a dispute or of any of the matters in dispute is arrived, the Board shall send a report thereof to the appropriate Government, together with a memorandum of the settlement signed by the parties to the dispute.

If no such settlement is arrived at, the Board shall report the reasons on account of which, in its opinion, settlement could not be arrived at its recommendations for the termination of the dispute. If, on the receipt of such a report, the appropriate Government does not make a reference to a Labour Court, Tribunal or National Tribunal, it shall record and communicate the parties concerned its reasons thereof.

Courts of Inquiry

The ID Act provides that the appropriate Government may, as occasion arises, constitute a Court of Inquiry to inquire into any matter appearing to be connected with or relevant to an industrial dispute.

A court may consist of one independent person or of such number of independent persons as the appropriate Government may think fit and where a Court consists of two or more members, one of them shall be appointed as the Chairman.

A Court shall inquire into the matters referred to it and report thereon to the appropriate Government ordinarily within a period of six months from the commencement of its inquiry.

Labour Courts

The appropriate Government may constitute one or more Labour Courts to adjudicate industrial disputes relating to any matter specified in the Second Schedule and to perform such other functions as may be assigned to them under the Act. A Labour Court shall consist of one person only to be appointed by the appropriate Government. (The Second Schedule covers matters such as issues related to Standing Orders, discharge or dismissal of workers, illegality or otherwise of strikes and lockouts withdrawal of any customary benefit).

Tribunals

The appropriate Government may constitute one or more Industrial Tribunals to adjudicate an industrial dispute relating to any matter, whether specified in the Second Schedule or Third Schedule, and to perform such other functions as may be assigned to them under this Act. A Tribunal shall consist of one person only to be appointed by the appropriate Government. (The Third Schedule covers matters such as wages, bonus, allowances and certain other benefits, certain working conditions, discipline, rationalisation, retrenchment and closure of establishment).

National Tribunals

The Central Government may, by notification in the Official Gazette, constitute one or more National Industrial Tribunals to adjudicate an industrial dispute which, in the opinion of the Central Government, involve questions of national importance or are of such a nature that industrial establishments situated in more than one State are likely to be interested in, or affected by, such disputes. A National Tribunal shall consist of one person only to be appointed by the Central Government. The Central Government may, if it so thinks fit, appoint two persons as assessors to advise the National Tribunal in the proceedings before it.

Duties of Labour Courts, Tribunals and National Tribunals: Where an industrial dispute has been referred to a Labour Court, Tribunal or National Tribunal for adjudication, it shall hold its proceedings expeditiously and shall within the period specified in the order referring such industrial dispute, or within the further period extended under the provisions of the Act, submit its award to the appropriate Government.

Reference and Awards

Where the appropriate Government is of the opinion that any industrial dispute exists or is apprehended, it may at any time refer the dispute or any matter appearing to be connected with it to the concerned authority.

Where an industrial dispute has been so referred to the concerned authority, the appropriate Government may prohibit the continuance of any strike or lock-out in connection with such dispute which may be in existence on the day of reference.

There is also a provision in the Act for voluntary reference of disputes to arbitration if the employer and the workman agree to that.

The award of the concerned authority on the dispute shall be in writing and shall, within a period of thirty days from the date of its receipt by the appropriate Government, be published in such manner as the appropriate Government thinks fit. (*Award* "means an interim or final determination of any industrial dispute or of any question relating thereto by any Labour Courts Industrial Tribunal and National Industrial Tribunal and includes an arbitration award" made under this Act).

An award shall become enforceable on the expiry of thirty days from the date of its publication. However, the appropriate Government may declare that the award shall not become enforceable on the expiry of the said period of thirty days if it thinks that it will be expedient so to do on public grounds affecting national economy or social justice. Where such a declaration has been made, the appropriate Government may, within ninety days from the date of the publication of the award, make an order rejecting or modifying the award, and shall, on the first available opportunity, lay the award, together with a copy of the order, before the State legislature or Parliament, as the case may be.

Prohibition of Strikes and Lock-outs

The Act prohibits strikes and lock-outs in public utilities without sufficient notice as specified in the Act. It also prohibits strikes and lock-outs during the pendency of proceedings relating to the dispute before the concerned authority and a certain specified period after that. Further, strikes and lock-outs are prohibited during any period in which a settlement or award is in operation in respect of any of the matters covered by the settlement of the award.

Where a strike or lock-out in pursuance of an industrial dispute has already commenced and is in existence at the time of the reference of the dispute to the authority, the continuance of such strike or lock-out shall not be deemed to be illegal, provided that such strike or lock-out was not at its commencement in contravention of the provisions of this Act and the continuance thereof was not prohibited under the Act. Further, a lock-out declared in consequence of an illegal strike or a strike declared in consequence of an illegal lock-out shall not be deemed to be illegal.

The Act also provides that no person shall knowingly expend or apply any money in direct furtherance or support of any illegal strike or lock-out. Any person who violates this shall be punishable with imprisonment for a term which may extend to six months, or with fine up to ₹ 1,000 or both.

BOX 30.1 : NATIONAL COMMISSION ON LABOUR ON STRIKES

The second National Commission on Labour in its Report observed that strike could be called only by the recognised negotiating agent and that too only after it had conducted a strike ballot amongst all the workers, of whom at least 51 per cent support the strike. Correspondingly, an employer will not be allowed to declare a lock-out except with the approval at the highest level of management except in cases of actual or grave apprehension of physical threat to the management or to the establishment. The appropriate government will have the authority to prohibit a strike or lock-out by a general or special order and refer for adjudication the issue leading to the strike/lock-out. The general provisions like giving of notice of not less than 14 days, not declaring a strike or lock-out over a dispute which is in conciliation or adjudication and so on will be incorporated in the law. In this context we also recommend that an illegal strike or illegal lock-out should attract similar penalties. A worker who goes on an illegal strike should lose three days wages for every day of illegal strike, and the management must pay the worker wages equivalent to three days wages per day of the duration of an illegal lock-out. The union which leads an illegal strike must be derecognised and debarred from applying for registration or recognition for a period of two or three years.

The Commission also discussed the question whether any distinction should be made between 'strike' and 'work stoppage' and came to the conclusion that the existing definition of 'strike' in the Industrial Disputes Act 1947 may stand, "Go slow" and "work to rule" are forms of action which must be regarded as misconduct. Standing Orders and Provisions relating to unfair labour practices already include them and provide for action both in the case of "go slow" and "work to rule".

Driving the dispute into the realm of law and order, and using the strong arm of the State to convert industrial disputes into matters for the police or the law and order enforcement machinery is not to the advantage of the workers, and perhaps to that of the industry as well.

There are some industries or services where the effects of industrial action create situations which threaten the lives and normal and essential needs and activities of the vast majority. One's liberty has to be seen in the light of the equal right that everyone else has to demand and enjoy liberty. Social intervention thus becomes justified and necessary to protect the interests of all concerned. The Commission has, therefore, recommended that in the case of socially essential services like water supply, medical services, sanitation, electricity and transport, when there is a dispute between employers and employees in an enterprise, and when the dispute is not settled through mutual negotiations, there may be a strike ballot as in other enterprises, and if the strike ballot shows that 51 per cent of workers are in favour of a strike, it should be taken that the strike has taken place, and the dispute must forthwith be referred to compulsory arbitration (by arbitrators from the panel of the Labour Relations Commission (LRC), or arbitrators agreed to by both sides).

The Commission has recommended the withdrawal of the Essential Services Maintenance Act.

Other Important Provisions of the Act

The Industrial Disputes Act lays down the conditions of lay-off and retrenchment; the right of workmen laid-off for compensation; the procedure for closing down an undertaking; the compensation for workmen in the event of the closure and transfer of undertakings; and penalties for illegal strikes and lock-outs, instigation, breach of settlement or award, disclosing confidential information, closure without notice and other offences.

The Act also lays down that no employer or workman or a trade union shall commit any unfair labour practice. Any person who commits any unfair labour practice shall be punishable with imprisonment for a term which may extend to six months or with fine which may extend to ₹ 1,000, or both.

While presenting the Union Budget 2001-2002, the Finance Minister made the following observation. Some existing provisions in the Industrial Disputes Act have made it almost impossible for industrial firms to exercise any labour flexibility. The Government is now convinced that some change is necessary in this legislation. Chapter VB of the ID Act stipulates that employers in specified industrial establishments must obtain prior approval of the appropriate government authority for effecting lay-off, retrenchment and closure, after following the prescribed procedure.

It is proposed that these provisions may now apply to industrial establishments employing not less than 1000 workers instead of 100. The requirement of compensation will be increased from 15 days to 45 days for every completed year of service. The enhancement of compensation would act as a deterrent on employers to take recourse to lay-off, retrenchment and closure in a routine manner.

SUMMARY

The term industrial relations covers the various aspects of interactions between employer and employees, employees and employees, employers and employers, and between the state, employers and employees.

Many a time, industrial relations are far from satisfactory and industrial disputes are not uncommon. According to the Industrial Disputes Act, 1947, the term "industrial dispute" means any dispute or difference between employers and employers, or between employers and workmen, or between workmen and workmen, which is connected with the employment or non-employment, or the terms of employment or with the conditions of labour, of any person."

Though there is a large area in which the interests of employers and employees are the same, there are at least three areas in which conflict is certain to occur. First, there is the conflict of interests over the division of the total product of the industry. Second, there is the conflict between the human rights of the workers and the property rights of the employers. Third, there is a continuing conflict between the efficiency aspirations of the management and the security aspirations of the workers.

The important issues causing industrial disputes are economic (wages, bonus, economic insecurity – fear of loss of job), and working conditions and labour welfare. External factors like political reasons, sympathy to workers in other establishments etc. may also cause labour problems. In the absence of effective personnel management, grievances and unrest, which can be solved at the incipient stage, may spark off a dispute. Sometimes psychological factors also cause industrial relations problem.

Prevention is better than cure. There are several measures that may be taken at the enterprise level and at the macro level to prevent the occurrence of industrial disputes.

At the enterprise level, a good personnel management and cordial employer-employee relationship, and a proper system for the redressal of individual grievances contribute to industrial peace.

Certain general measures have been taken to prevent disputes and to promote industrial peace, such as the establishment of a number of tripartite bodies, the adoption of the Code of Discipline, and the Industrial Truce Resolution.

The ID Act provides for the constitution of a Works Committee consisting of representatives of employers and workmen in every industrial establishment in which one hundred or more workmen are employed to promote measures for securing and preserving amity and good relations between the employer and workmen.

There are a number of authorities under the Industrial Disputes Act to deal with industrial disputes. They are Conciliation Officers, Board of Conciliation, Court of Enquiry, Labour Court, Industrial Tribunal and National Industrial Tribunal.

The Industrial Disputes Act prohibits strikes and lock-outs in public utilities without sufficient notice as specified in the Act. It also prohibits strikes and lock-outs during the pendency of proceedings relating to the dispute before the concerned authority and a certain specified period

after that. Further, strikes and lock-outs are prohibited during any period in which a settlement or award is in operation in respect of any of the matters covered by the settlement of the award.

The Act lays down the conditions of lay-off and retrenchment; the right of workmen laid-off for compensation; the procedure for closing down an undertaking; the compensation for workmen in the event of the closure of undertakings; and penalties for illegal strikes and lock-outs, instigation, breach of settlement or award, disclosing confidential information, closure without notice and other offences.

The Act also lays down that no employer or workmen or a trade union shall commit any unfair labour practice.

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8. K.N. Srivastava, *Industrial Peace and Labour in India*, (Cited by Nagaraju, *ibid.*, p. 26).
9. A.D. Butler, *Labour Economics and Labour Institutions* (Cited by Nagaraju, *ibid.*, p. 26).
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ANNEXURE 30.1

Schedules to the Industrial Disputes Act, 1947

The First Schedule
Industries which May be Declared to be Public Utility Services Under Sub-clause (VI) of Clause (N) of Section 2

1. Transport (other than railways) for the carriage of passengers or goods, by land or water.
2. Banking.
3. Cement.
4. Coal.
5. Cotton textiles.
6. Foodstuffs.
7. Iron and Steel.
8. Defence establishments.
9. Service in hospitals and dispensaries.
10. Fire Brigade Service.
11. India Government Mints.
12. India Security Press.
13. Copper Mining.
14. Lead Mining.
15. Zinc Mining
16. Iron Ore Mining.
17. Service in any oil field.
18. Service in the Uranium Industry.
19. Pyrites Mining Industry.
20. Security Paper Mill, Hoshangabad.
21. Service in the Bank Note Press, Dewas.
22. Phosphorite Mining.
23. Magnesite Mining.
24. Currency Note Press.
25. Manufacture or production of mineral oil (crude oil), motor and aviation spirit, diesel oil, kerosene oil, fuel oil, diverse hydrocarbon oils and their blends including synthetic fuels, lubricating oils and the like.
26. Service in the International Airports Authority of India.
27. Industrial establishment, manufacturing or producing nuclear fuel and components, heavy water arid allied chemicals, and atomic energy.

The Second Schedule
Matters within the Jurisdiction of Labour Courts (*Section 7*)

1. The propriety or legality of an order passed by an employer under the standing orders.
2. The application and interpretation of standing order.
3. Discharge or dismissal of workmen including reinstatement of, or grant of relief to, workmen wrongfully dismissed.
4. Withdrawal of any customary concession or privilege.
5. Illegality or otherwise of a strike or lock-out.
6. All matters other than those specified in the Third Schedule.

The Third Schedule
Matters within the Jurisdiction of Industrial Tribunals (*Section 7A*)

1. Wages, including the period and mode of payment.
2. Compensatory and other allowances.
3. Hours of work and rest intervals.
4. Leave with wages and holidays.
5. Bonus, profit sharing, provident fund and gratuity.
6. Shift working otherwise than in accordance with standing orders.
7. Classification by grades.
8. Rules of discipline.
9. Rationalisation.
10. Retrenchment of workmen and closure of establishment.
11. Any other matter that may be prescribed.

The Fourth Schedule
Conditions of Service for Change of which Notice is to be Given (*Section 9A*)

1. Wages, including the period and mode of payment.
2. Contribution paid, or payable, by the employer to any provident fund or pension fund or for the benefit of the workmen under any law for the time being in force.
3. Compensatory and other allowances.
4. Hours of work and rest intervals.
5. Leave with wages and holidays.
6. Starting, alteration or discontinuance of shift working otherwise than in accordance with standing orders.
7. Classification by grades.
8. Withdrawal of any customary concession or privilege or change in usage.
9. Introduction of new rules of discipline, or alteration of existing rules, except insofar as they are provided in standing orders.
10. Rationalisation, standardisation or improvement of plant or technique which is likely to lead to retrenchment of workmen.

11. Any increase or reduction (other than casual) in the number of persons employed or to be employed in any occupation or process or department or shift, not occasioned by circumstances over which the employer has no control.

The Fifth Schedule
Unfair Labour Practices [Section 2{RA)]

I. On the Part of Employers and Trade Unions of Employers

1. To interfere with, restrain from, or coerce, workmen in the exercise of their right to organise, form, join or assist a trade union or to engage in concerted activities for the purposes of collective bargaining or other mutual aid or protection, that is to say—
   (a) threatening workmen with discharge or dismissal, if they join a trade union;
   (b) threatening a lock-out or closure, if a trade union is organised;
   (c) granting wage increase to workmen at crucial periods of trade union organisation, with a view to undermining the efforts of the trade union at organisation.
2. To dominate, interfere with or contribute support, financial or otherwise, to any trade union, that is to say,
   (a) an employer taking an active interest in organising a trade union of his workmen; and
   (b) an employer showing partiality or granting favour to one of several trade unions attempting to organise his workmen or to its members, where such a trade union is not a recognised trade union.
3. To establish employer sponsored trade unions of workmen.
4. To encourage or discourage membership in any trade union by discriminating against any workman, that is to say,
   (a) discharging or punishing a workman, because he urged other workmen to join or organise a trade union;
   (b) discharging or dismissing a workman for taking part in any strike (not being a strike which is deemed to be an illegal strike under this Act);
   (c) changing seniority rating or workmen because of trade union activities;
   (d) refusing to promote workmen of higher posts on account of their trade union activities;
   (e) giving unmerited promotions to certain workmen with a view to creating discord amongst other workmen, or to undermine the strength of their trade union;
   (f) discharging office-bearers or active members of the trade union on account of their trade union activities.
5. To discharge or dismiss workmen—
   (a) by way of victimisation;
   (b) not in good faith, but in the colourable exercise of the employer's rights;
   (c) by falsely implicating a workman in a criminal case on false evidence or on concocted evidence;
   (d) for patently false reasons;
   (e) on untrue or trumped up allegations of absence without leave;
   (f) in utter disregard of the principles of natural justice in the conduct of domestic enquiry or with undue haste;

(g) for misconduct of a minor technical character, without having any regard to the nature of the particular misconduct or the past record or service of the workman, thereby leading to a disproportionate punishment.

6. To abolish the work of a regular nature being done by workmen, and to give such work to contractors as a measure of breaking a strike.
7. To transfer a workman malafide from one place to another, under the guise of following management policy.
8. To insist upon individual workmen, who are on a legal strike to sign a good conduct bond, as a precondition to allowing them to resume work.
9. To show favouritism or partiality to one set of workers regardless of merit.
10. To employ workmen as "badlis", casuals or temporaries and to continue them as such for years, with the object of depriving them of the status and privileges of permanent workmen.
11. To discharge or discriminate against any workman for filing charges or testifying against an employer in any enquiry or proceeding relating to any industrial dispute.
12. To recruit workman during a strike which is not an illegal strike.
13. Failure to implement award, settlement or agreement.
14. To indulge in acts of force or violence.
15. To refuse to bargain collectively, in good faith with the recognised trade unions.
16. Proposing or continuing a lock-out deemed to be illegal under this Act.

II. On the Part of Workmen and Trade Unions of Workmen

1. To advise or actively support or instigate any strike deemed to be illegal under this Act.
2. To coerce workmen in the exercise of their right to self-organisation or to join a trade union or refrain from joining any trade union, that is to say—

   (a) for a trade union or its members to picketing in such a manner that non-striking workmen are physically debarred from entering the workplaces;

   (b) to indulge in acts of force or violence or to hold out threats of intimidation in connection with a strike against non-striking workmen or against managerial staff.
3. For a recognised union to refuse to bargain collectively in good faith with the employer.
4. To indulge in coercive activities against certification of a bargaining representative.
5. To stage, encourage or instigate such forms of coercive actions as wilful, "go-slow", squatting on the work premises after working hours or "gherao" of any of the members of the managerial or other staff.
6. To stage demonstrations at the residence of the employers or the managerial staff members.
7. To incite or indulge in wilful damage to employer's property connected with the industry.
8. To indulge in acts of force or violence or to hold out threats of intimidation against any workman with a view to prevent him from attending work.

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Chapter 31

TRADE UNIONS

Structure

Meaning
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Trade unions are very important, sometimes very critical, environment of business. While responsible trade unions would be beneficial to the workers, business and the society, irresponsible trade unions could be harmful to all.

MEANING

Under the Trade Unions Act, the expression trade union includes both employers' and workers' organisations.

According to the Indian Trade Unions Act, 1926, a "Trade union means any combination, whether temporary or permanent, formed primarily for the purpose of regulating the relations between workmen and employers, or between workmen and workmen, or between employers and employers, or for imposing restrictive conditions on the conduct of any trade or business, and includes any federation of two or more trade unions." The Act does not, however, affect:

1. Any agreement between partners as to their own business.
2. Any agreement between an employer and those employed by him as to such employment.
3. Any agreement in consideration of the sale of the goodwill of a business or of instruction in any profession, trade or handicraft.

Under the Indian Trade Unions Act, the definition of Trade Unions is very broad; workers' union is just one of the different forms of Trade Unions.

The term trade union, however, is commonly used to refer to the organisation of workers formed to protect their rights and enhance their welfare. In this chapter, the discussion is limited to the organisation of workers. According to V.V. Giri, "trade unions are voluntary organisations of workers formed to promote and protect their interests by collective action."[1] A trade union "must possess definite aims; its members must be welded together in a united front for the good of the whole group rather than for the promotion of any selfish individual interests; and it must, to be effective, take on a definite and permanent form of organisation through which it strives to accomplish its goal".[2]

Functions of Trade Unions

Trade unions are intended to protect the rights and enhance the welfare of the members in particular and of the working class in general. According to the National Commission on Labour (NCL), the important functions of the trade unions are:[3]

1. To secure for workers fair wages.
2. To safeguard security of tenure and improve conditions of service.
3. To improve opportunities for promotion and training.
4. To improve working and living conditions.
5. To provide for educational, cultural and recreational facilities.
6. To cooperate in and facilitate technological advance by broadening the understanding of workers of its underlying issues.
7. To promote identity of interests of the workers with their industry.
8. To offer responsive cooperation in improving levels of production and productivity, discipline and high standard of quality.
9. To promote individual and collective welfare.

Social Responsibilities of Trade Unions

It is not uncommon that the organised might of the trade unions holds public life to ransom as pressure tactics to serve their purpose, throwing civil rights and liberties to the winds. While the unions have the right to fight for their legitimate rights, it is high time they realised that they have no right to misuse their organised might to deny the unorganised innocent public their legitimate rights.

Trade unions are expected to be socially responsible and responsive to the social conditions and demands.

As the NCL observes, it is imperative that unions keep the well-being and progress of the community constantly before them even in the midst of their endeavours to help the working class. Unions have a stake in the success of the national plans for economic development, since these are formulated and implemented as much for maximising production as for distributing the product in an equitable manner. Unions have to adapt themselves to changing social needs, and rise above the divisive forces of caste, religion and language. In this context, some important social responsibilities of trade unions appear to be in the field of:[4]

1. Promotion of national integration;
2. Generally influencing the socio-economic policies of the community through active participation in their formulation at various levels; and
3. Instilling in their members a sense of responsibility towards industry and the community.

According to Giri, "the scope of trade unions should not be confined merely to the workers' demands, but should include the inculcation in the workers of a sense of discipline and responsibility, an appreciation of their moral responsibility to do a fair day's work for a fair day's wages. The unions should make every worker understand fully, first, his duties and responsibilities and then, his rights and privileges. This means that the objects of a trade union should be such as to instill in the individual worker a spirit of self-reliance, toleration and cooperation. In fact, in a society which is well set on the road to socialism and in which the workers' claim to proper wages and good working conditions receives constant attention, the worker has substantial responsibilities which he should fully understand and discharge. Socialism requires the establishment of an industrial democracy, which in turn calls for discipline on the one hand and sincere and efficient work on the other.'[5]

TRADE UNION MOVEMENT IN INDIA

Though the trade union movement in India had its germination in the last quarter of the nineteenth century, it was only in the first quarter of the twentieth century that the trade union movement, as it is understood today, took its birth. N.M. Lokhande, who was a factory worker in Bombay, is regarded as the founder of the organised labour movement in India.

Factors Which Contributed to Growth

As Giri observes,[6] the following factors helped the growth of trade union movement of India:

1. *World War I:* Though the labour movement in India began about a century ago, it was only from the end of the First World War (1914-1918) that it gathered momentum. Giri points out that both economic and political conditions alike contributed to the new awakening. Prices had shot up during the war and there had been no corresponding increase in the wages, though the employers had amassed fantastic profits. In the political field, new ideas were in the air. The Indian National Congress had formulated its demand for immediate self-government. All this was reflected in considerable labour unrest, one of the features of the nineteen twenties. These conditions led, inevitably, to the formation of a large number of trade unions throughout the country.[7]

Several developments within and outside the country fostered the trade union movement in India

2. *Influence of Political Leaders:* The early stages of the development of trade union movement in India owe a lot to the contributions of some political leaders, social reformers and philanthropists. "The mass movement started by Lokmanya Tilak, Annie Besant and later by Mahatma Gandhi caused ripples in the trade union movement. In particular, the non-cooperation movement launched by Gandhiji during 1919-21 and the espousal by him of the cause of the peasants and industrial labour had a profound impact on the working class. Gandhiji was also greatly responsible for giving a reorientation to the labour movement by establishing the Ahmedabad Textile Labour Association, which had, as its main plank, the settlement of trade disputes by negotiations and peaceful methods before resorting to direct action."[6]

3. *The ILO:* The establishment of the International Labour Organisation, of which India was a founder member, prompted the formation of trade unions in India. In choosing its nominees to the International Labour Conference, held annually, the Government had to consult the organisations of the workers and employers to represent their interests. This led to the establishment of the All-India Trade Union Congress as the central body of workers, representing the various trade unions affiliated to it.

4. *The Russian Revolution:* The success of the Russian revolution gave an impetus to the labour movement because of the feeling it generated that the solidarity of the working class could achieve great things.

5. *The Trade Unions Act:* The Indian Trade Unions Act, passed in 1926, is landmark in the history of trade union movement in India because this Act gave trade unions a legal status and immunity to its officers and members against civil and criminal liability for concerted action.

Some Important Developments

As indicated earlier, it was only after the First World War that the trade union movement in India gathered momentum. The widespread labour unrest in the immediate post-war period led to the formation of a number of trade unions in different industries on a permanent basis. In 1920, the All-India Trade Union Congress (AITUC) was established to coordinate and guide the activities of the individual unions and to express their views on the general policy matters and programmes affecting labour. As Giri observes, the foundation of the AITUC marked the first recognition of the common interest of labour throughout the country, and it gave a great fillip to the rapid formation of unions in different parts of the country and in industries, big and small.

In addition to the rights conferred on the registered unions by the Act, their registration enhanced the status of unions in the eyes of the public as well as the employers. In this process, even unregistered unions benefited, and the movement as a whole gained greater confidence of workers.

The conflicts between the moderates and leftists within the All-India Trade Union Congress resulted in a split in the organisation in 1929, with the leftists capturing the congress. The break away group formed the All-India Trade Union Federation "with a realistic policy, programme and objectives".

The early nineteen thirties were an unfavourable period for the trade union movement. Apart from the serious economic depression which the country had been passing through, Gandhiji's civil disobedience movement, launched in 1930, had diverted the attention of the political leaders of India from the trade union movement. The second split in the All-India Trade Union Congress occurred in 1931, resulting in the formation of a new organisation called the Red Trade Union Congress which, in the next year, united with the parent organisation. The All-India Trade Union Federation and the railway unions joined the National Trade Unions Federation which came into existence in 1933, with a view to forging unity in the trade union movement. The National Trade Union Federation, which claimed a larger membership than the AITUC, and the AITUC merged together in 1938.

BOX 31.1 : IMPACT OF POLITICAL AND SOCIAL FORCES

The National Commission on Labour in its Report (1969) has made the following observation.

Forming of trade unions and the shaping of their activities by the political workers and their philosophy, were not entirely unknown in the past. They have acquired new dimensions with the advent of Independence and the environment which the political system has operated in or has created for itself. Though unions are apparently free from organisational ties with political parties, the association of many unions/federations with politics through ideology and leadership cannot be denied. Such ties have led to fragmentation of unions, to inter-union and intra-union rivalries, and some confusion in the minds of the rank and file of workers.... A demand for freeing unions from political influence is gaining ground and assertions about their autonomous character in relation to their ideological political partners are frequently made.

A major change on the social side has been brought about by the Hindu Code with its two important components: the Hindu Succession Act, 1955, and the Hindu Marriage Act, 1956. The first gave women equal rights with men in the matter of succession to and holding of property; the second struck at the root of polygamy and provided for divorce with alimony and maintenance. The joint family system is losing its hold, more particularly in urban areas where provision for social security by the State is encouraging nuclear families; because of the growth of nuclear families, demand for improvement of social security provisions is also gaining in strength.

The period of the Second World War (1939-45) was again a bad time for the trade union movement in India. The unity in the movement that was secured before the war did not last long. Differences arose on the question of the attitude of labour towards the war. The attitude of the communists in the AITU swung in favour of the Russian involvement in the war. In the early days of the war, the communists were opposed to the war effort of the British Government because the USSR had been in the opposite camp with Germany. A section of labour leaders, who supported the war effort of the British Government, led by the radical democratic leader, M.N. Roy, seceded from the All-India Trade Union Congress and formed a separate central organisation called the Indian Federation of Labour. The Federation, which had the support of the Government, also gained strength and the support of a large number of trade unions. In many industries, rival unions were formed by those who did not subscribe to the view that workers should assist the British in their war efforts.

When Hitler and Stalin fell out and the Soviet Union changed over to the side of the Allies, the communists in India changed their attitude too, and at the behest of the Secretary of the British Communist Party, lent support to the war efforts.

The nationalist elements in the All-India Trade Union Congress, however, followed the lead of the Indian National Congress, and most of them were arrested and detained for a long time. Their absence from the trade union field enabled the leaders of the Indian Federation of Labour to strengthen their hold on the workers and the communist leaders to dominate the All-India Trade Union Congress. Even though the official outlook of the AITUC was one of neutrality, there were different groups in it having different views on the war.

The pattern of trade union movement in India was influenced by developments in the political scenario.

Because of the sharp increase in the cost of living and the failure of the employers to appreciate the workers' demands, there was widespread labour unrest. The Government used the Defence of India Rules and prohibited strikes and lock-outs, and referred industrial disputes for conciliation and adjudication. However, the deteriorating economic condition of the workers made the latter conscious of the need for making organised efforts to secure relief. This gave a fillip to the trade union movement, and there was a marked increase, both in the number of unions and of organised workers, by the end of the War. The two central organisations, namely, the All-India Trade Union Congress and the Indian Federation of Labour, actively strove to organise workers in different industries; but the absence of nationalist trade union leaders from the field and the general national outlook of the people operated as a negative factor.

The strained economic conditions following the war and the partition of the country at the time of its independence increased the number of the unemployed and made the plight of the workers very miserable, resulting in widespread labour unrest. There was a feeling on the part of the nationalist-minded trade union leaders, when they came out of jails, that the trade union movement was in a most unorganised manner and that steps should be taken to re-establish the unity which had been noticeable in the thirties. The All-India Trade Union Congress was in the grip of the communists; and the Indian Federation of Labour, because of the patronage it had received from the British, was suspect in the eyes of the people. The Indian National Trade Union Congress (INTUC) was, therefore, started in 1947 under the patronage of the Indian National Congress. In the next year, the Hind Mazdoor Sabha (HMS) was formed by the Praja Socialist Party, and the United Trade Union Congress (UTUC) was formed in the following year by some radicals.

The trade union movement in India after independence has become highly politicised, so much so that conflicts in the political parties and political alliances and realignments have had their impact on the trade unions as well. Splits in political parties have usually led to splits in the trade unions related to the parties concerned. Thus, for instance, the split in the communist party and the emergence of the Communist Party of India (Marxists) led to a split in the AITUC and the formation of the Centre of Indian Trade Unions (CITU) by the CPI(M). The successive splits in the Indian National Congress and other political parties have had similar effects.

Limitations and Problems of Trade Unionism in India

The trade union movement in India suffers from a number of limitations and problems. Important among them are the following:

1. ***Limited Representation:*** Trade unions encompass only a small portion of the total workforce of the country. The extent of unionisation is very limited in the unorganised sectors; particularly in agriculture. However, in some places like Kerala, irresponsible trade unionism sometimes is a curse of the agricultural sector.

2. ***Small Size and Increasing Number:*** There has been an increase in the number of trade unions. One reason for this increase has been the break-up of the existing unions into two or more fractions. Besides, new small unions have been taking birth. The small size of unions poses problems of weak financial and administrative position, weakening of collective bargaining power, inter-union rivalry, difficulty in establishing employer-employee rapport, etc.

3. ***Multiplicity of Unions:*** The multiplicity of unions has become a very serious problem. As indicated above, the ever-increasing number of unions reduces the average size of the unions, so much so that, in many a situation, no single union has an absolute majority support of the workers. Even when a single union can claim majority, the existence of a number of other unions create serious problems for it. The multiplicity of unions weakens the collective bargaining strength of labour. It also makes employer-employee negotiations and the settlement of issues very difficult. The ideal of "one union for one industry" is likely to remain a dream for a very long time to come.

4. ***Inter-union and Intra-union Rivalries:*** Inter-union rivalries are a corollary of the multiplicity of unions. Instances of one union trying to beat another union even at the expense of the interests of labour are not uncommon. Inter-union rivalries tend to be intense when the different unions subscribe to different political ideologies, or when they are controlled by mutually opposing political parties. Such rivalries often undermine the effectiveness of collective bargaining and lead to industrial unrest. Sometimes, intra-union rivalries create problems. The personal aspirations of the members, personality conflicts, personal rivalries, etc., are among the causes of intra-union rivalries.

The Trade Union Movement in India suffers from a number of problems arising mostly from the socio-economic and political conditions and attitudes of Trade Union leaders and employers.

5. *Political Infiltration:* Politicisation is a serious problem afflicting trade unionism in India. The major trade unions of India – the Indian National Trade Union Congress (INTUC), the All-India Trade Union Congress (AITUC), the Centre of Indian Trade Unions (CITU), the United Trade Union Congress (UTUC), etc. — have political affiliations. Indeed, each political party tries to have its own trade union. As a corollary of this, political rivalries are extended to trade unions. Split in the political parties and political rivalries may have impact on the trade union also. The politicisation of the trade unions many a time leads to a situation wherein the trade unions become tools in the hands of political parties.

As Giri observes, "the introduction of politics in to the trade union movement and its domination by leaders of political parties have shattered the unity and strength of the trade union movement in the country. The Indian trade union movement has, therefore, become organisationally weak and, as an institution, it may not be able to effectively promote and protect the interests of the workers, unless and until unions are scientifically managed, placing the genuine economic interests of the workers uppermost in their plan of action."[9]

6. *Outside Leadership:* True, in the early stages of the growth of trade unionism in India, outside leadership made very significant contributions. In the past, such leaders were, by and large, dedicated to the cause of labour. But, today, the situation appears to be different. It seems that, today, for many outside leaders trade unions are a means to their personal ends. Outside leadership causes a number of problems like inter-union rivalries, misdirection and misuse of trade union movement, etc.

7. *Meagre Funds:* Because of the low income of the Indian working class and the small number of members, the funds of the unions are very meagre. Financial constraints come in the way of having full-time officials, organisation and administration, so that it is very difficult to properly organise and sustain strikes and to undertake welfare activities for the members and their dependants, etc.

8. *Low Income:* The low income of the workers is a negative factor in the growth of trade unions. Because of their low income, workers may feel it difficult to regularly subscribe to the unions. As a result, they may hesitate to join a union. As the Indian workers have a hand-to-mouth existence, he is not able to strike work for a long time.

9. *Illiteracy:* Illiteracy and lack of education of the workers hinder the growth of the trade union movement because workers are often unable to appreciate, and contribute to, the positive role of trade unionism. This also encourages outside leadership. The ignorance and indifference of workers may result in lack of proper control of the leadership and misdirection.

10. *Lack of Integrity:* Lack of integrity and dedication on the part of trade union leaders is a major drawback of trade unionism in India. Leaders deceiving workers in the negotiations with the employer, misusing their position and funds, using the union for vested interests, etc., are not uncommon. These lead to the disillusionment of workers, so that they may even back out of the union.

11. *Unhealthy Attitude of Employers:* Many employers in India still regard trade unions as something very bad. There is lack of appreciation of the positive role of trade unions. Many employers are accused of trying to foster disunity among the workers, encouraging inter-union rivalries, disintegrating unions and resorting to unfair practices to weaken trade unionism.

REGULATION OF TRADE UNIONS – THE TRADE UNIONS ACT

Trade unions in India are regulated by the *Indian Trade Unions Act, 1926,* amended from time to time.

The Trade Unions Act lays down the procedure for the registration of trade unions and their rights and the liabilities.

Registration of Unions

Any seven or more members of a trade union may, by subscribing their names to the rules of the trade union and otherwise complying with the provisions of this Act with respect to registration, apply for the registration of the trade union under this Act. Every application for the registration of a trade union shall be made to the Registrar, and shall be accompanied by a copy of the rules of the trade union, and provide all other particulars required by the Act.

The Act lays down that the following Acts, namely: The Societies Registration Act 1960; The Cooperative Societies Act, 1912; and The Companies Act, 1956, shall not apply to any registered trade union, and that the registration of any such trade union under any such Act shall be void.

Rights and Responsibilities of Registered Unions

The Act lays down the rights and liabilities of registered trade unions. Some of the important rights and liabilities of the registered unions are:

1. The general funds of a registered union shall not be spent on any other objects than those specified in the Act.

   A registered union may constitute a separate fund from contributions separately levied for or made to that fund, from which payments may be made for the promotion of the civil and political interests of its members, in furtherance of any of the objects specified in the Act.

2. No office-bearer or member of a registered trade union shall be liable to punishment under sub-section (2) of Section 120-B of the Indian Penal Code in respect of any agreement made between the members for the purpose of furthering any such object of the trade union as is specified in Section 15, unless the agreement is an agreement to commit an offence.

3. No suit or other legal proceeding shall be maintainable in any civil court against any registered trade union or any office-bearer or member thereof in respect of any act done in contemplation or furtherance of a trade dispute to which a member of the trade union is a party on the ground only that such an Act induces some other person to break a contract of employment, or that it is an interference with the trade, business or employment of some other person or with the right of some other person to dispose of his capital or of his labour as he wills.

   Further, a registered trade union shall not be liable in any suit or other legal proceeding in any civil court in respect of any tortious act done in contemplation or furtherance of a trade dispute by an agent of the trade union, if it is proved that such person acted without the knowledge of, or contrary to express instructions given by, the executive of the trade union.

4. The account books of a registered trade union and the list of members thereof shall be open to inspection by an office-bearer or member of the trade union at such times as may be provided for in the rules of the trade union.

5. A person shall be disqualified for being chosen as, and for being a member of, the executive or any other office-bearer of a registered trade union if: *(a)* he has not attained

the age of eighteen years; *(b)* he has been convicted by a court in India of any offence involving moral turpitude and sentenced to imprisonment, unless a period of five years has elapsed since his release.

6. Not less than one-half of the total number of office-bearers of every registered trade union shall be persons actually engaged or employed in an industry with which the trade union is connected. However, the appropriate Government may, by a special or general order, declare that the provisions of this section shall not apply to any trade union or class of trade unions specified in the order.
7. Any registered trade union may, with the consent of not less than two-thirds of the total number of its members and subject to the provisions of Section 25, change its name.
8. Any two or more registered trade unions may become amalgamated together as one trade union with or without the dissolution or division of the funds of such trade unions or either or any of them, provided that the votes of at least one-half of the members of each or every such trade union entitled to vote are recorded, and that at least sixty per cent of the votes recorded are in favour of the proposal.
9. When a registered trade union is dissolved, notice of the dissolution signed by seven members and by the secretary of the trade union shall, within fourteen days of dissolution, be sent to the Registrar, and shall be registered by him if he is satisfied that the dissolution has been effected in accordance with the rules of the trade union, and the dissolution shall have effect from the date of such registration.

   Where the dissolution of a registered trade union has been registered and where its rules do not provide for the distribution of the funds of the union on dissolution, the Registrar shall divide the funds among the members in such manner as may be prescribed.
10. A registered trade union shall send to the Registrar a properly audited annual statement of all receipts and expenditure in the prescribed form within the prescribed time. Along with this, a statement showing all the changes in the office-bearers made by the union during the year and a copy of the rules of the union corrected up to the date of despatch should also be sent.
11. A copy of every alteration made in the rules of a registered trade union shall be sent to the Registrar within fifteen days of the making of the alteration.
12. For the purpose of examining the documents of a registered union, as specified in the Act, the Registrar, or any officer authorised by him, may, at any reasonable time, inspect the certificate of registration, account books, registers and other documents relating to the trade union at its registered office or may require their production at such place as he may specify in this behalf; but no such place shall be at a distance of more than ten miles from the registered office of the trade union.

Amendments to Trade Unions Act

The Trade Unions Act was amended with effect from January 9, 2002. Accordingly:

First, no trade union of workmen shall be registered unless at least 10 per cent or 100, whichever is less, of workmen engaged or employed in the establishment of industry with which it is connected are members of such trade union on the date of making application for registration. However, in no case shall a union be registered without a minimum strength of seven workmen.

Secondly, a registered trade union shall at all times continue to have not less than 10 per cent or 100 members whichever is less, subject to a minimum of seven persons engaged or employed in the establishment or industry with which it is connected, as its members.

Thirdly, all office-bearers of a registered trade union, except not more than one-third of the total number of office-bearers or five, whichever is less shall be persons actually engaged or employed in the establishment or industry with which the trade union is connected.

It is also provided that the employees who have been retired or have been retrenched shall not be construed as outsiders for the purpose of holding an office in the trade union concerned. This provision was specifically included at the behest of trade union leaders who had appeared before the Parliamentary Standing Committee on Labour and Welfare, to which the Bill had been referred for examination.

An aggrieved trade union may even go for an appeal before Industrial Tribunal/Labour Court in case of non-registration or for restoration of registration.

BOX 31. 2 : SECOND NATIONAL COMMISSION LABOUR ON TRADE UNIONS

Coming to the question if it would have been desirable if the Trade Union Act, 1926, had also provided for a ceiling on the total number of trade unions of which an 'outsider' can be a member of executive bodies. Amendments made in Section 4 recently appear to disentitle workers in the unorganised sector from getting their trade unions registered. To overcome this difficulty, a specific provision may be made to enable workers in the unorganised sector to form trade unions, and get them registered even where an employer-employee relationship does not exist or is difficult to establish; and the proviso stipulating 10 per cent of membership shall not apply in their case.

A question was raised whether the right to registration as Trade Unions should be confined to organisations of workers only or employer's organisations should also enjoy this right as provided in the existing provisions. We have come to the conclusion that the present system of eligibility for registration may continue. All benefits which accrue to workers as a result of collective bargaining do not distinguish between those who are members of Trade Unions and those who are not. A worker who is not a member of any Trade Union will have to pay an amount equal to the subscription rate of the negotiating agent or the highest rate of subscription of a union out of the negotiating college. The amounts collected on this account may be credited to a statutory welfare fund.

Any such dispute, which currently goes under the appellation of inter-union or intra-union rivalries, should be capable of being resolved by reference of the dispute to the labour court having jurisdiction, either suo moto or by one or both the disputing parties or by the state.

Federations of trade unions as also Central organisations of trade unions and federations should be covered within the definition of trade union and be subject to the same discipline as a primary trade union. The same dispensation will apply to employers' organisations and employees' organisations.

The Commission does not favour craft-based or caste-based organisations of workers or employees or employers. An unregistered organisation shall not be entitled to any privileges, immunities, and rights.

Other provisions of the Trade Unions Act 1926 including the provision to set up a separate political fund may be allowed to continue and appropriately included in the proposed integrated law. However, care must be taken to ensure that the general funds of trade unions are not used for political purposes.

SUMMARY

Trade unions are voluntary organisations of workers formed to promote and protect their interests by collective action. As V.V. Giri has advised, the scope of trade unions should not be confined merely to the workers' demands, but should include the inculcation in the workers of a sense of discipline and responsibility, an appreciation of their moral responsibility to do a fair day's work for a fair day's wages.

The trade union movement, as it is understood today, took birth in India in the first quarter of the twentieth century and it was only from the end of the First World War (1914-1918) that it gathered momentum. Both economic and political conditions alike contributed to the new

awakening. Prices had shot up during the war and there had been no corresponding increase in the wages, though the employers had amassed fantastic profits. The widespread labour unrest in the immediate post-war period led to the formation of a number of trade unions in different industries on a permanent basis. The early stages of the development of trade union movement in India owe a lot to the contributions of some political leaders, social reformers and philanthropists. The non-cooperation movement launched by Gandhiji during 1919-21 and the espousal by him of the cause of the peasants and industrial labour, in particular, had a profound impact on the working class. The success of the Russian revolution gave an impetus to the labour movement because of the feeling it generated that the solidarity of the working class could achieve great things.

The establishment of the International Labour Organisation, of which India was a founder member, also encouraged the formation of trade unions in India.

An important landmark in the history of trade union movement in India was the passing of the Trade Unions Act, 1926, which gave trade unions a legal status and immunity to its officers and members against civil and criminal liability for concerted action. This Act deals with the registration of trade unions and their rights and responsibilities. It also seeks to ensure that the funds of the registered unions are properly utilised.

Almost all major political parties, and even many small parties, have trade unions affiliated to them. The trade union movement in India after independence has become highly politicised, so much so that conflicts in the political parties and political alliances and realignments have had their impact on the trade unions as well.

The trade union movement in India suffers from a number of limitations and problems such as limited representation, small size and increasing number of trade unions, multiplicity of unions, inter-union and intra-union rivalries, political infiltration, meagre funds, illiteracy of workers, lack of integrity and dedication on the part of many trade union leaders, unhealthy attitude of employers and so on.

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Chapter 32

WORKERS' PARTICIPATION IN MANAGEMENT

Structure

Meaning

Workers' Participation Schemes in India

Summary

References

MEANING

Though the concept of workers' participation in management has become very popular, it is very difficult to define it clearly, for there are various forms and levels of participation, ranging from the role of workers limited to making suggestions on certain matters which are not very important to active involvement in decision-making and administration.

As the International Institute of Labour Studies remarks, "the participation results from practices which increase the scope for employees' share of influence in decision-making at different tiers of the organisational hierarchy with concomitant assumption of responsibility."[1] We should hasten to add here the apt remark of group of practising managers that "workers' participation in management is involvement of workers only in such areas of activities of the enterprises where they can make some positive contribution."[2] If the workers' mental and emotional involvement in decision-making and execution of programmes should be substantial, workers' participation may be defined as a "principle of ensuring industrial democracy through mutual understanding, faith, trust and cooperation of workers and managements by establishing an effective communication system for attaining the wholehearted involvement of each worker in the area of his competence and concern with a view to maximising results in regard to the achievement of the organisational goals and individual well-being."[3]

The extent of WPM varies very widely from making suggestions on certain matters to complete management of an enterprise.

However, as mentioned earlier, the form and extent of workers' participation in management varies widely. In some cases, it is limited to making suggestions on certain matters, whereas, at the other extreme, workers are represented on the Board of Directors so that they are a part and parcel of decision-making and administration; in some cases, even the whole management of the enterprise is vested in the workers.

Objectives

The objectives of workers' participation in management may vary from country to country and from enterprise to enterprise. However, the various objectives may be listed as follows:

1. To promote industrial peace
2. To promote industrial democracy
3. To give due recognition to the personality of the workers
4. To safeguard the interest of workers
5. To regulate the self-centred actions of the capitalists
6. To give a social orientation to the business
7. To ensure the best utilisation of the human resources
8. To improve employee morale
9. To satisfy workers' urge for self-expression
10. To improve industrial productivity.

Problems and Limitations

Workers' participation in management, however, poses certain problems and has some limitations.

1. Workers may not be competent enough to understand and appreciate the managerial aspects of the enterprise. This is particularly so in developing countries.

2. It has been argued that workers are more bothered about labour welfare and the like than about the growth, dynamics and challenging problems of the enterprise.
3. It is possible that the workers' representative in the management may be an outsider – a politician or a trade union leader. To that extent, the "real" participation or involvement of the workers is limited.
4. The possibility of the workers' representative on the Board falling in line with the capitalists against the interests of the workers cannot be completely ruled out.
5. The worker-management collaboration may sometimes turn against the interest of society. The capitalist may get the support of labour to exploit the consumers. Labour may lend its support to the capitalist in this respect if it can also share the enlarged cake.

Forms of Participation

As mentioned earlier, the forms and levels of labour participation in management may vary widely between enterprises. The nature of participation depends on a number of factors, such as the socio-political attitudes and situation, the attitude of management and labour, labour-management relations, the relative strengths of labour and management, the peculiarities of the industry or enterprise, etc. Further, "there could be various forms of managerial decisions in social, personnel and economic matters which have an impact on the workforce of an enterprise. Some decisions, especially economic ones, can be taken only at the higher level where basic policies are decided. There are also some decisions at the middle and lower levels concerning the formulation and execution of policies, especially in the area of social and personnel matters."[4] Accordingly, "workers' participation in management will have to be at different levels and in different forms. Workers may be given an opportunity to influence or take part in managerial decisions at the higher level through their representatives on Supervisory Boards or the Board of Directors or through Work Councils. Participation may also be at lower levels at which workers are given some authority to plan and take decisions about their work, like job enrichment, job enlargement, delegation, etc. Workers may participate in managerial decisions through collective bargaining. They may also participate informally through the participative style of supervision. Some consider that workers' participation in ownership is also a form of participation. However, it has to be realised that participation is the result of an enterprise through profit sharing or some schemes does not, in the real sense mean participation in management."[5]

WPM can be at different levels and different forms, ranging from lower levels to Board level.

The common forms of workers' participation in management are the following:

Collective Bargaining: It is common to decide certain matters, especially those which have direct economic significance for workers, on the basis of collective bargaining. The growth of trade unionism, the workers' awareness of their rights and strength, and the recognition of the importance of negotiations by labour and management have contributed to the growth of collective bargaining. Some of the common subject matters of collective bargaining are wages, bonus, working conditions, and welfare matters.

Joint Consultation: The functions of joint bodies, comprising representatives of the management and employees, may range from decision-making on some issues to merely advising the management as consultative bodies. Joint consultation as a form of WPM is common in countries like India and Britain. The essential features of the Joint Management Council in India are the following.

(a) The Council is entitled to be consulted on certain specified matters.

(b) In some others, the management is expected to share information with the Council, and, in a set of functions, administrative responsibilities have to be given to it.

Though the Joint Management Councils/Committees have been tried in some countries, they have, generally, "not been found effective". There is a certain amount of lack of clarity of objectives. Moreover, being advisory or consultative bodies, neither the management nor the workers take them seriously. Often, they merely work as forums where workers and management freely vent their complaints and grievances without solving them. Some consider that unless these joint committees are vested with powers to take binding decisions, they will remain ineffective. There are others who feel that such joint committee should not be given authority to take decisions on such issues as are normally the concern of the management. In such a case, joint management committees would be accused of shedding their advisory role and becoming a kind of management body instead; and no sooner does Committee become managerial, there would be need for a new consultative body.[6]

Joint Decision-making and Administration: For the purpose of joint decision-making and administration, the workers are represented on the Board of Directors. Sometimes, the worker representative's role is limited to participating in decision-making; but the actual execution of the programmes is the responsibility of the management. In the area of joint administration, however, workers and management share the responsibility and power of execution. In India, the scheme of worker-directors has been introduced, both as a statutory arrangement in nationalised banks as well as voluntary one in selected Central public enterprises. As Virmani observes, though "legally the workers' representative on the Board may have all the rights and obligations like the other members of the Board, his ability to participate in managerial decision-making, to a large extent, will depend on his quality, his knowledge of company affairs, his educational background, his level of understanding and also on the number of worker representatives on the Board. Most of the decisions in which the workers are interested are normally made at the lower levels of management."[7]

Complete Control of Management: In some cases, like the system of self-management in Yugoslavia, workers have complete control over the management of the enterprises. Under the system in Yugoslavia, the workers have the option to influence all the decisions taken at the top level; but in actual practice, the Board and the top management team assume a fairly independent role in taking policy decisions for the enterprise, especially on economic matters. The system of complete control of management cannot, obviously, fit into a capitalistic system. A potential danger of complete control of management by the workers is that, like capitalists, the workers might try to maximise their benefits even at the expense of the consumers or society.

Workers' Participation in Share Capital: As the Sachar Committee observes, workers' participation in equity and in management are in some sense interrelated from the point of view of attaining the ultimate goal of co-partnership in industry. In favour of the workers' participation in share capital, it has been said that, besides giving them a sense of dignity and status as co-partners, equity participation secures for them a share in the company's future prosperity while holding out promises for improved industrial relations and steady growth of internal finances for the company's operations. It has also been said that the improved performance of industry and harmonious industrial relations pave the way for the ultimate gain of the community as well as the State.

The majority view of the Sachar Committee was that in all future issues of shares by the companies, they should reserve a portion of new shares, say, about 10 to 15 per cent, exclusively for the workers, to be called workers' shares. These shares in the first instance must be offered to the existing shareholders or to the public.[8]

It may be noted that several private enterprises, particularly in the IT sector, in India have introduced employee's stock option scheme (ESOP) to attract and retain talented people and many employees have become multi-millionaires' thanks to the appreciation of the stock prices.

WORKERS' PARTICIPATION SCHEMES IN INDIA

The Government of India is of the view that, at the enterprise level, workers' participation in management should become an integral part of the industrial relations system to serve as an effective instrument of modern management, and that it should be made a vehicle for transforming the attitudes of both employers and workers with a view to establishing a cooperative culture which may help in building a strong, self-confident and self-reliant country with a stable industrial base.

In the discussion on WPM in the Indian Labour Conference, while workers wanted 50 per cent representation at the Board level, employers wanted to confine it to only one representative.

The Directive Principles of State Policy, enshrined in the Indian Constitution, lays down that "the State shall take steps, by suitable legislation or in any other way, to secure the participation of workers in the management of undertakings, establishments or other organisations engaged in any industry" (Article 43A). Some of the Five Year Plan documents and industrial policy statements have also mentioned the importance of labour participation in management.

Various measures have been tried in India to promote workers' participation. Starting with the limited scheme of statutory Works Committees, voluntary arrangements were made in the form of joint management councils, the scheme of worker-directors, both as statutory arrangements in nationalised banks as well as a voluntary one is selected Central public enterprises; and voluntary schemes of workers' participation in the manufacturing/mining industries introduced in 1975 and in commercial and service organisations in the public sector introduced in 1977.

Works Committees/Joint Committees

The Industrial Disputes Act, 1947, provides for the setting up of a Works Committee, consisting of representatives of management and employees, in every undertaking employing 100 or more workmen "to promote measures for securing and preserving amity and good relations between the employer and workmen and, to that end, to comment upon matters to their concern and endeavour to compose any material difference of opinion in respect of such matters." The representatives of the workmen, whose number shall not be less than the number of representatives of the employer, are to be chosen from among the workmen engaged in the establishment and in consultation with their recognised trade union, if any.

The usefulness of the Works Committees as a channel for joint consultation and the need for strengthening and promoting this institution was stressed in the labour policy statements in the successive Plans. The legal requirement and encouragement given by the Government led to the setting up of works committees in a number of undertakings. The Works Committees, however, have not proved effective. The vagueness in the legal definition of the scope and functions of the Committees was a major reason for this ineffectiveness. To remedy this defect, the Indian Labour Conference in 1956 drew up an illustrative list of items which Works Committees would normally deal with, and a list of items which would be beyond their scope.

The items which Works Committees would normally deal with include consultation on:

1. The conditions of work, such as ventilation, lighting, temperature and sanitation, including latrines and urinals.
2. Amenities, such as drinking water, canteens, dining rooms, rest rooms, medical and health services.
3. Safety and accident prevention, occupational diseases and protective equipment.
4. Adjustment of festivals and national holidays.
5. Administration of welfare and fine funds.

WPM through Works Committees has not been successful because of the method of constitution of WCs and the functions assigned to them.

6. Educational and recreational activities.
7. Implementation and review of decisions arrived at in meetings of Works Committees.

The items specifically excluded were discussion on:

1. Wages and allowances.
2. Bonus and profit-sharing bonus.
3. Rationalisation and matters connected with the fixation of the workload.
4. Matters connected with the fixation of a standard labour force.
5. Programmes of planning and development.
6. Matters connected with retrenchment and lay-off.
7. Victimisation for trade union activities.
8. Provident fund, gratuity schemes and other retirement benefits.
9. Quantum of leave, and national and festival holidays.
10. Incentive schemes.
11. Housing and transport services.

In spite of these clarifications, the Works Committees have not, generally, proved very successful.

Reasons for Failure

A number of factors have contributed to the failure of Works Committees.

In the evidence before the National Commission on Labour (NCL), State Governments expressed the view that the advisory nature of the recommendations, vagueness regarding their exact scope and functions, inter-union rivalries, union opposition, reluctance of employers to utilise such media etc. have rendered Works Committees ineffective. The employers' associations have attributed the failure of Works Committees to factors like inter-union rivalries, union antipathy, and the attitude of members (workers' wing) in trying to raise in the Committee discussions extraneous issues. According to the unions, conflict between the Works Committees and the unhelpful attitude of the employers had generally led to their failure.

Suggestions

The NCL indicated that the effectiveness of these committees will depend on the following factors.

1. A more responsive attitude on the part of the management.
2. Adequate support from unions.
3. A proper appreciation of the scope and functions of the Works Committees.
4. Wholehearted implementation of the recommendations of the Works Committees.
5. Proper coordination of the functions of the multiple bipartite institutions at the plant level.

Joint Management Councils

The Scheme of joint management councils (JMCs) is based on a draft prepared by the tripartite committee appointed by the 15th Session of the Indian Labour Conference, as subsequently modified by two tripartite national seminars on the subject held in 1958 and 1960.

Objectives: The main objectives in the establishment of JMCs were:

1. To promote cordial relations between management and workers.
2. To build up understanding and trust between management and workers.
3. To effect a substantial increase in productivity.
4. To secure better welfare and other facilities for workers.
5. To train the workers to understand and to share the responsibilities of management.

Functions: The essential features of the scheme of JMC are:

1. The Council is entitled to be consulted on certain specified matters.
2. In some others, the management is expected to share information with the Council.
3. In a set of functions, administrative responsibilities have to be given to it.

(a) The Councils would be consulted by the management on such matters as:

1. The administration of Standing Orders and their amendment, when needed.
2. Retrenchment.
3. Rationalisation.
4. Closure, reduction in, or cessation of operations.

(b) The Council/Councils would also have the right to receive information, to discuss and to give suggestions on:

1. The general economic situation of the concern.
2. The state of the market, production and sales programmes.
3. The organisation and general running of the undertaking.
4. The circumstances affecting the economic position of the undertaking.
5. The methods of manufacture and work.
6. The annual balance sheet and profit and loss statement and connected documents and explanation.
7. Long-term plan for expansion, re-deployment.
8. Such other matters as may be agreed to.

(c) The Councils would be entrusted with administrative responsibility in respect of:

1. Administration of welfare measures.
2. Supervision of safety measures.
3. Operation of vocational training and apprenticeship schemes.
4. Preparation of schedules of working hours and breaks and of holidays.

JMCs have different roles in respect of different categories of matters.

5. Payment of rewards for valuable suggestions received from the employees.

6. Any other matter.

(*d*) All matters, *e.g.,* wages, bonus, etc., which are subjects for collective bargaining, are excluded from the scope of the Council/Councils. In short, the creation of new rights as between employers and workers should be outside the jurisdiction of the Management Council. Individual grievances are also excluded for its/their scope.

Shop/Departmental Councils and Joint Councils

In October 1975, the Government announced a model scheme for workers' participation in management. This scheme, meant for implementation in all manufacturing and mining enterprises employing 500 or more workers, envisaged shop councils at shop/departmental levels and a joint council at the enterprise level.

The two councils were to have an equal number of representatives of the employers and employees. The representatives of the workers on the councils were to be nominated by the management, in consultation with the union, from amongst the workers actually engaged in the enterprises. All decisions of a Shop Council should be on the basis of consensus and not be a process of voting, provided that either party might refer the unsettled matters to the Joint Council for consideration. Every decision of the shop council is to be implemented within a month, unless otherwise provided in the decision itself.

The main functions of the Shop Council are to help management in achieving production targets, improving productivity, assist in maintaining general discipline in the shop, attend to physical conditions of working, welfare and health measures, and to ensure a proper flow of adequate two-way communication between the management and the workers, particularly on matters relating to production schedules and the progress in achieving the targets.

The main functions of the Joint Council are fixation of productivity norms, dealing with the unresolved problems referred to it by the Shop Councils, awarding of rewards for creative suggestions from workers, ensuring optimum use of raw materials, ensuring the quality of finished products, etc.

The issues thrown up by the working of the scheme of 1975 were discussed at a tripartite labour conference held in May 1977. On the recommendations of the conference, a Committee on Workers' Participation in Management and Equity, consisting of representatives of central organisations of employers and trade unions, of some of the States and professional institutions of management, was appointed in September 1977. The report of the Committee submitted to the Government showed that a majority of the members favoured adoption of a three-tier system of participation, *viz.,* at the corporate level, at the plant level and at shop-floor level. The Committee laid down the detailed functions of the various councils at shop, plant and corporate levels. It commended that the workers' representatives on the participation forums should be optional. Further, it recommended that an organisation be set up, both at the Centre and in the States, to monitor the implementation of the scheme and review its working.

The Government introduced in 1983 a new and comprehensive scheme for the workers' participation in Central public sector undertaking. The State Governments have been requested to introduce it in their enterprises and the private sector has also been encouraged to introduce the scheme.

The issue of WPM was discussed by the Indian Labour Conference in November 1986 and the conference agreed in principle to the implementation of the scheme of workers' participation in public, private and cooperative sectors.

BOX 32.1 : IMPERATIVES OF WORKERS' PARTICIPATION IN MANAGEMENT

There is overwhelming evidence to suggest that wherever the system has been introduced the enterprises and the economy as a whole have shown tremendous growth. Workers and the management have to join together to not only sort out their day-to-day problems, but build up confidence in each other, improve work culture, ensure the introduction of new technology; improve production processes, achieve production targets, smoothen retrenchment and welcome introduction of new technologies, to make the enterprises capable of standing up to global competition.

Our efforts made in this regard during more than half century underline the extreme importance of a cooperative approach. Almost all the economically advanced nations have worked out their own variants of industrial cooperation and co-determination. All of them have found systems of participatory management useful and beneficial for efficiency; and for creating the atmosphere necessary to meet the demands of competitiveness.

It has also improved human relations which has led to improved industrial relations.

Content of work has undergone a sea change in many essential processes and all production processes are no longer carried out under one roof. The knowledge worker has taken the place of the old unskilled worker. Collective excellence, it has been found, depends very much on cooperation, voluntary vigilance and coordination.

India cannot be an exception to this state of affairs in the age of new technology.

Globalisation will accentuate and accelerate this process. It will, therefore, make it necessary for us to reach higher levels of participatory activity. With globalisation, the time has come when we cannot leave the question of participative management to be determined by the management or the trade unions. We believe, therefore, that the time has come for the Government to enact a law to provide for participatory forums at all levels keeping in mind the necessity to ensure that the responsibility and freedom to take managerial decisions are not fragmented to the detriment of the enterprise, the social partners or society at large.

(Adopted from the Report of the National Commission on Labour, 2002)

SUMMARY

Although the concept of workers' participation in management is very popular, there is no unanimity of opinion as to what should it exactly be. Indeed, the form and extent of workers' participation in management varies widely. In some cases, it is limited to making suggestions on certain matters, whereas, at the other extreme, workers are represented on the Board of Directors so that they are a part and parcel of decision-making and administration; in some cases, even the whole management of the enterprise is vested in the workers. However, in India, the general view seems to be that "workers' participation in management is involvement of workers only in such areas of activities of the enterprises where they can make some positive contribution."

The various objectives of workers' participation in management include promotion of industrial peace and industrial democracy; safeguarding of the interests of workers; satisfying workers' urge for self-expression; improving employee morale; regulating the self-centred actions of the capitalists and giving a social orientation to the business etc.

There are several problems in realising a meaningful workers' participation in management. Workers may not be competent enough to understand and appreciate the managerial aspects of the enterprise; they may be more bothered about labour welfare and the like than about the growth, dynamics and challenging problems of the enterprise. If the workers' representative in the management is an outsider – a politician or a trade union leader – the "real" participation or involvement of the workers is limited. There is also possibility of collusion between the workers' representatives and the capitalists.

The common forms of workers' participation in management are summarised in Figure 32.1.

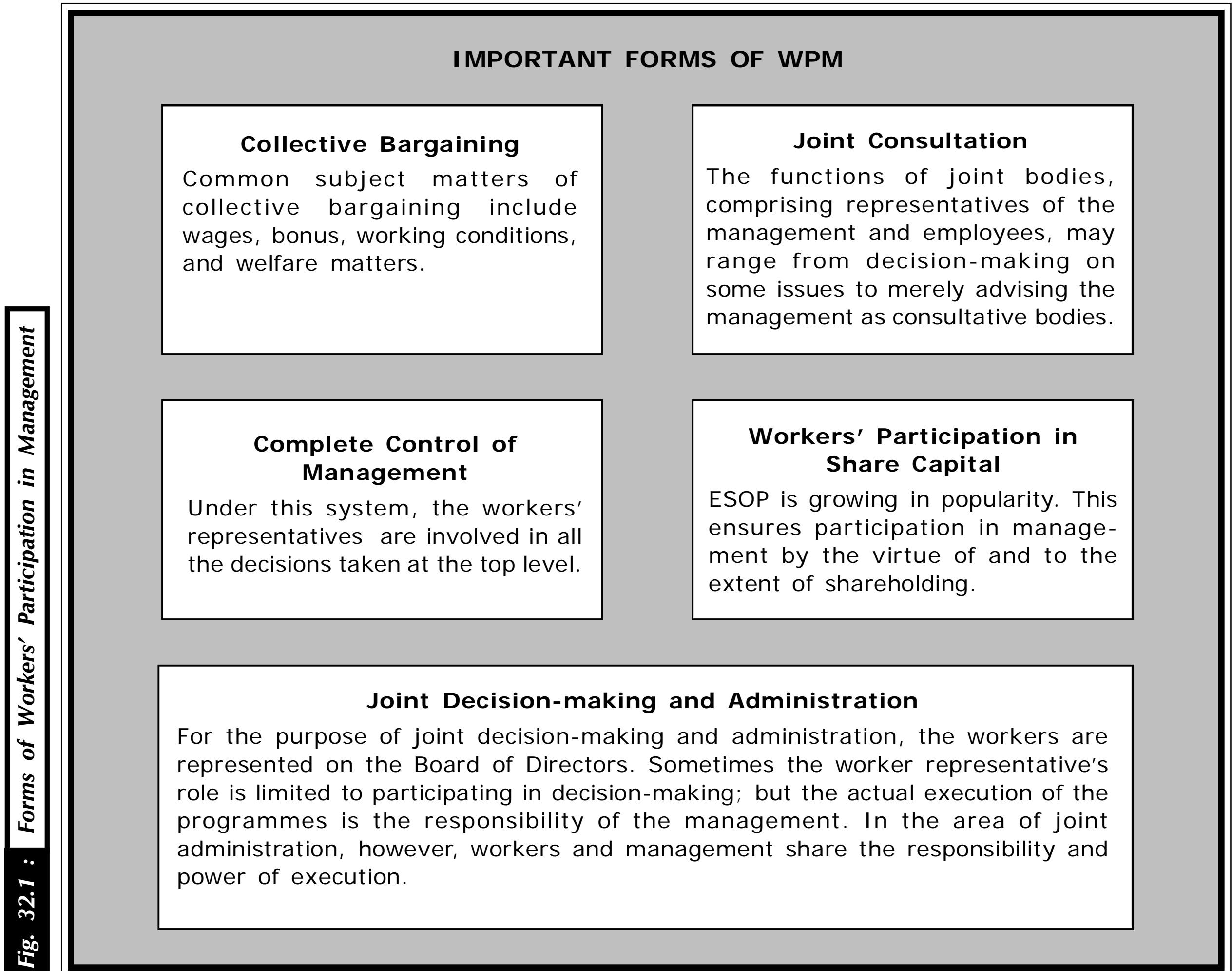

Fig. 32.1 : Forms of Workers' Participation in Management

Various measures have been tried in India to promote workers' participation. Starting with the limited scheme of statutory Works Committees, voluntary arrangements were made in the form of joint management councils, the scheme of worker-directors, both as statutory arrangements in nationalised banks as well as a voluntary one is selected Central public enterprises; and voluntary schemes of workers' participation in the manufacturing/mining industries and in commercial and service organisations in the public sector. Figure 32.2 gives summary view of the schemes of workers' participation in management in India.

WPM SCHEMES IN INDIA

Works Committees/Joint Committees

The Works Committee, which is statutory requirement in undertaking employing 100 or more workers, consisting of representatives of management and employees, may be consulted on matters related to the working conditions and labour welfare. A number of matters such as wages and allowances; bonus; provident fund, gratuity schemes and other retirement benefits; rationalisation; retrenchment and lay-off, planning and development are specifically excluded from the scope of these committees.

Joint Management Councils

JMC (1) is entitled to be consulted on certain specified matters. (2) In some others, the management is expected to share information with the Council. (3) In a set of functions, administrative responsibilities have to be given to it. The Councils would be consulted by the management on such matters as administration of Standing Orders and their amendment, retrenchment, rationalization, closure/ reduction in, operations. Matters of collective bargaining and individual grievances are also excluded from their scope.

Shop/Departmental Councils and Joint Councils

Both the Councils shall have an equal number of representatives of the employers and employees. The main functions of the Shop Council are to help management in achieving production targets, improving productivity, assist in maintaining general discipline in the shop, attend to physical conditions of working, welfare and health measures, and to ensure a proper flow of adequate two-way communication between the management and the workers, particularly on matters relating to production schedules and the progress in achieving the targets.

The main functions of the Joint Council are fixation of productivity norms, dealing with the unresolved problems referred to it by the Shop Councils, awarding of rewards for creative suggestions from workers, ensuring optimum use of raw materials, ensuring the quality of finished products, etc.

ESOP

Now, many organisations, particularly in IT sector, have Employees' Stock Option Scheme.

Fig. 32.2 : Schemes of Workers' Participation in Management in India

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Chapter 33

EXIT POLICY

Structure

Need for Exit Policy

Extent of Overmanning

VRS and Golden Handshake

National Renewal Fund

Conclusion

Summary

Reference

With the new economic policy which would pave way for economic restructuring, *Exit Policy* has become a widely debated subject in India.

Exit policy refers to the policy regarding the retrenchment of the surplus manpower resulting from restructuring of industrial units or the workers becoming unemployed by the closure of sick units. The exit policy in its wider context covers the policy for the compensation for the employees who leave the organisation and the measures for their rehabilitation also.

NEED FOR EXIT POLICY

Surplus manpower is a major problem of many industrial units in India. In other words, the industrial sector too is characterised by *disguised unemployment*. (There is disguised unemployment if some labour employed in an enterprise can be withdrawn without adversely affecting the production. This concept was originally used to describe the situation which exists in the agricultural sector of the developing countries.) This problem is very rampant in the public sector. The private sector also seriously suffers from this problem.

An exit policy is often required to facilitate corporate restructuring and to redeploy/reemploy workers.

In the seller's market which existed in India under the protected economic system, the high costs of surplus manpower employed by the companies could be passed on to the consumers by way of high prices. However, survival in a competitive system demands cost efficiency improvement and cost reduction in every possible way. It may become necessary not only to get rid of the surplus manpower under the existing technology but also to cut the labour force size further due to modernisation. In some cases, it may also become necessary to give up some of the lines of business to maintain or improve the health of the enterprise. Thus, some of the measures which industrial undertakings take to improve the competitiveness and to ensure survival would render a part of the existing manpower unemployed. If the enterprises do not take such measures in time, it may even ultimately lead to the closure of the units throwing all the workers unemployed.

There are also a large number of unviable sick units, both in the public and private sectors. There is no economic and social justification for their continuation. Those who argue that the State should run the sick units fail to recognise the fact that the society will have to bear the cost of the huge losses these units make and that amount could be invested elsewhere for generation of productive employment or for enhancing the social welfare.

If the required restructuring to improve competitiveness and the closure of unviable sick units are not allowed, the whole economy would become sick in due course. There are, therefore, no options.

The new economic policy may create unemployment at the enterprise level in a large number of cases. It does not, however, mean that NEP would increase the total unemployment in the economy. Contrary to that, it would help increase the total employment. In fact, a deviation from the old policy was a must even to maintain the existing level of employment in the long run.

Technology is becoming more and more labour-saving. Technological developments are making several industries which in the past were labour-intensive more and more capital-intensive. Countries which do not adapt themselves to the changing environment would ultimately see their employment shrinking.

Technological developments which increase productive efficiency are affecting employment in many organisations all over the world. Downsizing the manpower is inevitable due to other reasons also. The multinational giant IBM which has assiduously followed a cardinal philosophy of non-retrenchment for a very long time has been compelled to give up this policy. Modernisation

or restructuring may lead to job cuts at the enterprise level. But will this mean a fall in total employment or only a change in the pattern of employment generation? The evidence from other countries suggests the latter. Had this not been so, the level of unemployment would have been highest in Japan where the rate of technological change is the swiftest. Instead, it is the lowest, with Germany only a step behind.

One of the major failures of Indian system has been the inability to recognise the implications of technological developments. The unpragmatic employment protection policies have created many long-term problems. "Experience the world over suggests that modernisation can work only if labour is trimmed sharply. Modern looms need only one-fifth the labour that obsolete ones do. If a company cannot shed labour, modernisation will saddle it with both high capital costs and high labour costs, a recipe for bankruptcy. Indeed, the inability of the Indian firms to tailor their workforce to the level of capital employed has been an important reason why firms have not modernised. This rigidity in the labour market has also meant that the Indian labour, contrary to popular belief, is not at all cheap. The Japanese have pointed this out often, saying that while it may be cheap in the first round of investment, thereafter it becomes expensive because swift capital-labour adjustment are just not possible."

It is high time that India corrected the growth defeating policy of protecting the existing jobs at high social costs. Employment generation by the industrial sector depends, *inter alia,* on the dynamism of the industrial sector.

EXTENT OF OVERMANNING

A large member of the people employed in the industrial and other sectors of India is surplus. However, there is no reasonably accurate estimate of the extent of the surplus of the manpower employed.

Many industrial enterprises and other organisations in India are overburdened by huge excess manpower.

The overmanning has two dimensions, *viz.,* the surplus even with the existing technology employed by the enterprises and the surplus that will emerge if the existing technology is replaced by modern technology.

In many cases, the Indian industry uses more labour than those in other countries even when the technology used is the same. *For example*, the Aditya Birla Group uses the same textile machinery in India that it does in its other plants in South-East Asia. But it takes just two workers to process 100 kg. of yarn in Indonesia and three in Philippines and Thailand; in India, Birla's Grasim Industries needs seven people for the same job. This made the labour cost of processing 100 kg. of yarn in India 14 times more than it in Indonesia.[1]

Use of obsolete technology causes very high labour costs. The use of obsolete technology makes cost of production very high in India in several cases. For instance, while it took a South Korean worker 11 hours to make a tonne of steel, his counterpart in TISCO would take two days. With vintage factories, some of which were more than 75 years old, ACC produced 475 tonnes of cement per worker while Gujarat Ambuja produced 2000 tonnes per head.

By estimating the number of workers in sick public and private sector units, Sudipto Mundle arrived at a figure of 2.4 million surplus manpower in the industrial sector in India. Assuming the same level of redundancy in government employment (18 per cent), Mundle has assumed for estimating the surplus in public sector companies, *Business Today* estimated that 1.8 million of the total of over 10 million government staff, including administrative staff and workers in departmental undertakings (like railways, telecom, etc.) was excess.

According to Pramod Verma, even without technological change, it should have been possible to reduce labour by five to seven per cent which meant between 13 and 18 lakh people and if technology was upgraded, the organised sector would lose another 25 lakh jobs.

The problem of excess manpower is particularly serious in the public sector.

A study by the Textile Ministry had estimated that there was 80,000 surplus workers in the National Textile Corporation (44 per cent of total employment). There was a surplus of about 50,000 workers in Coal India and this figure could be much higher once the technology for underground mining was upgraded. Besides, the Singareni Collieries which had been referred to the BIFR, had about one lakh workers.

A study by Mrityunjaya Athreya, conducted in 1987, revealed that the Steel Authority of India (SAIL) had a surplus of 80,000 workers.

At least 50 per cent of the workers of the State road transport undertakings were estimated to be surplus. The same may be true of state electricity boards.

The figures given above give some indication of the extent of the alarming overmanning of the Indian economy.

VRS AND GOLDEN HANDSHAKE

It is necessary to dispense with the excess manpower for improving the health of an organisation. If this is not done, the excess labour could cause industrial sickness.

A popular method to trim the manpower is the voluntary retirement scheme (VRS). Under the VRS, employees who have attained forty years of age or ten years of service would seek voluntary retirement. The minimum benefits under this scheme would be forty-five days' emoluments for each completed year of service before normal date of retirement or the monthly emoluments at the time of retirement multiplied by the remaining months of service before the normal date of service, whichever is less. The benefits would be in addition to the amount that has accrued to the Provident Fund as per the rules or to the Gratuity fund whichever is applicable.

Some companies offer very attractive package of benefits to the employees who would opt for VRS. Such schemes are often referred to as golden handshake scheme. While the golden handshake scheme offered by some companies in the past worked very well, the offers made by some other companies failed to elicit the required response from the employees. An important reason for this was said to be the higher expectations workers began to entertain as the concept of golden handshake became popular. The VRS offered by some banks like the SBI and Canara Bank in 2001 have got very high response.

One possible drawback of the VRS is that the efficient employees would leave the company while the inefficient may stay back; the efficient ones would be hopeful of alternatives outside while the inefficient may not be very optimistic.

A number of companies have already reduced their workforce by VRS. These VRSs have taken different forms. In fact, the process of getting rid of the excess labour started in several companies much before the economic reforms ushered in India.

The ACC had brought down its workforce from 25,000 to 16,000 in 10 years. Between 1987 and early 1993, SAIL got rid of 17,000 workers through its VRS and by 2000 another 57,000 were estimated to retire.

The VRS takes different forms. While in SRF Ltd. the VRS cost was a low ₹ 25,000 to one lakh per head, in Hindustan Geigy it was about ₹ 4.4 lakh per head on an average. The absolute limit set by the government is ₹ 5 lakh.

The NTC had offered looms at subsidised rates to the workers under the VRS package. They are also offered sheds for housing the looms and marketing facilities to sell their production. Between November 1992 and March 1993, 25,000 NTC workers had accepted VRS. Road transport firms can offer buses to the employees under the VRS.

Between April 1997 and March 1999, the central public undertakings reduced their manpower by over one lakh.

NATIONAL RENEWAL FUND

A very important step taken by the Central Government to benefit the workers affected by industrial restructuring, modernisation or closure of the unit was the establishment of the National Renewal Fund which was operationalised in 1992. The objectives of the NRF are the following.

1. To provide assistance to firms to cover the cost of retraining and redeployment of employees arising as a result of modernisation and technological upgradation of existing capacities and from industrial restructuring.
2. To provide funds for compensation to employees affected by restructuring or closure of industrial units, both in the public and private sectors.
3. To provide funds for employment generation schemes in the organised and unorganised sectors in order to provide social safety net for labour.

The NRF is administered by the Department of Industrial Development. The first set of cases taken up by the Department were those relating to the National Textile Corporation.

The NRF was proposed to have a corpus of ₹ 2,000 crore which would be contributed by three sources; ₹ 200 crore as budgetary support (the 1991-92 Budget earmarked this amount); ₹ 1,000 crore from the disinvestment of public sector undertaking's shares and ₹ 800 crore from the World Bank.

The NRF was proposed to have two parts. The first part is the Employment Generation Fund, which would provide resources to approved employment schemes in the organised sectors. The second part is the National Renewal Grant Fund to meet the compensation and training expenditures of retrenched workers.

The World Bank has offered (in February 2001), to fund Government of India's downsizing plan, estimated to cost a minimum of ₹ 5,000 crore, provided the Government is willing to settle for a young bureaucracy.

CONCLUSION

Although a full-fledged, detailed exit policy has not yet been formulated, the establishment of the National Renewal Fund is very important step. This is indeed a clear indication of the appreciation of the need for modernisation, restructuring and even closure of units in inevitable cases and that if these measures render workers unemployed the right policy is not to resist such measures but to retrain and redeploy the workers to the extent possible.

Schemes like NRF should not be made completely dependent on the national exchequer. A scheme for regular contribution to such a fund by the companies and workers should be designed and implemented.

As mentioned earlier, many companies and organisations all over the world, one time or the other, have faced the problem of surplus manpower. It was reported that the Chinese Government had decided to bring about sweeping changes in the Central Government structure causing a 20 per cent cut in the number of government employees. India cannot afford to be blind towards hard realities. Organisations should be allowed and facilitated to swiftly respond to environmental realities to enable them to become efficient and competitive.

Many a time vested interests mislead workers in respect of exit policy

The workers have a lot of apprehension about the very term exit policy. One of the important objectives of an exit policy is to protect the interests of the workers. However, instead of educating the workers about it, the trade unions and politicians seem to be causing unnecessary fears in the minds of the workers. It is pointed out that "the exit policy on which the union bosses are currently declaiming pertains to their own impending exit and not that of the common worker.

It is almost a certainty that the average retrenched blue-collared person will get a fair deal by way of compensation, retraining and redeployment."

In fact, "the biggest loser of not having an exit policy is the labour because the legitimate interests of labour are protected only when there is a legal closure of a sick mill. In a situation of a sick unit not functioning and not legally closed, workers may remain years together without employment, wages and not getting their legitimate dues. One may therefore, argue that "if properly implemented, it is the most pro-labour policy imaginable."

There is however, a growing realisation among the workers of a need to increase productivity to survive the domestic and foreign competition; if firms do not shed the excess manpower all the workers would sink with the firm. While in some companies the unions cooperate with the VRS, in several companies they have strongly opposed. In a number of cases, the workers defied the call of the unions to boycott the VRS.

The response of the workers to the VRS may depend upon the attractiveness of the scheme, their assessment of the future of the enterprise etc. In 1989, when the Hindustan Lever (HLL) lifted its year long lock-out at its Sewree plant in Bombay, more than 550 workers availed of the VRS. But in 1992 when the HLL offered another Scheme to retire 500 workers, only nine of them accepted it.

SUMMARY

Exit policy refers to the policy regarding the retrenchment of the surplus manpower resulting from restructuring of industrial units or the workers becoming unemployed by the closure of sick units. The exit policy in its wider context covers the policy for the compensation for the employees who leave the organisation and the measures for their rehabilitation also.

The economic liberalisation has made exit policy highly important because of restructuring of enterprises and closure of units.

Surplus manpower is a common problem of the private as well as the public sectors in India. In a globally competitive environment, no organisation can survive with large surplus human resource. It is, therefore, necessary to have an appropriate exit policy to make the transition smooth.

There is a feeling that exit policy is something anti-labour. The fact, however, is that the biggest loser of not having an exit policy is the labour. It is argued that "if properly implemented, it is the most pro-labour policy imaginable."

A popular method to trim the manpower is the voluntary retirement scheme (VRS). Some companies offer very attractive package of benefits to the employees who would opt for VRS. Such schemes are often referred to as golden handshake scheme. One possible drawback of the VRS is that the efficient employees would leave the company while the inefficient may stay back; the efficient ones would be hopeful of alternatives outside while the inefficient may not be very optimistic.

A very important step taken by the Central Government to benefit the workers affected by industrial restructuring, modernisation or closure of a unit was the establishment of the National Renewal Fund (NRF) with a view to: (1) providing assistance to firms to cover the cost of retraining and redeployment of employees arising as a result of modernisation and technological upgradation of existing capacities and from industrial restructuring; (2) providing funds for compensation to employees affected by restructuring or closure of industrial units, both in the public and private sectors; (3) providing funds for employment generation schemes in the organised and unorganised sectors in order to provide social safety net for labour.

The workers have a lot of apprehension about the very term exit policy. One of the important objectives of an exit policy is to protect the interests of the workers. However, instead of educating the workers about it, the trade unions and politicians seem to be causing unnecessary fears in the minds of the workers.

REFERENCE

1. **The statistics quoted in this subsection and in the next are from Neeraj Kaushal and Shekhar Gosh, "Axing 4 million Jobs" and Shekhar Gosh, "Painless Fair-well", *Business Today,* April 22-May 6, 1993.**

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Chapter 34

QUALITY CIRCLES

Structure

Origin and Development

Meaning and Nature

Structure

Objectives/Philosophy

The Process of QCs

Conditions for Success of QCs

Reasons for Failure

Conclusion

Summary

References

Annexure 34.1: Research Findings on Quality Circles

ORIGIN AND DEVELOPMENT

Quality Circle is a participative management concept that has been gaining more and more popularity. Although it is in Japan that this concept was concretised and demonstrated its enormous potential for contribution to increase in productivity and employee morale building, its rudimentary origin is traced to the United States where problem-solving groups have existed since the 1930s.

The quality circles developed in Japan in the 1960s. Much of their development was due to the early work of the American experts Joseph Juran and Edward Deming both of whom made frequent trips to Japan in the 1950s. "Deming emphasised statistical quality control while Juran emphasised the advantages of good group process in getting quality improvement suggestions from employees. During the late 1950s and early 1960s, many large Japanese Corporations began to take quality improvement seriously. As part of their strategy to improve product quality, they made widespread use of employee problem-solving groups called quality control circles".

QCs have become universal. They find application in almost every field of human activity: industry, offices, hospitals and other service organisations, family etc.

The quality circle in its form known today was conceived and introduced by Dr. Kaotu Ishikawa, a Japanese chemical engineer and quality control expert, when he was an Advisor with JUSE (Union of Japanese Scientists and Engineers) in 1962.

The role played by quality circles in transforming the Japanese industry, generally characterised by low quality of the products, to one which excels in quality and low cost has made the quality circles very popular in other countries too.

The quality circle concept took birth in India in 1980 when this concept was introduced in the Hyderabad unit of the Bharat Heavy Electricals Ltd. (BHEL). The growing popularity of the quality circles in India is evident from the increase in the number of organisations which introduced quality circles.

MEANING AND NATURE

A quality circle is "a voluntary group of people who meet together on a regular basis to identify, analyse and solve quality, productivity, cost reduction, safety and other problems in their work area, leading to improvement in their performance and enrichment of their worklife."[1]

Ideally, members of a particular circle should be from the same work area or who do similar work, so that the problems they discuss will be familiar to all of them.

The generally regarded ideal size of a QC is around ten members. As every member of the Circle is expected to actively participate in the QC meetings, a large number is not good. Too small a number of members would tend to make the circle dormant.

An organisation may have a number of QCs. If the number of workers of any particular department/section who volunteer to join the QC is more than the ideal number that one QC can accommodate, two or more circles may be formed in the same area. Thus, an organisation could have one or more QC in every department or section. There are organisations where all the workers have become members of QCs.

STRUCTURE

Figure 34.1 shows the structure of organisation of quality circles.

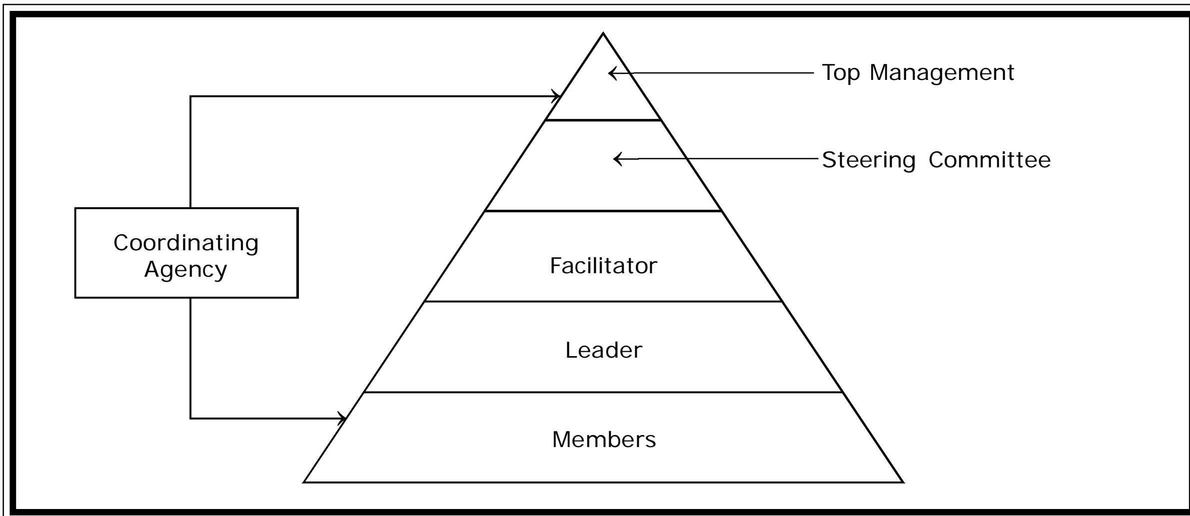

Fig. 34.1 : Structure of Organisation of Quality Circle

Top Management: For the success of quality circles, earnest support of the top management is essential.

Steering Committee: The Steering Committee usually consists of the heads of major departments of the organisation and is presided over by the Chairman who is preferably the Chief Executive of the organisation. Facilitators are invited to the Steering Committee for giving brief reports on the functioning of the circles in their respective areas.

The Steering Committee sets the goals and objectives for the quality circle activities which establishes operational guidelines and takes an overview of the quality circle activities.

Facilitator: The facilitator is a senior official nominated by the management responsible for facilitating and guiding QC activities in his area. The facilitator's functions include liaisoning with the coordinator on all aspects of QC activities; execution of all QC policies, procedures and code of conduct; upward and downward communications in respect of QCs, etc.

Leader: Every quality circle must have a leader whose functions include encouraging members to actively participate in the circle activities, ensuring proper conduct of the QC meetings, making regular progress reports and maintaining circle records, providing agenda for the meeting etc.

The leader is elected by the members. In many cases, a supervisor or foreman is initially chosen as the leader.

Members: Members are the group of workers who have voluntarily formed the quality circle. Workers who are not members of QCs are called non-members. The members are the core of the quality circle.

OBJECTIVES/PHILOSOPHY

The objectives/philosophy of the quality circles are the following.[2]

1. Reduce errors and enhance quality and productivity.
2. Inspire more effective teamwork.

3. Promote job involvement and participation.
4. Increase employee motivation.
5. Create problem-solving capability.
6. Build an attitude of 'problem prevention'.
7. Improve communication in the organisation.
8. Develop harmonious manager-worker relationship.
9. Promote personal and leadership development.
10. Develop a greater safety awareness.
11. Promote cost reduction.
12. Catalyse attitudinal changes for greater cohesiveness and teamwork.

THE PROCESS OF QCs

As indicated earlier, a quality circle is a group of people who meet at regular intervals, say once in a week or fortnight, to solve work-related problems. The process involves the following.

Identification of Problems: The members may be able to identify several problems in their area. Quality, productivity, cost reduction, housekeeping and safety are but some of the general categories of problems which may be identified by QC. Techniques such as brainstorming may be used to help problem identification.

The QC process is systematically sequenced.

Problem Selection: Problem selection is a prerogative of the Circle. When several problems are identified, a selection of problem(s) for the further process of the QC may become necessary.

Problem Analysis: The circle members analyse the selected problems. If needed, the circle may take the assistance of experts and consultants.

Recommendation to the Top Management: Finally, the circle makes its recommendations to its departmental heads in the first instance, normally once in 7-8 weeks, and selected cases of all circles are presented to the top management, normally once in 2-3 months (known as management presentation). In a management presentation, the leader and members describe to their manager what project they have been working on and what recommendations they wish to make concerning it.

It is the top management who decides whether the recommendation should be accepted and implemented.

CONDITIONS FOR SUCCESS OF QCs

There are a number of prerequisites for the success of QCs.

The success of quality circles depend on a number of factors like the following.

1. Active support and commitment from the part of top management.
2. Proper coordination.
3. Commitment and ability of facilitators and leaders.
4. Proper education about the quality circle philosophy and sufficient training for facilitators, leaders and members.

5. Systematic development of the quality circle movement. Only limited number of circles shall be started initially and the number should be increased gradually. Starting many circles initially or increasing the number very rapidly may cause problems of lack of concentration etc.
6. The first circles to start should be in those areas with scope for quick, tangible and easily visible results.

REASONS FOR FAILURE OF QCs

The important reasons for failure of QCs are:

1. Lack of commitment and support from the top management.
2. Lack of ability or commitment of facilitators and leaders.
3. Lack of sufficient education about QC philosophy and training to members, leaders and workers.
4. Opposition from trade unions.
5. Wrong notions about QC.

CONCLUSION

Many organisations have realised savings running into lakhs of rupees due to the implementation of suggestions of quality circles. There are enough evidences to show that quality circles can produce immense tangible and intangible benefits. These include cost reduction, improvements in operational methods, waste reduction, quality improvement, improvement in productivity, improvement in interpersonal communications, improvement in employee morale and labour-management relations, reduction in man-days lost, increase in profits etc.

However, there are also many cases of failures of quality circles because of the absence of the conditions necessary for their success mentioned above. There are also many cases of circles which were successful becoming dormant later. Absence of proper motivation, or a change in the top management resulting in lack of top management commitment to QC etc. could be reasons for this.

Quality circles are just a fad as far as a some managements are concerned.

The concept of quality circles does not envisage any direct monetary benefit to the members. Mainly because of this, some people argue that it is a management tactic to exploit the workers. It is not a right argument.

The workers may materially benefit from the quality circles. Some organisations have reward system for good employee suggestions. If the financial position of an organisation improves because of quality circles, it may enable the organisation to spend more on employee welfare, increase bonus etc. Further, if the QC helps prevent an enterprise from becoming sick that would save the workers from becoming unemployed by preventing the closure of the unit due to sickness.

Quality circles can play a great role in improving quality, increasing productivity, production and improving the health and competitiveness of the industrial and services sectors of India. It can greatly help in realising the potentials of the individuals working in an organisation, elevating the status of workers, improving interpersonal relations, improving employee morale and happiness, and improving industrial relations.

Quality circle is primarily "a people building philosophy and not people using." It is a "concept which combines humanistic, scientific, and spiritual principles in its concept and philosophy."

SUMMARY

Quality Circle (QC) is a participative management concept originated in USA but concretised and popularised by Japan. The role played by quality circles in transforming the Japanese industry, generally characterised by low quality of the products, to one which excels in quality and low cost has made the quality circles very popular in other countries too.

QCs, which have become universal, find application in almost every field of human activity: industry, offices, hospitals and other service organisations, family etc.

A quality circle is "a voluntary group of people who meet together on a regular basis to identify, analyse and solve quality, productivity, cost reduction, safety and other problems in their work area, leading to improvement in their performance and enrichment of their worklife".

The generally regarded ideal size of a QC is around ten members. Members of the QC are the group of workers who have voluntarily formed the quality circle. The members are the core of the quality circle. As every member of the Circle is expected to actively participate in the QC meetings, a large number is not good. Too small a number of members would tend to make the circle dormant. Ideally, members of a particular Circle should be from the same work area or who do similar work, so that the problems they discuss will be familiar to all of them. An organisation may have a number of QCs.

For the success of quality circles, earnest support of the top management is essential. A QC shall have a Steering Committee which, usually, consists of the heads of major departments of the organisation and shall have a Chairman who is preferably the Chief Executive of the organisation. Facilitators are invited to the Steering Committee for giving brief reports on the functioning of the circles in their respective areas. The Steering Committee sets the goals and objectives for the quality circle activities which establishes operational guidelines and takes an overview of the quality circle activities.

A QC shall also have a Facilitator who shall preferably be a senior official nominated by the management responsible for facilitating and guiding QC activities in his area. The facilitator's functions include liaisoning with the coordinator on all aspects of QC activities; execution of all QC policies, procedures and code of conduct; upward and downward communications in respect of QCs, etc.

Every quality circle must have a leader whose functions include encouraging members to actively participate in the circle activities, ensuring proper conduct of the QC meetings, making regular progress reports and maintaining circle records, providing agenda for the meeting etc:

The success of quality circles depend on a number of factors like active support and commitment from the part of top management; proper coordination; commitment and ability of facilitators and leaders; proper education about the quality circle philosophy and sufficient training for facilitators, leaders and members; and systematic development of the quality circle movement.

Failure of QCs are not uncommon. The important reasons for failure of QCs include lack of commitment and support from the top management; lack of ability or commitment of facilitators and leaders; lack of sufficient education about QC philosophy and training to members, leaders and workers; opposition from trade unions; and wrong notions about QC.

The quality circle concept took birth in India in 1980 when this concept was introduced in the Hyderabad unit of the Bharat Heavy Electricals Ltd. (BHEL). The growing popularity of the quality circles in India is evident from the increase in the number of organisations which introduced quality circles.

Quality Circles can produce immense tangible and intangible benefits. These include cost reduction, improvements in operational methods, waste reduction, quality improvement, improvement in productivity, improvement in interpersonal communications, improvement in employee morale and labour-management relations, reduction in man-days lost, increase in profits etc.

REFERENCES

1. **Quality Circle Forum of India, *Quality Circle*, 1990, p. 3.**
2. ***Ibid.*, pp. 4-5.**

ANNEXURE 34.1

Research Findings on Quality Circles

A doctoral research on Quality Circles by Bino Thomas,* done under the guidance of this author, has identified a number of benefits of QCs, reasons for the failure of QCs and the conditions necessary for their success. Some of the main findings of the study are reproduced below.

Impact of Quality Circles

Quality Circles, if properly practised, can produce substantial tangible benefits and significant intangible benefits.

Tangible Benefits: Various case studies presented by different Quality Circles on the diverse types of manufacturing companies demonstrate that Quality Circles can contribute to:

1. Reduction in wastage/scrap.
2. Financial saving and/or reduction in cost of production.
3. Innovativeness.
4. Increase in production.
5. Reduction in the frequency of breakdown of the machinery/machine down-time or increase in machine productivity.
6. Better quality.
7. Greater safety.
8. Better housekeeping.
9. Reduction in time loss/man-hour saving.
10. Work simplification.
11. Self-reliance.
12. Reduction in maintenance cost or replacement cost.
13. Reduction in rework/rejection.

Intangible Benefits: This study has observed that Quality circle has a number of intangible benefits. It has been found that Quality Circles:

1. Create an overall awareness of quality outlook in all spheres of operation.
2. Help to satisfy the higher human needs of recognition and self-development.
3. Provide the members with an opportunity to become involved more deeply with the organisation.
4. Help to increase job satisfaction.
5. Help to attain an increased feeling of belongingness to the organisation.
6. Help in acquiring qualitative leadership.
7. Help to achieve better attitude towards change.
8. Promote a participative culture.
9. Provide an opportunity to express workers' views regarding work-related problems.
10. Make an improvement in human relations and work area morale.

11. Enable better communication with the top management.
12. Enhance problem-solving capability of employees.
13. Encourage an attitude of problem prevention.
14. Foster better teamwork.
15. Help to achieve better inter-departmental cooperation.

Determinants of Success

The following conditions need to be satisfied for the success of Quality Circles in an organisation.

1. Quality Circles are to be made an integral part of the Total Quality Management.
2. Before launching the Quality Circle, all concerned should be made well aware of the Quality Circle philosophy and they are to be given proper training.
3. All levels of management should take a keen interest in the Quality Circle because the role played by the management in initiating, launching, spreading and sustaining Quality Circle is very crucial. If the top management takes an active interest, the management down the line will also follow suit.
4. The Quality Circle is to be conceived as a 'people-building' philosophy and not as a 'people-using' technique.
5. Feasible and useful recommendations of the Quality Circles are to be implemented. If any one of the suggestions cannot be implemented, the reasons for this are to be properly communicated to the Quality Circle.
6. Intelligent suggestions are to be appreciated and rewarded.
7. Workers should believe that Quality Circles benefit them as well as the organisation.
8. It is ensured that Quality Circle meetings are to be held regularly and properly.
9. Facilitators and leaders must be committed and competent.

Reasons for Failure of Quality Circles

The important reasons for the failure of the Quality Circles identified by this study are:

1. Some of the Quality Circles were introduced as a 'firefighting' measure without the Quality Circle philosophy being imbibed and without the proper steps of initiation and launching.
2. Lack of interest on the part of management.
3. Non-implementation of the recommendation made by Quality Circles and the failure of management in communicating to the Circles the reasons for non-implementation have resulted in the workers losing interest in the Quality Circles in some organisations.
4. Lack of commitment and inefficiency of facilitators and leaders.
5. Absence of a proper initiation.
6. In several cases, Quality Circle meetings were not held regularly. This indicates the lack of commitment on the part of the leader, facilitator, steering committee and the top management.

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Part 6

ECONOMIC PLANNING AND DEVELOPMENT

The scope of, pattern and direction of development, and scope of different businesses are affected by economic policy and development policy. The Five Year Plans and Perspective Plans determine the development objectives and strategy and set targets for the economy as a whole and for different sectors and sub-sectors. The Plans also indicate the scope/roles of public and private sectors and the priorities of development. The Plan outlays would depend, naturally, on the priorities, targets and roles. The scope and prospects of business in different sectors are affected by the development, strategies, priorities and resource allocations.

It may be noted that even the development plans for the agricultural sector have a number of implications for the industrial and commercial sectors. For example, plans to boost agricultural production may increase the demand for agricultural machinery like pump sets, inputs like fertilisers, pesticides and better seeds, materials like cement and steel (to build up irrigation systems etc.) and so on. The increase in the agricultural income in turn would increase the demand for the output of the consumer goods industries, other industries and services.

A lot of information needed for business decision-making like investment decision-making can be obtained by analysing the development plans like the Five Year Plans.

This *Part* provides a bird's eye view of the planning process and Five Year Plans in India, followed by a review of the industrial development strategy.

Chapter 35

PLANNING IN INDIA

Structure

The Planning Machinery

Formulation of the Plan

Review of the Plans

12th Five Year Plan

Performance of the Plans

Summary

References

The pattern of economic development in India is very significantly affected by Government planning. The direction of the development pattern of the various sectors and the relative priorities within each sector are determined by the Five Year Plans. The scope and prospects of different industries and other businesses, therefore, depend, to a very large extent, on the development planning.

THE PLANNING MACHINERY

Planning Commission

The Planning Commission plays a major role in the formulation of Five Year Plans.

The Planning Commission was set up in March 1950, by a Resolution of the Government of India, with the following functions.

- To make an assessment of the material, capital and human resources of the country, including technical personnel, and investigate the possibilities of augmenting such of these resources as are found to be deficient in relation to the nation's requirements.
- To formulate a plan for the most effective and balanced utilisation of the country's resources.

National Development Council

A number of Committees and Commissions are also working under or associated with the Planning Commission. One of the most important among them is the National Development Council (NDC). The NDC is presided over by the Prime Minister and is composed of Union Cabinet Ministers, Chief Ministers of States and Union Territories and Members of the Planning Commission. The other Union and State Ministers may also be invited to participate in the deliberations of the Council. The Secretary of the Planning Commission acts as Secretary of the NDC, and the Commission is expected to provide such administrative and other support as may be necessary. The main functions of the NDC are:

The role of the NDC signifies the federal and democratic nature of the Indian planning.

1. To prescribe guidelines for the formulation of the National Plan including the assessment of the resources for the plan.
2. To consider the National Plan as formulated by the Planning Commission.
3. To consider important questions of social and economic policy affecting national development.
4. To review the working of the plan from time to time and to recommend such measures as are necessary for achieving the aims and targets set out in the National Plan, including measures to secure the active participation and cooperation of the people, improve the efficiency of the administrative services, ensure the fullest development of the less advanced regions and sections of the community, and through sacrifice borne equality by all the citizens, build up resources for national development.

From the functions mentioned above, it is quite obvious that the NDC has a decisive role in the formulation and follow-up of the execution of the National Plan.

NITI Aayog

For six-and-a-half decades, the Five Year Plans of India were formulated by Planning Commission.

With effect from January 1, 2015, the Planning Commission was replaced by NITI Aayog (National Institution for Transforming India).

Functions

(i) (a) To evolve a shared vision of national development priorities sectors and strategies with the active involvement of States in the light of national objectives.

(b) To foster cooperative federalism through structured support initiatives and mechanisms with the States on a continuous basis, recognizing that strong States make a strong nation.

(c) To develop mechanisms to formulate credible plans at the village level and aggregate these progressively at higher levels of government.

(d) To ensure, on areas that are specifically referred to it, that the interests of national security are incorporated in economic strategy and policy.

(e) To pay special attention to the sections of our society that may be at risk of not benefitting adequately from economic progress.

(f) To design strategic and long-term policy and programme frameworks and initiatives, and monitor their progress and their efficacy. The lessons learnt through monitoring and feedback will be used for making innovative improvements, including necessary mid-course corrections.

(g) To provide advice and encourage partnerships between key stakeholders and national and international like-minded think tanks, as well as educational and policy research institutions.

(h) To create a knowledge, innovation and entrepreneurial support system through a collaborative community of national and international experts, practitioners and other partners.

(i) To offer a platform for resolution of inter-sectoral and inter-departmental issues in order to accelerate the implementation of the development agenda.

(j) To maintain a state-of-the-art Resource Centre, be a repository of research on good governance and best practices in sustainable and equitable development as well as help their dissemination to stakeholders.

(k) To actively monitor and evaluate the implementation of programmes and initiatives, including the identification of the needed resources so as to strengthen the probability of success and scope of delivery.

(l) To focus on technology upgradation and capacity building for implementation of programmes and initiatives.

(m) To undertake other activities as may be necessary in order to further the execution of the national development agenda, and the objectives mentioned above.

There does not appear to be any rationale for the replacement of the Planning Commission by the NITI. It is the result of the Narendra Modi government's eagerness to condemn the old system for the sake of it. It may be noted that the earlier BJP-led government did not feel it necessary to dismantle the Planning Commission.

The Planning Commission was a better organisation than the NITI Aayog. The Planning Commission was a more focused organisation with a clear role, unlike the new organisation

which with a gamut of roles and functions over a wide spectrum which can result in confusions and conflicts.

One of the criticisms of the Planning Commission by the advocates of the new regime is that under the old system the States did not have a role. The NDC described above makes it clear that it is not a correct view.

The view that liberalisation has made national planning irrelevant is not right. National planning is very much relevant for India. The right thing would have been to reform the Planning Commission appropriately.

In short, national planning continues to be very important for the nation and NITI Aayog is a wrong substitute for the Planning Commission.

STATE PLANS

State Plans account for about one-half of the total outlay of the Government under a Five Year Plan. The subjects that come under State jurisdiction include such vital sectors of development as agriculture, small industries, irrigation and power, roads and road transport, and education and social services.

A successful implementation of major national policy objectives calls for an organisation at the State level which can coordinate effectively and provide guidance to local democratic bodies, and take a wider view of development than is generally possible for individual departments. The States have Planning Boards and Departments which co-ordinate the work of other departments for the preparation of development plans, and present reports on the execution of State Plans. State Planning generally receives directions from a committee of the State cabinet and is supported by the State Statistical Bureau.

FORMULATION OF THE PLAN[1]

The preparation of a Five Year Plan is usually spread over a period of two to three years. The first stage is the consideration of the general approach to the formulation, involving an examination of the state of the economy, an appraisal of past trends in production, and the rate of growth in relation to the long-term view of the economy. Preliminary conclusions on these and related matters are submitted by the Commission to the Central Cabinet and to the National Development Council. On their approval, these are published in the form of a document and circulated widely for country-wide debate.

Formulation of the Five Year Plan is an elaborate exercise involving several stages.

The second stage consists of studies which are intended to lead to a consideration of the physical content of the plan. While these studies proceed, the Planning Commission constitutes groups for each sector, composed of its own specialists and those of Ministers and non-official experts, which review the situation in their respective fields and make the assumptions to be made in the formulation of the plan, and indicate the targets of production to be achieved.

While preliminary documents are being debated throughout the country, the Commission holds detailed discussions with the Union Ministers, State Governments and Union Territories at the highest level. The Consultative Committee of Members of Parliament on Planning keeps in close touch with plan formulation constantly by periodic meetings and informal discussions.

On the basis of the preliminary studies undertaken by the groups and discussions with the various interests, the Commission presents the main features of the plan under formulation in the form of a draft plan, which is discussed in detail by the Cabinet and is placed again before the

National Development Council. With the approval of the Council, the Draft Plan was published for public consideration and country-wide debate.

The comments and suggestions on the Draft Plan offered by Members of Parliament and people from different walks of life are taken into consideration in the preparation of the final document of the plan. This document, prepared by the Planning Commission, outlines the objectives, policies and programmes of the plan. It is once again submitted to the Cabinet and the National Development Council. With such modifications as the National Development Council might suggest, the document was presented to Parliament for final approval. The situation changed with the abolition of the Planning Commission in 2015.

REVIEW OF THE PLANS

The era of planned development dawned in India with the launching of the First Five Year Plan on April 1, 1951. The process of implementation of Five Year Plans was, however, interrupted in 1966, after the completion of the Third Five Year Plan by the end of March 1966. The Fourth Plan, which should have, in normal course, commenced in April 1966 did not get off on schedule due to some problems during the Third Plan which seriously disrupted the development process, like the aggressions by China and Pakistan and the severe drought in the country, particularly in the last year of the Third Plan, 1965-66, (and also the year that followed) resulting in fall in income, sharp rise in prices and fall in savings; serious balance of payments problems which led to the devaluation of the Rupee by 36.5 per cent in June 1966 etc.

The time horizon of Five Year Plan was disrupted several times due to economic adversities and political reasons.

The Fourth Five Year Plan was put off by three years. The intervening period between the Third and the Fourth Plans (*i.e.,* 1966-67 to 1968-69) had Annual Plans. This period is referred to by some people as Plan Holiday.

The political change at the Central Government led to a premature end to the Fifth Five Year Plan. The new Government, headed by *Janata* Party, which assumed power in 1977, terminated the Fifth Plan at the end of the fourth year, *i.e.,* in March 1978 instead of March 1979 and formulated a Draft Five Year Plan for 1978-83.

The *Janata* Government also introduced the concept of *Rolling Plan*. Under the rolling plan, when one year elapses another year is added to the planning horizon so that we will always have a 'Five Year Plan'. The main advantage claimed for the rolling plan is that plan performance can be reviewed and targets revised on the basis of the changing situation. However, the success of rolling plan in a country like India is constrained by the non-availability of up-to-date data needed for such revisions.

The fall of the *Janata* Government also led to the end of the Five Year Plan formulated by them. The Congress Government which came to power in 1980 terminated the Five Year Plan formulated by the previous government at the end of its second year and formulated a Five Year Plan for 1980-85 (the Sixth Plan). On the completion of the Sixth Plan, the Seventh Five Year Plan was launched on April 1, 1985. The Eighth Plan was launched only in 1992. The Ninth Plan (1997-2002) commenced on time. So are the next two plans.

Objectives

The main objectives of the Indian plans have been:

- Proper utilisation of the national resources in accordance of the national priorities and fast development of the economy.

- Alleviation and ultimate removal of unemployment and poverty.
- Improvements in the standard of living in general.

The avowed objectives of planning like rapid increase in income, generation of employment, social or redistributive justice, self-reliance etc. are obviously means to achieve the objectives or aspects of the objectives mentioned above.

There were some variations in the development priorities through Five Year Plans.

There have been changes in the priorities of development and emphasis on objectives through the plans. *For example*, the development priority shifted from agriculture in the First Plan to basic and heavy industries in the Second Plan. The Third Plan recognised the importance of export promotion and the Fourth Plan emphasised self-reliance as an objective of development. *Growth with Social Justice* has been receiving added emphasis since the Fifth Plan. The Fifth Plan, which realised that a *direct attack on poverty* was necessary for rapid eradication of poverty, formulated a specific package of programmes, known as the *minimum needs programme*, to improve the living conditions of the poor and these programmes have been continued, with modifications, in the subsequent plans.

A significant step-up in the rate of growth of the economy, strengthening the redistributive bias of the public policies and services in favour of the poor were among the major objectives of the Sixth Plan. The focus of the Seventh Plan was on food, work and productivity.

Special schemes for improving the living conditions of the poor were introduced since the Fifth Plan.

The Eighth Plan (1992-97) launched at a time of momentous changes in the world and India sought to carry the competitive stimulus of the economic reform process further and gave much greater emphasis on private initiative in industrial development. This Plan was indicative in nature. It concentrated on building a long-term strategic vision of the future and set forth the priorities of the nation. While for the public sector, the Plan went into the details examining the alternatives and identifying the specific projects in various sectors, for the rest of the economy it worked out sectoral targets and tended to provide promotional stimulus to the economy to grow in the desired direction. The Plan recognised "human development" as the core of all developmental effort. The priority sectors that were identified to contribute towards realisation of this goal were health, education, literacy and basic needs, including drinking water, housing and welfare programmes for the weaker sections.

BOX 35.1 : NEW ENVIRONMENT, NEW ROLE

In line with the changed circumstances, we have redefined the role of the Planning Commission. From a highly centralised planning system, we are gradually moving towards indicative planning. Through clear prioritisation of goals, efforts will be made to reduce the bottlenecks, making higher rates of growth possible. If each sector can clearly visualise what is expected of it, then it can gear up to meet the set target. Through the instrument of indicative planning, it will be possible to provide a clear picture of the effects on the entire economy of any change in governmental policy.

The Planning Commission will play an integrative role and help in the development of a holistic approach to the policy formulation in critical areas of development. The Planning Commission will play a mediatory and facilitating role for managing the change smoothly and creating a culture of high productivity and efficiency in the Government.

In addition to the resource allocation role, the Planning Commission will concern itself with resource mobilisation for development as well as with efficient utilisation of the funds. The key to efficient utilisation of resources lies in the creation of appropriate self-managed organisations at all levels. In this area, the Planning Commission will play a systems change role and provide internal consultancy for developing better systems.

– Pranab Mukherjee, Deputy Chairman, Planning Commission, in the Preface to the Eighth Plan (1992-97).

The focus of the Ninth Plan was *growth with social justice and equality*. It gave priority to agriculture and rural development with a view to generating adequate employment and eradication of poverty. The other objectives included acceleration of growth with stability; ensuring food and nutritional security for all, particularly the vulnerable sections of the society; providing certain basic minimum facilities and services to all; population control; ensuring environmental sustainability; empowering women and socially disadvantaged groups; promoting people's participation in the development process etc.

The Tenth Five Year Plan (2002-2007) emphasised the need to incorporate the quality parameter of the development objective. It was underlined that economic growth cannot be the only objective for national planning and indeed over the years, development objectives were being defined not just in terms of increases in GDP or per capita income but more broader in terms of enhancement of human well-being. This includes not only an adequate level of consumption of food and other types of consumer goods but also access to basic social services especially education, health, availability of drinking water and basic sanitation. It also includes the expansion of economic and social opportunities for all individuals and groups and greater participation in decision-making. The Tenth Plan, therefore, sought to set suitable targets in these areas to ensure significant progress towards improvement in the quality of life of all people. The Plan established specific and monitorable targets for a number of key indicators of human development.

11TH FIVE YEAR PLAN

The Background

Despite the not-so-bad overall performance of the economy, large parts of the population are still to experience a decisive improvement in their standard of living. Although the percentage of the population below the poverty line is declining, the pace of it is only modest. As the Planning Commission points out, far too many people still lack access to basic services such as health, education, clean drinking water and sanitation facilities without which they cannot be empowered to claim their share in the benefits of growth. These problems are more severe in some states than in others, and in general they are especially severe in rural areas.[2] Poverty is estimated to have decreased at the rate of 0.79 percentage points per year during 1999-2005,[3] which is disappointing.

Inclusive growth implies that the growth process shall encompass the poor and common man.

Against the background of the very slow progress in reducing poverty, the Approach to the 11th Five Year Plan of India, formulated against the trend of massive investments characterised by centripetal and centrifugal forces of global ramifications which often generate islands of prosperity even at the expense of deprivation of regions and communities, aims at 'faster and more inclusive growth'.

The title of the Approach to the 11th Five Year Plan of India *Towards Faster and More Inclusive Growth* rightly acknowledges that faster growth and target-specific programmes aimed at eradication of poverty and alleviation of certain deprivations are needed to achieve fast reduction in poverty.

Faster growth and target-specific programmes aimed at eradication of poverty and alleviation of certain deprivations are needed to achieve fast reduction in poverty.

The approach to the 11th Plan was in line with the prevailing argument for inclusive market economy. This, however, is not a new dimension of the growth objective brought into the Indian planning. A cardinal objective of the Fifth Five Year Plan (1974-79, terminated in 1978 by the *Janatha* Government) which was inspired by the slogan *garibi hatao* (eradicate poverty), for example, was growth with social justice and the main strategy of the new Sixth Plan (1980-85) put in place by the Congress government was "direct attack on poverty." Many of the schemes

for making growth inclusive in operation or proposed are continuation, extension or new *avathar* of the *20 Point Economic Programme* introduced in the second half of the 1970s.

The experiences of economic-political system of all shades clearly show that while growth is a prerequisite for improving the living conditions of the poor and underprivileged, it is not sufficient. Target-oriented specific programmes designed to deal with the deprivations of the identified segments of the population are essential to ensure that the fruits of the growth percolate down to the lower strata of the society. This is particularly so in large, especially densely populated, developing economies.

The Eleventh Plan Approach Paper, therefore, emphasises the need to restructure policies to achieve a new vision based on faster, more broad-based and inclusive growth, designed to reduce poverty, focusing on bridging the various divides that continue to fragment our society.

Vision of 11th Five Year Plan

With the objective *Faster and More Inclusive Growth*, the vision of the 11th Plan has been set as follows: The Plan must aim at putting the economy on a sustainable growth trajectory with a growth rate of approximately 10 per cent by the end of the Plan period. It will create productive employment at a faster pace than before, and target robust agriculture growth at 4 per cent per year. It must seek to reduce disparities across regions and communities by ensuring access to basic physical infrastructure as well as health and education services to all. It must recognise gender as a cross-cutting theme across all sectors and commit to respect and promote the rights of the common person. The first steps in this direction were initiated in the middle of the 10th Plan based on the National Common Minimum Programme adopted by the government. These steps must be further strengthened and consolidated into a strategy for the 11th Plan.

The 11th Plan aims at accelerating and broad-basing growth and reducing disparities across regions and communities by ensuring access to basic physical infrastructure as well as health and education services to all.

Rapid growth was conceived as an essential part of the strategy for two reasons. Firstly, it is only in a rapidly growing economy that we can expect to sufficiently raise the incomes of the mass of our population to bring about a general improvement in living conditions. Secondly, rapid growth is necessary to generate the resources needed to provide basic services to all. Work done within the Planning Commission and elsewhere suggests that the economy can accelerate from 8 per cent per year to an average of around 9 per cent over the 11th Plan period, provided appropriate policies are put in place. With population growing at 1.5 per cent per year, 9 per cent growth in GDP would double the real per capita income in 10 years. This must be combined with policies that will ensure that this per capita income growth is broad-based, benefiting all sections of the population, especially those who have thus far remained deprived.

Growth Target and Achievement of 11th Plan

To summarise, the task of achieving an average growth rate of around 9 per cent in the 11th Plan was regarded as macroeconomically feasible. However, mainly because of the global economic crisis and its impacts, the actual achievement was about 8 per cent GDP growth.

TWELFTH FIVE YEAR PLAN (2012–2017)

Vision

The broad vision and aspirations which the Twelfth Five Year Plan (2012-17) seeks to fulfill are reflected in the subtitle: **Faster, Sustainable, and More Inclusive Growth**. The simultaneous achievement of each of these elements is regarded critical for the success of the Plan.

Objectives and Targets

The multi-dimensional objectives are reflected in the adoption of 25 monitorable targets in the Twelfth Plan of which growth of GDP is only one. The other targets cover the many features

of development which measure inclusiveness and sustainability. Individual states have also been encouraged to set state-specific targets in the same areas.

Twenty-five core indicators that are listed below reflect the vision of rapid, sustainable and more inclusive growth:

Economic Growth

1. Real GDP Growth Rate of 8.0 per cent.
2. Agriculture Growth Rate of 4.0 per cent.
3. Manufacturing Growth Rate of 10.0 per cent.
4. Every State must have an average growth rate in the Twelfth Plan preferably higher than that achieved in the Eleventh Plan.

Poverty and Employment

5. Head-count ratio of consumption poverty to be reduced by 10 percentage points over the preceding estimates by the end of Twelfth Five Year Plan.
6. Generate 50 million new work opportunities in the non-farm sector and provide skill certification to equivalent numbers during the Twelfth Five Year Plan.

Education

7. Mean Years of Schooling to increase to seven years by the end of Twelfth Five Year Plan.
8. Enhance access to higher education by creating two million additional seats for each age cohort aligned to the skill needs of the economy.
9. Eliminate gender and social gap in school enrolment (that is, between girls and boys, and between SCs, STs, Muslims and the rest of the population) by the end of Twelfth Five Year Plan.

Health

10. Reduce IMR to 25 and MMR to 1 per 1,000 live births, and improve Child Sex Ratio (0-6 years) to 950 by the end of the Twelfth Five Year Plan.
11. Reduce Total Fertility Rate to 2.1 by the end of Twelfth Five Year Plan.
12. Reduce undernutrition among children aged 0-3 years to half of the NFHS-3 levels by the end of Twelfth Five Year Plan.

Infrastructure, Including Rural Infrastructure

13. Increase investment in infrastructure as a percentage of GDP to 9 per cent by the end of Twelfth Five Year Plan.
14. Increase the Gross Irrigated Area from 90 million hectare to 103 million hectare by the end of Twelfth Five Year Plan.
15. Provide electricity to all villages and reduce AT&C losses to 20 per cent by the end of Twelfth Five Year Plan.
16. Connect all villages with all-weather roads by the end of Twelfth Five Year Plan.

17. Upgrade national and state highways to the minimum two-lane standard by the end of Twelfth Five Year Plan.
18. Complete Eastern and Western Dedicated Freight Corridors by the end of Twelfth Five Year Plan.
19. Increase rural tele-density to 70 per cent by the end of Twelfth Five Year Plan.
20. Ensure 50 per cent of rural population has access to 40 lpcd piped drinking water supply, and 50 per cent *gram panchayats* achieve Nirmal Gram Status by the end of Twelfth Five Year Plan.

Environment and Sustainability

21. Increase green cover (as measured by satellite imagery) by 1 million hectare every year during the Twelfth Five Year Plan.
22. Add 30,000 MW of renewable energy capacity in the Twelfth Plan.
23. Reduce emission intensity of GDP in line with the target of 20 per cent to 25 per cent reduction over 2005 levels by 2020.

Service Delivery

24. Provide access to banking services to 90 per cent Indian households by the end of Twelfth Five Year Plan.
25. Major subsidies and welfare related beneficiary payments to be shifted to a direct cash transfer by the end of the Twelfth Plan, using the *Aadhar* platform with linked bank accounts.

PERFORMANCE OF THE PLANS

Although the Plans have, by and large, failed to achieve the targets and shortfalls are conspicuous in several areas, India has made, undoubtedly, very significant progress. With about 30 per cent of the population still below the poverty line, India is one of the largest industrial powers in the world and has the third largest stock of scientific manpower.

When compared to the modest targets, the performance of the First Plan was satisfactory. In the Fifth, Sixth, Seventh and Eighth Plans, the actual growth rates slightly exceeded the targets. Growth rates in other Plans lagged behind the targets — moderately to substantially. See Table 35.1.

During the five year period ending in 2007-08, the annual GDP growth rate was above 8 per cent and the average growth of per capita income was 7.2 per cent per annum, almost double that of the previous two decades. There has been an acceleration in domestic investment and saving rates to drive growth and provide the resources for meeting the 9 per cent (average) growth target of the Eleventh Five Year Plan

TABLE 35.1 : INDIA'S GROWTH PERFORMANCE DURING THE PLANS

Sl. No.		*Target*	*Actual*
1	First Plan (1951-56)	2.1	3.60
2	Second Plan (1956-61)	4.5	4.21
3	Third Plan (1961-66)	5.6	2.72
4	Fourth Plan (1969-74)	5.7	2.05
5	Fifth Plan (1947-79)	4.4	4.83
6	Sixth Plan (1980-85)	5.2	5.54
7	Seventh Plan (1985-90)	5.0	6.02
8	Eighth Plan (1992-97)	5.6	6.68
9	Ninth Plan (1997-02)	6.5	5.5
10	Tenth Plan (2002-07)	8.0	7.2*
11	Eleventh Plan (2007-12)	9.0	7.9

**Estimate*

Source: Government of India, India 2005 (Publications Division, Ministry of Information and Broadcasting) and Planning Commission, Government of India, Towards Faster and More Inclusive Growth – An Approach to the 11th Five Year Plan, December, 2006.

To solve the basic problems, the additional number of children to be educated, the additional number of people to be provided with medical facilities and so on during one Five Year Plan in India is more than what most nations have done over centuries.

It is common to criticise the Indian Planning for its failures, pointing out the magnitude of poverty, unemployment, housing problem etc., prevailing today despite over five decades of planning. The total population of only a few countries like China and the USA is more than the size of the Indian population below the poverty line. Similarly, the number of people unemployed in India is larger than the labour force of many countries; the number of households in India without satisfactory housing is larger than the total number of households in most countries. In fact, the number being added to the Indian population during a decade is larger than the total population in most of the countries. All these highlight the gigantic task facing a poor nation. It is, therefore, not right to view the prevalence of certain problems of large magnitude only as a reflection of the failure of the planning; they should also be viewed as an alarming problem of the magnitude which no other country in the world, except perhaps China, faces.

It goes to the credit of India that it achieved steady growth, albeit moderate, throughout the planning period of the last six-and-a-half decades, without serious social catastrophes, unlike in China where an estimated more than 30 million people, mostly peasants, died in the Great famine during 1959-62.[4] It may be noted that in 1978, the year in which China started the economic reforms, the per capita income of India was higher than that of China. Although the growth rate of the Indian economy has been poor in comparison with those of several South-East Asian countries, India is one among the countries whose per capita income in the early 1990s was higher than ever before. Over much of the period since 1980 to early 1990s, economic decline or stagnation affected about 100 countries, reducing the incomes of more than a quarter of the world's population. In 70 of these countries, average incomes in the early 1990s were less than they were in 1980 and in 43 countries less than they were in 1970. Among the 48 low human development countries, India is the only country whose annual growth in per capita income was above 1.5 per cent during the period 1960-1993.

India achieved more or less steady economic growth throughout the planning period of the last six-and-a-half decades, unlike the case of most of the developing countries.

The human tragedy of the 1959-62, the biggest in the economic history of any nation, is a telling reflection of the palpable failures of the Chinese system to usher in social justice and to ensure the basic necessity of life to a large section of its citizens. According to the estimates of the Chinese government, there were about 260 million people – one-third of the rural population — below the poverty line in China in 1978.[5] The faster economic growth that was made possible by the economic liberalisation had the result of reducing the number of rural poor from 260 million in 1978 to 97 million by 1985. The Chinese economic growth began to accelerate in the second half of the 1980s mainly because of the massive investments in the industrial sector and the thrust on export growth. However, economic disparities and poverty tended to rise. By 1989, the number of rural poor increased to 103 million. Educational achievements also faltered.[6]

Despite many odds, significant progress was made in almost all important spheres. Of course, it would have been possible to achieve better results with better planning, more efficient implementation of the programmes and pragmatic policies.

In the Foreword to the Seventh Five Year Plan, Prime Minister Rajiv Gandhi observed: "Planning has given us a strong base for building a modern, self-reliant industrial economy. Indian industry today is highly diversified, producing a wide range of products, many embodying a high level of technology. The public sector has commanding presence and has played a pioneering role in many areas. We have a broad entrepreneurial base and ample technological and managerial manpower. But some weaknesses have also become evident. Much of our industry suffers from high cost. There is inadequate attention to quality. In many areas, we are working with technology that is obsolete. We have reached a watershed in our industrial development, and in the next phase we must focus on overcoming these problems. Our emphasis must be on greater efficiency, reduction of cost and improvement of quality. This calls for absorption of new technology, greater attention to economies of scale and greater competitions". It may be noted that efforts are being made in these directions.

SUMMARY

The planning system is an important business environment because the direction of the development pattern of the various sectors and the relative priorities within each sector are determined by the Five Year Plans

The Plans are drawn up by the Planning Commission in accordance with the guidelines given by the National Development Council (NDC) which is presided over by the Prime Minister and is composed of Union Cabinet Ministers, Chief Ministers of States and Union Territories and Members of the Planning Commission. The NDC has a decisive role in the formulation and follow-up of the execution of the National Plan. Its role signified the federal and democratic nature of the Indian planning.

With effect from January 1, 2015, the Planning Commission was replaced by a new organisation by name NITI Aayog.

The States also have their own Plans. State jurisdiction include such vital sectors of development as agriculture, small industries, irrigation and power, roads and road transport, and education and social services. The States have Planning Boards and Departments which coordinate the work of other departments for the preparation of development plans, and present reports on the execution of State Plans. State Planning generally receives directions from a committee of the State cabinet and is supported by the State Statistical Bureau.

Following the economic liberalisation, a shift in the planning strategy has taken place. In the past, planning envisaged a dominant role for the public sector with massive investments in basic and heavy industries. Since the Eighth Plan, the private sector began to gain greater significance and from a highly centralised planning system we are gradually moving towards indicative planning

The main objectives of the Indian plans have been proper utilisation of the national resources in accordance of the national priorities and fast development of the economy; alleviation and ultimate removal of unemployment and poverty, and improvements in the standard of living in general. The avowed objectives of planning like rapid increase in income, generation of employment, social or redistributive justice, self-reliance etc. are obviously means to achieve the objectives or aspects of the objectives mentioned above.

There have, however, been changes in the priorities of development and emphasis on objectives through the plans. For example, the development priority shifted from agriculture in the First Plan to basic and heavy industries in the Second Plan. The Third Plan recognised the importance of export promotion and the Fourth Plan emphasised self-reliance as an objective of development. *Growth with Social Justice* has been receiving added emphasis since the Fifth Plan. The Fifth Plan, which realised that a *direct attack on poverty* was necessary for rapid eradication of poverty, formulated a specific package of programmes, known as the *minimum needs programme*, to improve the living conditions of the poor and these programmes have been continued, with modifications, in the subsequent plans. A significant step-up in the rate of growth of the economy, strengthening the redistributive bias of the public policies and services in favour of the poor were among the major objectives of the Sixth Plan. The focus of the Seventh Plan was on food, work and productivity. The Eighth sought to carry the competitive stimulus of the economic reform process further and gave much greater emphasis on private initiative in industrial development. The Plan recognised "human development" as the core of all developmental effort.

The focus of the Ninth Plan has been described as *Growth with Social Justice and Equity*. The development strategy for the future has been formulated against the emerging new economic environment in which private sector has a greater role than in the past.

The Ninth Plan has set a target of 6.5 per cent. Annual growth for GDP, an industrial growth rate of 8.2 per cent, agricultural growth rate of 3.9 per cent and export growth rate of 11.8 per cent per annum.

The poverty ratio has been expected to come down from about 29 per cent in 1996-97 to 18 per cent by the end of the Ninth Plan, less than 10 per cent by 2006-07 and less than 5 per cent by 2011-12.

Indian Plans have, by and large, failed to achieve the targets and shortfalls are conspicuous in several areas. The long-term average annual growth rate of the economy was only about 3.5 per cent and of the per capita income about 1.5 per cent. There has, however, been an acceleration of the growth rates since the Sixth Plan.

Despite many odds, significant progress was made in almost all important spheres. Of course, it would have been possible to achieve better results with better planning, more efficient implementation of the programmes and pragmatic policies.

It is common to criticise the Indian planning for its failures, pointing out the magnitude of poverty, unemployment, housing problem etc. prevailing today despite over five decades of planning. It is, however, not right to view the prevalence of certain problems of large magnitude only as a reflection of the failure of the planning; they should also be viewed as alarming problems of the magnitude which no other country in the world, except perhaps China, faces.

As Prime Minister Rajiv Gandhi observed, "Planning has given us a strong base for building a modern, self-reliant industrial economy. Indian industry today is highly diversified, producing a wide range of products, many embodying a high level of technology. The public sector has commanding presence and has played a pioneering role in many areas. We have a broad entrepreneurial base and ample technological and managerial manpower. But some weaknesses have also become evident. Much of our industry suffers from high cost. There is inadequate attention to quality. In many areas, we are working with technology that is obsolete. We have reached a watershed in our industrial development, and in the next phase we must focus on overcoming these problems. Our emphasis must be on greater efficiency, reduction of cost and improvement of quality. This calls for absorption of new technology, greater attention to economies of scale and greater competition.

Although the growth rate in the five years preceding 2008 was about 9 per cent annually, it declined under the impact of the global economic crisis and other factors. The Eleventh Plan GDP growth was only about 8 per cent.

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Chapter 36

INDUSTRIAL DEVELOPMENT STRATEGY

Structure

Salient Features of Industrial Planning and Development
An Evaluation
Summary
References

The Industrial Policy has been an important instrument to help implement the economic development strategy.

SALIENT FEATURES OF INDUSTRIAL PLANNING AND DEVELOPMENT

The salient features of planning and development of industries in India, as clear from the industrial policy statements, other policy announcements, plan documents, etc., are the following.

Monopoly/dominance of public sector in important industries, special attention to small and cooperative sectors, development of backward areas and import substitution were salient features of the industrial development strategy until 1991.

1. Dominance of public sector in the key industries.
2. Synchronised development of small and large industries.
3. Special assistance for the development of small industries.
4. Accelerated development of backward areas and achievement of balanced regional development.
5. Encouragement of new entrepreneurs and diffusion of ownership.
6. Prevention of concentration of economic power.
7. Achievement of self-reliance.
8. Encouragement of the cooperative sector.
9. Encouragement of import substituting and export promoting industries.
10. Balanced development of capital goods and consumer goods industries.
11. Synchronised development of industrial, agricultural and other sectors.
12. The economic reforms ushered in 1991, however, resulted in some of the above principles losing their place or flavour. (*For example*, dominance of public sector in the key industries and prevention of concentration of economic power).

Until 1991, the development of the private sector was under strict government control. This was exercised through industrial licensing and other means. Laws like the Industries (Development and Regulation) Act and the Companies Act gave the government enormous control over the management and functioning of the industrial undertakings. The MRTP Act controlled mergers, amalgamations, takeovers etc. involving large industrial undertakings and dominant undertakings.

Control of the private sector was also sought to be exercised by giving the public sector control over the commanding heights of the economy.

The new economic policy of India, however, has removed many of the policy hurdles to the growth of the private sector and has drastically abridged the scope of the public sector.

Capital Goods vs. Consumer Goods

The strategy and pattern of development and the performance of the industrial sector have, however, not been free from criticism. One criticism has been that the basic and capital goods industries were accorded a pride of place and the consumer goods were given a low priority. One school of thought maintains that, in a country like India, consumer goods industries should have been given priority to improve the living conditions of the poor by expanding employment opportunities and supply of *wage goods* at a faster rate. Another school emphasises the need for balanced development of the consumer goods and capital goods sectors. However, the development

strategy followed by India has been complimented by a number of people on the ground that it enabled the country to strengthen the industrial base and to attain self-reliance. "In the process of capital accumulation, it may be argued, certain capital-intensive, or large-scale, sectors producing non-importable commodities – the prime examples being railway transport and electricity – are bound to grow. Again, it has been argued that India cannot, at a reasonable cost, expand her imports rapidly; and that, as a consequence, the expanded production of fertilisers, dams, railways, textiles and buildings, require some domestic production of the necessary capital goods and intermediates. The response of the agricultural sector to invest may be slow and uncertain. The most promising source of saving to finance development may be the profits of the organised sector."[1] So go the arguments.

Indian development strategy had a bias in favour of basic and heavy industries.

Even in the case of consumer goods, the growth of output of consumer non-durables was much slower than that of consumer durables which cater mostly to the needs of the affluent and better-off sections of society. The implication of the slow growth of consumer goods, particularly consumer non-durables, is that the common man has not benefited much from the type of industrial development we have had, though "establishment of basic and heavy industries has laid the foundation for further development, contributed to the promotion of self-reliance in respect of capital goods and modern technology and incidentally helped to build up the defence strength of the country which enabled it to successfully stem the attack make by China and Pakistan."[2]

The *heavy industry strategy* of the Mahalanobis model was initiated in the Second Plan. The Mahalanobis model purports that, for the attainment of a self-reliant and self-sustained growth, it is imperative that India should build up its own basic and capital goods industries for which the country has intrinsic comparative advantage by virtue of possessing the required natural resource base. In an economy constrained by resource scarcity, the Mahalanobis model requires severe curbs on the development of consumption goods industries to make resources available for the growth of the capital goods industries. The restraint on consumption is considered to be a necessary and worthwhile sacrifice in the interests of building up a large enough capital base to provide significant increments in output in the long run. "The restrictions on consumption envisaged relate to industries producing luxury goods and relatively inessential consumer goods and also to having a large variety within each type of consumer goods. These restrictions are to be imposed by an appropriate use of various policy instruments, such as licensing, allocation of foreign exchange and other resources, and promoting the standardisation of consumer articles, etc. The success of heavy industry strategy depended, *inter alia,* very much on these regulatory devices being effectively used. Experience has shown that the mechanism of industrial control and regulation was not quite successfully operated, and that this has also been admitted by the Planning Commission itself."[3]

The bias in favour of the capital goods industries has contributed to the inflationary pressure because these industries involve heavy investments and long gestation periods. Further, the "heavy industry strategy would have probably produced better results if it had not been accompanied by a relative indifference towards the problems of a quick agricultural transformation and the rural requirements, thereby keeping a very big segment of the economy outside the full impact of development planning. What this neglect has meant is now widely known. The shortfalls in agricultural production have, time and again, jeopardised the smooth progress of industrial development itself. Besides causing shortages in the supplies of foodgrains and raw materials, they also prevented the demand for the products of industry from growing adequately, thereby aggravating the chronic problem of underutilisation of capacity in industry."[4]

The basic and heavy industry bias and shortage of consumer goods caused inflation.

An appraisal of the chosen industrial plan strategy of imbalance between capital goods and consumption goods industries in favour of the former lead to the following conclusions:[5]

1. It was not efficiently implemented.
2. It had inherent weaknesses against which corrective measures were not taken.

3. It was not fully planned, and did not take note of the choices within the capital goods and of the dynamic need for a gradual shift towards a better balance between the two categories.
4. It had not the wider support of adequate agricultural development.

A recognition of several of these weaknesses of the earlier approach to industrial development has, since the Fifth Plan, led to a change in approach.

Roles of Public and Private Sectors

Another controversial aspect has been the relative roles of the private and public sectors. Over the years, the public sector had attained a dominant position in the critical and key sectors. Apart from its performance, the expansion of the public sector had been objected on ideological grounds. However, the crucial role of the public sector in a developing country like India has been widely recognised.

The growth and performance of the private sector have been regulated in a number of ways. It is interesting to note that while, on the one hand, there was criticism on the ground that the private sector, especially the large industrial houses sector, was given enormous opportunities for growth and expansion, on the other hand, it was argued that the dominant role assigned to the public sector and the numerous checks and controls on the private sector retarded the pace of development.

With the Industrial Policy Resolution of 1956, the future development of 17 key industries became the exclusive responsibility of the State, and in another 12 important industries, the state was to play an active role. Further, the state had the power to enter any other industry.

The industrial policy that was followed until 1991 gave only a limited role for private sector.

Central Government investment in industrial enterprises increased substantially in the four decades since the commencement of planning. The public sector also took over a number of sick units from the private sector because of the social obligations of protecting employment. The National Textile Corporation (NTC) has under it a number of units which were taken over because they were sick.

As a corollary to its growth, the share of the public sector in the value added in mining and manufacturing (organised sector) had grown very substantially. The development of the public sector had been an import element in the drive for industrial diversification; and in industries like steel, non-ferrous metals, petroleum, fertilisers, petrochemicals and heavy engineering, the public sector units came to play a dominant role.

The role of the large houses in the private sector was confined, by and large, to the core and heavy investment sectors. They were also been expected to make a significant contribution to the development of the backward areas, particularly to "no industry districts," and to the development of the export sector. The positive role of the private sector in the industrial development of the country was, thus recognised to a certain extent.

The current economic policy gives enormous scope for the private sector.

There has also been an emphasis on the role of the cooperative sector. The cooperative sector has made progress in industries like sugar, cotton textiles and fertiliser. The growth of this sector is expected to promote industrial democracy and discourage concentration of economic power in a few hands.

The joint sector has been promoted to facilitate the utilisation of the resources and talents of the private sector and function with the social orientation of the public sector.

The new economic policy of India is characterised by a redefinition of the roles of the public and private sectors. The essential feature is an abridgement of the role of the public sector and a substantial expansion of the scope of the private sector: Accordingly:

1. The role of the public sector would be confined mainly to areas where investment is of an infrastructural nature and where private participation is not forthcoming to an adequate extent within reasonable time. Thus, the public sector will continue to play a dominant role in areas like energy, transport, communications and irrigation. However, if private initiative comes forward to participate in creating such infrastructure on reasonable terms, including full protection of people's interests, such initiatives would be encouraged.
2. The public sector would play a useful role in augmenting basic resources of the country like land, forest, water, ecology and science and technology. The public sector will have responsibility for meeting social needs and for regulation of long-term interests of the society like population control, health, education, etc.
3. In large part of its operations where commodities or services are produced and distributed, the principle of market would be applied as basic operating guidelines, unless it is necessary to protect the interests of the poorest in the society. This implies recovery of costs and efficiency in operations.

Village and Small Industries

The plan documents and policy statements on industrialisation have emphasised the importance of village and small industries. But it has been felt that "the outlays made under the plans for village and small industries were not commensurate with the importance which these industries deserved in the Indian situation".[6] Although in the initial years of the planning era, this sector received a reasonable allocation of funds, ranging between 2 and 4 per cent of the Plan Outlays; of late, the actual availability has come down to about 1.5 per cent.[7]

To foster the growth of the small-scale sector, the manufacture of a large number of items have been exclusively reserved for it and several other measures of protection have been accorded. The SSI policy, though encouraged the growth of small-scale units, have had several adverse effects, as pointed out in the chapter on *Village and Small Industries*.

Comparative Cost Dynamics

One of the criticisms levelled against the development strategy in India is that the agricultural sector should have been given greater importance than industry. "When India and several other newly-emerged independent nations made a bid for rapid industrialisation after the Second World War, the Western nations looked upon this more as being generally contrary to the comparative cost advantages. But very soon India's claims to become an industrial power based on a dynamic interpretation of comparative cost advantage were widely recognised. With the rich and variegated mineral agricultural resource base, the high potential for power generation, the ability of the people to acquire and absorb modern technology and a potentially expanding market for manufactures – both domestic and foreign – very few today dispute India's innate ability to develop as a big industrial power in the world."[8]

Import Substitution and Export Contribution

Import substitution assumed importance after the Second Plan. Industries with a potential for import substitution have been given great importance. At the beginning of the planning era, India relied very heavily on foreign sources of supply for the requirements of capital goods and a number of basic and other important inputs. In the early decades of planning, considerable import substitution took place in many important areas in capital goods, organic chemicals, pharmaceuticals, dyestuffs, etc.

The Import Substitution Industrialisation Strategy (ISI) followed in India has had several adverse effects.

However, the manner in which the policy of import substitution has been carried forward has been subject to criticism. *For example*, it has been argued that, "in the Indian context, the emphasis on import substitution has often run counter to the objective of technology development."

The diversification achieved in the industrial sector is reflected in the changing structure of the country's exports. Mention has been made about priority for industries which help exports only in the priority list of the Fifth Plan onwards, and not in those of the earlier plans. However, the Export Policy Resolution of 1970 emphasised the importance of continuous development and expansion of export-oriented production. The share of manufactured products in India's exports has increased significantly.

The high protection from foreign competition, a corollary of the SI strategy, resulted in high costs, poor quality, indifference towards consumers, lack of innovativeness etc. Further, as Manmohan Singh points out, in the mid-1950s, while export industries like jute and cotton textiles were denied foreign exchange for their much-needed modernisation, a much too liberal approach was followed in India in allocating foreign exchange to many non-essential industries in the name of import substitution.[9] The import restrictions, high costs and poor quality also very severely affected India's export performance.

Capacity Utilisation

The importance of fully utilising the installed capacity needs no emphasis. Underutilisation of capacity not only amounts to wastage of scarce resources but also leads to cost-push inflation. It may also create a demand-supply imbalance and affect the balance of trade, employment, saving and investment. Though only the First Plan gave top priority to the fuller utilisation of pre-existing capacity, all other five year plans included it in the list of priorities. However, capacity utilisation in general has been quite unsatisfactory throughout the plan period.

Of course, some degree of underutilisation of industrial capacity due to such factors as "planned excess capacity" calculated to meet the demand in the foreseeable future, technological "indivisibilities", which may inevitably create capacity in excess of that warranted by present demand; and initial "testing" troubles of new industries inescapable in the developing economy may have to be accepted as a normal feature. But India's almost chronic excess industrial capacity should be regarded as something that is due to more fundamental causes, which were not correctly appreciated in Indian Planning.[10] Input shortages, infrastructural bottlenecks and demand problems have been mainly responsible for low capacity utilisation. Improvements in capacity utilisation will, therefore, depend on the developments in the infrastructural sector, input supplies and demand generation. The development of the agricultural sector is important from the point of view of improving input supplies as well as demand generation. It is feared that the import liberalisation may cause flood of imports in some cases, affecting the capacity utilisation of domestic firms.

Regional Disparities

The removal of regional disparities assumed particular importance since the Third Plan. Large public sector industrial investments were made in the backward areas. Incentive schemes were introduced, particularly since the Fourth Plan, to lure private sector enterprises to backward areas. However, much headway could not be made in this direction. One criticism of the new economic policy is that the backward area development by industrialisation is not given importance.

AN EVALUATION

Despite several problems, the industrial sector of India has made commendable achievements in several respects. Large investments have been made in building up capacity over a wide spectrum of industries; and though India is still primarily an agrarian society, she is one of the majority industrial powers of the world.

Since the commencement of planned development in 1951, India has made significant progress in industrialisation, though the development has been characterised by deficiencies and lopsidedness.

As the Seventh Five Year Plan document, reviewing the industrial development after independence, observes, "there has been substantial diversification of the industrial base with the consequent ability now to produce a very broad range of industrial products. Substantial self-reliance has been achieved in basic and capital goods industries which now account for as much as one-half of the total value added in manufacturing. Indigenous capacities have been established to the point to virtual self-sufficiency so that further expansion in various sectors, such as mining, irrigation, power, transport and communications can be based primarily on indigenous equipment.

Between 1950 and 2000, the index to industrial production registered more than a twenty-two-fold increase, and the share of the secondary sector in the Gross Domestic Product increased from about 13 per cent in 1950-51 to nearly 25 per cent in the five decades of industrialisation since the commencement of planning.

According to Government sources, apart from the quantitative increase in output, the industrial structure has been widely diversified, covering broadly the entire range of consumer, intermediate and capital goods. In most of the manufactured products, the country has achieved a large measure of self-sufficiency, providing the capability to sustain the future growth of vital sectors of the economy primarily through domestic effort. This is reflected in the commodity composition of our international trade, in which the share of imports of manufactured products has steadily declined; on the other hand, industrial products have become a growing component of our exports. Industrial development has been accompanied by a corresponding growth in technological and managerial skills, not only for the efficient operation of highly complex and sophisticated industrial enterprises but also for their planning, design and construction. Considerable advance has also been made in industrial research and absorbing, adapting and developing industrial technology.

The process of industrialisation has also fostered entrepreneurship and the development of a wide variety of technical, managerial and operative skills. This less visible but critical investment in knowledge places India as a country with one of the largest pools of skilled manpower in the developing world.

The highly restrictive industrial policy followed until 1991 very adversely affected the achievement of the growth potentials of the industrial sector.

The task of achieving the multiple objectives of industrial planning, however, has not been without frustration. The principal failures of planning relate to the inability to utilise the growing potential of the industrial sector and inadequate attention paid to reducing costs and improving quality. The situation, however, has been improving as a result of the economic reforms, although there is still a long way to go.

One of the principal achievements has been the creation of capacity in the basic and heavy industries.

In the last six decades or so, although the industrial output grew at a rate much higher than those for agricultural production and GDP, it lagged very much behind the plan targets. Further, industrial growth in India has been poor compared to several developing countries and her share in the total manufactured output and manufactured exports of developing countries declined very remarkably.

In the initial years of planning, industrial development was largely based on import substitution and had the advantage of a captive market. A steady growth could, thus, be maintained. Thereafter,

the growth in industrial production was conditioned by the general pace of economic development in the country.

According to the Ninth Plan document, the reasons for the unsatisfactory rate of industrial growth include slow pace of investment especially in infrastructural sectors, lack of demand, inadequate availability and poor quality of infrastructure, global recession leading to slowdown in international trade, etc.

The negative effects of controls and several other problems like infrastructural bottlenecks, raw material shortages, etc., affected industrial growth in India.

One of the serious problems afflicting the industrial sector in India is the growing sickness in the small, medium and large sectors. Some of the government policies have also contributed to industrial sickness. Further, sometimes the attitude of the labour, government and financial institutions which does not allow a unit to take measures, before it becomes sick, to strengthen itself also may cause sickness.

The small-scale sector has been given considerable importance in India. It is high time a proper social cost-benefit analysis of the promotion of small-scale units involves heavy social costs. Besides the costs of various subsidies like concessional finance and the loss arising out of tax concessions, the price preference granted to small-scale sector in government purchase increases the loss to the exchequer. Another very important factor to be noted is the generally poor condition of the labour in this sector. When compared to the workers in the organised sector, the wages and other benefits available to the workers in the unorganised sector is meagre. The rationale of employment generation in the small-scale sector at the expenses of it in the organised sector, therefore, needs a serious evaluation.

The inefficiency of the public sector, which occupied a commanding height in the key sector, contributed in large measure to the poor industrial performance. Had the government taken the assistance of the private sector to supplement its efforts in crucial sectors, the performance of the infrastructural sector and some other important industries would have been much better.

The liberalisation has boosted the industrial development of India.

The industrial policy liberalisations or deregulations since 1991 are a reflection of the government's realisation of the counter-productive effects many of the regulations have had. The statement of the Chairman of a large industrial house in India that earlier businessmen used to go to Delhi with bended knees to protect their monopolies and interests but now they have to go with bended knees to the consumers is an indication of the impact of the liberalisation.

Growth is a prerequisite for achieving social justice. Optimum utilisation of the resources, including the technical and managerial skill, should be accorded a very high priority in a resource-scarce economy.

SUMMARY

The salient features of the industrial development strategy of India until 1991 were the following.

1. Monopoly or dominant position for the public sector in most of the industries and control of the "commanding heights of the economy" by the public sector.
2. Priority to the development of basic and heavy industries and relative neglect of the consumer goods, particularly the wage goods, sector.
3. Limited scope for private sector and stringent entry and growth restrictions, particularly on large firms.
4. Concern about concentration of economic power in private hands.

5. Emphasis on the development of small scale and cooperative sectors and new entrepreneurs.
6. Special attention to the development of backward areas.
7. Adoption of an import substitution industrialisation (ISI) strategy.

The above policies have had both positive and negative impacts. These are presented in Table 36.1.

TABLE 36.1 : PROS AND CONS OF THE INDUSTRIAL DEVELOPMENT STRATEGY

Strategy	*Pros*	*Cons*
Prominence to public sector	Control over commanding heights of the economy	Monopoly abuses and inefficiencies
	Prevention of concentration of economic power in private hands	Adverse effects on the development of a competitive industrial sector
Restrictions on private sector	Prevention of concentration of economic power in private hands	Adverse effects on industrial and economic development, R&D and innovation, competition, exploitation of economies of scale and scope, and globalisation
Basic and heavy industry bias	Development of the base for development of other industries	Relative neglect of consumer goods sector
	Development of indigenous capabilities and self-sufficiency in vital areas	Strain on foreign exchange resources Inflation
Import substitution industrialisation	Development of indigenous industries	High protection resulting in inefficiencies and high costs, neglect of consumer interests, lack of compulsion for innovation etc.
		Adverse effects on exports and globalisation due to high costs, poor quality lack of innovativeness and lucrativeness of domestic market.
Preferential treatment for small-scale sector	Growth of small scale units Wider dispersal of industrial activities.	High costs Poor quality Revenue loss to the government Adverse effects on exports and globalisation

The salient features of the industrial policy developments since 1991 are the following.

1. The scope of the private sector has been enormously expanded by throwing open all but a few industries to the private sector and by almost dismantling the entry and growth restrictions.
2. The role of public sector has been redefined. Now, only three industries are exclusively reserved for the public sector. Public sector has been withdrawing partially or fully from several of the enterprises by divestment.
3. The development strategy for the small sector has been reoriented. The list of items reserved for the SSIs is being pruned.

4. The dominance of the Central Government in industrial location decision is gone. It is left to the State Governments to lure and develop industries in their States. Indian industry can now access foreign technology, capital and other inputs much more easily than in the past.
5. The Indian industry is increasingly exposed to foreign competition.

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Chapter 37

PLANNING AND DEVELOPMENT OF AGRICULTURE

Structure

- Importance of Agriculture
- Phases of Development
- Expansion and Development of Inputs and Services
- Agricultural Marketing
- Agricultural Price Policy
- Commodity Exchange
- Summary
- Reference

IMPORTANCE OF AGRICULTURE

As the Planning Commission observes, agriculture has all along been the most crucial sector of the Indian economy.

Agriculture which contributes much less than one-fifth of India's GDP, provides livelihood for about two-thirds of the population, supplies raw materials for a number of important industries and contributes about one-fifth of the export earnings.

The development of agriculture is necessary to help solve the twin problems of unemployment and poverty. In fact, rural India represents one of the largest potential markets in the world for many manufactured products. The rural market accounts for well over 55 per cent of the demand for fast moving consumer goods (FMCGs). The development of the industrial and other non-agricultural sectors depends to a very large extent on the prosperity of the agrarian sector. It may be noted that confronted by recession or tapering of the demand growth, many companies turned to the rural market to increase sales. It is well recognised that fluctuations in agricultural income affects the fortunes of other sectors.

In short, agricultural development strategies, the pattern of development and the growth trends in agricultural incomes have important implications for business.

BOX 37.1 : FIFTY YEARS OF INDIAN AGRICULTURE

India inherited a stagnant agriculture at the time of independence in 1947. The first task of Indian Government in the immediate post-independence period was, therefore, to initiate growth process in agriculture. The agricultural policy was governed by a planning framework. The quantum of Plan outlay, its financing and the targets set for the agricultural sector were all decided through the planning process at the State and Central levels. The first three Five Year Plans concentrated on growth with some institutional changes including abolition of intermediaries in agriculture, like Zamindars and Jagirdars. In the mid-sixties, a new technology in the form of high-yielding varieties (HVVs) was introduced for cereals. Apart from the new technology, public investment in agriculture particularly in irrigation, was stepped up significantly. The public sector played an important role in promoting agricultural research and education. Large investments were made for the development of research system under the aegis of the Indian Council of Agricultural Research (ICAR) and the State Agricultural Universities (SAUs). Simultaneously, a well-designed extension network was created for disseminating new technologies to the farmers. The administered price policy has provided incentives to the farmers. Successive Five Year Plans aimed at improving the infrastructure through irrigation, stepping up the use of fertilisers, improved varieties of seeds implements and machinery and supply of credit. As a result, there has been a significant increase in the use of modern inputs leading to higher productivity and production.

The agricultural growth rate of around 2.7 per cent per annum in the post-independence period was much higher than the negligible growth rate of 0.3 per cent per annum in the first half of this century. The production of foodgrains increased from 50.8 million tonnes in 1950-51 to about 199.3 million tonnes in 1996-97. The production of commercial crops like cotton, oilseeds, sugarcane, fruits and vegetables, besides livestock products and fisheries has also recorded significant increase during the same period.

Courtesy: *Planning Commission, Ninth Five Year Plan.*

PHASES OF DEVELOPMENT

As the Sixth Five Year Plan document points out, starting from the beginning of this century, three major phases may be identified in our agricultural evolution.

- The first phase from 1900 to 1947 was marked by a near stagnation in farming, as is clear from a growth rate of about 0.3 per cent per annum achieved in agricultural production during this period.
- Phase II extending from 1950 to 1980, has been marked by considerable advance in the process of modernisation of agriculture, thanks to the steps taken in the development

and spread of: *(a)* Technologies based on scientific research; *(b)* Wide range of services; and *(c)* Public policies on land reform, pricing, procurement and distribution. As a result, agricultural production grew at an annual compound rate of 2.8 per cent during 1967-68 to 1978-79.

- The third phase, which has begun in the eighties, is marked by the need for greater attention to marketing and trade, and to institutional frameworks which can help to minimise the handicaps of small and marginal farmers and maximise the benefits of intensive agriculture offered by small holdings.

BOX 37.2 : THRUST AREAS OF DEVELOPMENT

The thrust areas of agricultural development identified by the Ninth Plan, which remains equally relevant today, are the following.

- *Conservation of land, water and biological resources.*
- *Rural infrastructure development.*
- *Development of rainfed agriculture.*
- *Development of minor irrigation.*
- *Timely and adequate availability of inputs.*
- *Increasing flow of credit.*
- *Enhancing public sector investment.*
- *Enhanced support for research.*
- *Effective transfer of technology.*
- *Support for marketing infrastructure.*
- *Export promotion.*

EXPANSION AND DEVELOPMENT OF INPUTS AND SERVICES

It has been indisputably proved that input expansion and development in agriculture can bring about a significant output expansion and remarkably increase labour absorption. The agricultural input development strategy has implications for business.

Our Five Year Plans have emphasised the role of agriculture in national development, and the Central and State Governments have taken a number of steps to develop the agrarian sector. Some of these important measures are reviewed in the following paragraphs.

Irrigation is one of the important inputs that significantly increases agricultural productivity and employment opportunities. The Union and State Governments have been endeavouring to expand the area under irrigation by executing major, medium and minor irrigation projects and exploiting the groundwater potential. Rural electrification programmes, too, have been given importance so that they may help improve agricultural operations by facilitating the energisation of pump sets, etc. These strategies brighten the prospects of industries which supply inputs for the development of the irrigation infrastructure (like cement, steel etc.), electrification (aluminium cables, steel etc.). It would also increase the demand for electric pump sets and products required for facilitating irrigation like PVC pipes, agricultural implements, insecticides and pesticides, fertilisers, bank credit etc.

Many measures have been taken by Central and State governments to develop the infrastructure and input supplies needed for agricultural development.

Recently, there has been a growing recognition of the role of the private sector in developing irrigation. Private sector participation involves not only the private corporate sector but also groups like farmers' organisations, voluntary bodies and the general public. About 90-95 per cent

of groundwater development is by private efforts either through own financing or institutional financing or both. However, in the case of surface water, especially major and medium projects, all the irrigation projects are not equally endowed with the potential for privatisation and, as such, identification of projects as a whole or partially (*i.e.,* planning and investigation, construction, operation and management financing and maintenance etc.) may have to be undertaken in the light of its viability *vis-à-vis* various privatisation options as available with hydel power generation and recreation, etc. along with irrigation, the viability for privatisation of a project improves.

Some States like Maharashtra, Madhya Pradesh and Andhra Pradesh have initiated the action for privatisation of irrigation projects. These projects are envisaged for privatisation on Build-Own-Operate (BOO), or Build-Own-Operate-Transfer (BOOT) or Build-Own-Lease (BOL) basis. In the case of projects on BOO basis, the Irrigation Department may buy water in bulk from the agency at mutually agreed price for distribution to the farmers. Apart from this, resources have been mobilised through issue of Public Bonds from the private market for major projects in several States.

A far-reaching event in the annals of Indian agriculture was the introduction of high-yielding varieties (HYV) of a number of field crops and hybrids of millets in particular. This programme covers major food crops, namely, wheat, rice, maize, jowar and bajra. The success of this programme has revolutionised agriculture and brought about a phenomenal and rapid increase in foodgrains production in the country. The high-yielding variety programme is one of the most important planks of the new agricultural strategy. The area under HYV seeds has been showing a progressive increase from year to year. The increasing use of HYVs increases the demand for plant nutrients and protectants like fertilisers, insecticides and pesticides. The increase in the agricultural income normally increases the demand for a variety of goods and services.

The National Seeds Corporation (NSC) and State Farms Corporation of India (SFCI) were set up in 1963 and 1969, respectively, by the Government of India for the supply of quality seeds. After the liberalisation, foreign firms have also set up shops in India.

Farm research in the country is carried out and coordinated by a number of public and quasi-public institutions, spearheaded by the Indian Council of Agricultural Research (ICAR). The Department of Agricultural Research and Education, set up in 1973, is responsible for coordinating research, education and extension education in the field of agriculture, animal husbandry and fisheries in India. Besides, it also helps in bringing about inter-institutional and intra-institutional collaboration, both at national and international levels, among agencies like the International Atomic Energy Agency and FAO engaged in allied fields.

A number of organisations have been established to assist the development of the agricultural sector in various ways.

The Government of India, the Reserve Bank of India and the State Governments have made commendable efforts in the field of agricultural credit. The cooperative structure, with its country-wide network of primary cooperatives, the commercial banks and the Regional Rural Banks (RRB), are the three main agencies involved in the provision of credit for agriculture and allied sectors. With a view to bringing about better coordination in the credit policies impinging on short-, medium- and long-term financing of agriculture and allied activities, including marketing, processing and shortage, as well as rural industries, it was decided to establish a National Bank for Agriculture and Rural Development (NABARD). It is an apex refinancing institution in the country for these activities and will combine the developmental and financial roles which were hitherto being performed by the RBI and the Agricultural Refinance and Development Corporation (ARDC).

Steps have been taken for plant protection, soil conservation, drought-prone area development, etc.

The Agro Service Centre Scheme was introduced in 1971 with the twin objectives of providing employment to trained entrepreneurs and providing inputs to farmers at their doorsteps at reasonable prices.

The Food Corporation of India (FCI), set up in 1965, serves the nation in the vital areas of procurement, distribution, storage and movement of foodgrains. It also performs other diversified activities, such as rice milling and production of nutritious processed foods.

The Central Warehousing Corporation acquires and builds godowns and warehouses for the storage of agricultural produce, inputs, implements and notified commodities. There are also State Warehousing Corporations.

AGRICULTURAL MARKETING

As the Sixth Five Year Plan document observes a marketing system, which protects the interests of both producers and consumers, is the backbone of agricultural development. Such a marketing system must have three essential elements.

- A suitable structure of support prices for various agricultural commodities adjusted from time to time in the light of the cost of production so as to ensure fair returns to the farmers.
- Adequate arrangements for the procurement of agricultural produce at support prices if the prices fall below that level.
- A well-spread-out and regulated infrastructure of marketing which will ensure a fair price to the producer in open market conditions and help eliminate the non-functional marketing margins of intermediaries.

The Union and State Governments have taken a number of measures with the objective of ensuring that the above conditions are satisfied.

The Agricultural Price Policy (it has been dealt with in some detail at the end of this chapter) seeks to achieve the first of the above-mentioned three objectives.

The principal public agencies involved in support price operations (procurement) on behalf of the Government to achieve the second objective are the Food Corporation of India, the Cotton Corporation of India, the Jute Corporation of India and the Cooperatives with the National Agricultural Cooperative Federation of India (NAFED) as their apex organisation.

Development of agricultural sector demands, among other things, a well developed and efficient marketing infrastructure and a suitable price support system.

Besides, some State Governments have also been procuring agricultural produce, particularly foodgrains, on support prices, either departmentally or through their own Civil Supplies Corporations.

To achieve the third objective, a number of steps have been taken since the commencement of planning, aimed at regulating the marketing practices, standardising weights and measures, developing suitable infrastructure facilities in assembling markets, introducing quality standards through *Agmark* certification, etc. The Agricultural Produce Markets Act as an important piece of legislation aimed at improving agricultural marketing practices.

Directorate of Marketing and Inspection

The establishment of the Directorate of Marketing and Inspection was a very important step. The important functions of the Directorate are:

1. Giving advice to the Central and State Governments on agricultural marketing problems.
2. Promoting the grading and standardisation of agricultural and allied activities.
3. Statutory regulation of markets and market practices.

4. Training of personnel.
5. Market extension.
6. Market research, planning and survey.
7. Administration of the Cold Storage Order, 1964, and Meat Food Products Order, 1973.

The Directorate enforces compulsory quality control before export on as many as 40 agricultural commodities. The important commodities graded under *Agmark* for internal consumption include cotton, vegetable oils, ghee, cream, butter, eggs, rice, wheat, atta, jaggery, potatoes, pulses, Kangra tea, honey and ground spices. To ensure the purity and quality of the products graded under *Agmark,* a number of laboratories have been set up in different parts of the country. The Directorate has formulated grade specifications and grading instructions for a large number of commodities.

Regulated Markets

Over the years, a number of regulated markets have been established to eliminate unhealthy marketing practices, reduce marketing charges and to ensure fair prices. *The regulated market is a market the activities of which are regulated by law and is meant for dealing in a specific commodity or group of commodities.*

The main objective of the regulated market is to save the farmers from the exploitation of unscrupulous market intermediaries and to ensure a fair price for their produce.

The regulated market is administered by a committee which represents different interests like the State Government, local institutions, traders, brokers, commission agents and farmers. The committee regulates the various activities connected with sales and purchases in the market. For instance, it issues licences to the functionaries of the market, fixes charges for weighing, brokerage, etc., ensures the use of standard weights and measures, and provides for the supervision and check-up of proper weighing and measuring. There are also arrangements for the settlement of disputes and punishment of the guilty.

The regulation of markets is the responsibility of State Governments.

The Directorate of Marketing and Inspection renders advice on framing market legislation and its enforcement.

Cooperative Marketing

The cooperative sector has been assigned an important role in agricultural marketing too. The National Cooperative Marketing Federation of India (NAFED) has been playing a useful role in this respect.

The cooperative movement has been promoted with the objective of helping the small farmers. Cooperative agencies can play a vital role by arranging to collect the produce of the small farmers, grading and storing it, and helping them to sell at an advantageous price. In short, cooperatives are expected to reduce market imperfections, render the required marketing services and to ensure fair prices. It should be noted that marketing is only one of the important functions of the cooperative sector.

The agricultural marketing infrastructure has not kept pace with the accelerated growth of production in the country. This has resulted in significant post-harvest losses of agricultural produce. The Central Government has provided assistance for the creation of infrastructure facilities, for marketing and for the setting up of rural godowns. The Ninth Plan proposed to encourage Panchayats also to involve themselves actively in creating marketing infrastructure at the rural level. Marketing extension, being a key factor in bringing desirable changes in attitude, skills and behaviour of the farmers, traders and consumers, it has been proposed to strengthen the agricultural marketing extension. Further, direct marketing has been promoted in the interests of both the producers and the consumers.

AGRICULTURAL PRICE POLICY

The agricultural price policy is essentially a part of the general price policy which is an important ingredient of the national economic policy. The fact that nearly two-thirds of the Indian population directly depends upon agriculture and that about one-fourth of the national product is generated by this sector indicates the importance of agricultural price policy in India.

The agricultural price policy of the Government of India has three main objectives:

1. To ensure a remunerative price to farmers;
2. To ensure the supply to the consumers at reasonable price; and
3. To establish a structure of relative prices which achieves a desirable cropping pattern.

To achieve the first objective, the Government fixes, from time to time, *Minimum Support Price/Procurement Price* for certain commodities.

The distribution at reasonable prices of certain commodities like foodgrains procured by the Government at prices fixed by it facilitates the achievement of the second objective. The third objective is achieved by making appropriate variations in the relative price structure.

The Commission for Agricultural Costs and Prices (CACP) recommends to the Government the prices that may be fixed for different agricultural commodities. While recommending the prices, the CACP is guided by the three objectives mentioned above. The policy of the Government, as mentioned above, is that the role of agricultural pricing policy should not be limited only to ensuring remunerative prices to farmers, but should also extend to achieving a better inter-crop balance through a desirable cropping-mix and reducing the existing variability of agricultural production and its consequent effects on the price levels and national income.

Agricultural commodities like wheat and paddy have *procurement prices* fixed for them; the *minimum support price* operates for several commodities—like barley, gram, arhar, moong, urad, mustard, groundnut, sunflower seed, soyabean, and cotton (kapas); and sugarcane, jute and tobacco are subject to *statutory minimum price*.

Purchases of the commodities controlled by the procurement/minimum support prices are made by official agencies. For instance, the Cotton Corporation of India purchases cotton, the Jute Corporation of India purchases jute and the National Agricultural Cooperative Marketing Federation purchases commodities like oilseeds, pulses, onions, potatoes, etc.

Despite the price support policies of the Government, the fact remains that the prices of many agricultural commodities are not remunerative enough. In case of several agricultural commodities, the Government has not taken any effective action to arrest the fall in prices to unremunerative levels.

However, it has been found in many instances that the Government agencies are not sufficiently equipped to efficiently carry out the large-scale purchase operations that are required to ensure the minimum price to the farmers. The result is that the expected benefits do not often reach the producers.

It is alleged that the Government's price policy is affected a lot by political considerations. *For example*, Government fixed a prices considerably higher than those recommended by the CACP for commodities like wheat (See Box 37.4) whereas no effective step has been taken to ensure remunerative price for commodities like coconut, rubber etc.

BOX 37.3 : NATIONAL AGRICULTURE POLICY

Recognising the need for agricultural sector reforms as part of economic reforms, the Central Government announced on 28th July, 2000, a National Agriculture Policy. The salient features of the Policy are given below.

- *The Policy aims at catapulting agricultural growth to over 4 per cent per annum by 2005. This growth is to be achieved through a combination of measures including structural, institutional, agronomics and tax reforms.*
- *Privatisation of agriculture and price protection of farmers in the post-QR regime would be part of the Government`s strategy to synergise agricultural growth. The focus of the new policy is on efficient use of resources and technology; adequate availability of credit to farmers and protecting them from seasonal and price fluctuations. Over the next two decades, the policy aims to attain a growth rate in excess of four percent per annum in the agriculture sector.*
- *Private sector participation would be promoted through contract farming and land leasing arrangements to allow accelerated technology transfer, capital inflow, assured markets for crop production, especially of oilseeds, cotton and horticultural crops.*
- *Private sector investment in agriculture would be encouraged, particularly in areas like agricultural research, human resource development, post-harvest management and marketing.*
- *In view of dismantling of quantitative restrictions (QRs) on imports as per WTO agreement on agriculture, the policy has recommended formulation of commodity-wise strategies and arrangements to protect farmers from adverse impact of undue price fluctuations in the world market and promote exports.*
- *Government would enlarge coverage of futures markets to minimise the wide fluctuations in commodity prices as also for hedging their risks. The policy hoped to achieve sustainable development of agriculture, create gainful employment and raise standards of living.*
- *The Policy envisages evolving a "National Livestock Breeding Strategy" to meet the requirement of milk, meat, egg and livestock products and to enhance the role of draught animals as a source of energy for farming operations.*
- *Plant varieties would be protected through a legislation to encourage research and breeding of new varieties. Development of animal husbandry, poultry, dairy and aquaculture would receive top priority.*
- *High priority would be accorded to evolve new location-specific and economically viable improved varieties of farm and horticulture crops, livestock species and aquaculture. Domestic agriculture market would be liberalised.*
- *The restrictions on the movement of agricultural commodities throughout the country would be progressively dismantled. The structure of taxes on foodgrains and other commercial crops would be reviewed.*
- *The excise duty on materials such as farm machinery and implements and fertilisers used as inputs in agricultural production, post-harvest storage and processing would be reviewed.*
- *Appropriate measures would be adopted to ensure that agriculturists, by and large, remained outside the regulatory and tax collection system.*
- *Rural electrification would be given high priority as a prime mover for agricultural development.*
- *The use of new and renewable sources of energy for irrigation and other agricultural purposes would be encouraged.*
- *Progressive institutionalisation of rural and farm credit would be continued for providing timely and adequate credit to farmers.*
- *Endeavour would be made to provide a package insurance policy for the farmers, right from sowing of crops to post-harvest operations, including market fluctuations in the price of agricultural produce.*

Courtesy: Government of India, *Economic Survey 2000-2001.*

COMMODITY EXCHANGE

Organised market are an aid to the efficient functioning of an economy, for they help to reduce marketing risks, increase marketing productivity, impart liquidity, provide profitable investment opportunities, augment resources, and so on.

There are two principal types of organised markets, namely, organised commodity market and organised stock market. These organised markets are popularly known as Commodity Exchanges and Stock Exchanges.

A commodity exchange is an organised market where transactions in the sale and purchase of commodities—primary articles like agricultural produce and minerals or manufactured articles—are carried out. In this market, business is transacted according to a prescribed set of rules, and participation in the business is limited to the registered members of an exchange. It is not necessary for the commodities to be physically exchanged; only the rights to ownership are.

Commodity exchanges in India are known as *recognised associations* under the Forward Contracts (Regulation) Act, 1952. There are a number of such associations; *for example*, the India Pepper and Spices Trade Association, Cochin; the Alleppey Oil Millers' and Merchants' Association, Alleppey; and so on.

Commodities Suitable for Dealing on Commodity Exchange

A commodity should have the following features if an organised market is to be developed for it.

1. Durability.
2. Classification, standardisation and grading facilities.
3. Large supply and large demand.
4. Uncertainty of supply and demand.
5. Uncontrolled and unrestricted supply and demand, *i.e.,* free competition.
6. Wide fluctuation in price.
7. Adequate storage facilities.

Spot and Futures Trading

The transaction in a Commodity Exchange can be classified as Spot Trading and Futures Trading.

Spot trading, also known as *cash transaction* or *non-futures transaction*, is a transaction in which the commodity is bought or sold by private transactions involving specific lots and grades for a definite delivery date either for cash or on credit.

The futures trading on a produce exchange refers to contracts for the future delivery of commodities. In futures trading, the commodities themselves are not brought to the futures or forward market; it is only the promises of future delivery, commonly called futures, that are traded.

A future contract can be effected only at the place reserved for this purpose, namely, the Pit or the Ring, and only during the hours prescribed by the exchange.

Hoffman has listed the differences between a spot contract and a futures contract[1] as shown in Table 37.1.

TABLE 37.1 : CHARACTERISTICS OF SPOT AND FUTURES CONTRACTS		
	Cash Contract	*Future Contract*
1	Is used to market or merchandise	Is used to speculate or hedge against price the commodity. changes of the commodity.
2	Is executed at tables of the exchange or privately.	Is executed in the pit or ring.
3	Trades in irregular amounts, *e.g.,* cart loads or lots of any number of bales.	Trades in round lots, *e.g.,* 1000 bales or 5000 bushels.
4	Varying lengths of time used for delivery for delivery.	A particular future month named is used.
5	May or may not have optional period of delivery.	Seller's option of the day of delivery.
6	Usually calls for specific grade or type of commodity for fulfillment.	Seller's option of grade of a commodity to be delivered.

Future contracts are standard contracts under the rules of the trading exchange. The contract has to be drawn up in the standard form prescribed by the exchange. It is always subject to the bye-laws and rules governing futures trading. A futures contract entered into outside the exchange is illegal.

The need for futures trading arises from:

- The need for protection against risk of price changes
- The need for stabilising prices
- The need for the price registering function

The futures market acts as a price barometer for producers, industry, exporters, consumers, etc., and enables them to plan their production, trading and other activities more profitably.

The primary service of the futures market lies in its provision of a means of insurance against the risks of adverse price fluctuations between the time of the production of the commodity and its final utilisation. The insurance function is carried out by hedging or taking an opposite position on the futures market from that held in the spot market. This enables the market functionaries to charge low rates of commission for their services. The cost of marketing is thus reduced.

A future market, by reducing market imperfections, helps to minimise price fluctuations. Price differences between different places are eliminated or minimised by arbitrage operations carried on by the speculators. A produce exchange collects all the data relevant to the commodity it deals in. A proper dissemination of market information helps to minimise upward or downward price swings, and enables the producers and consumers to sell and buy commodities at more competitive and reasonable prices.

The commodity exchange collects and disseminates information on all the prices of the commodity, including the prices which the speculative investors are willing to pay many months ahead. This ensures in elements of certainty and stability in all the phases of business transactions.

While the futures market serves some very useful purpose, it is also susceptible to speculative manipulations which sometimes may turn out to be detrimental to the public interest, particularly of the farmers and consumers.

Regulation of the Commodity Exchange

Various activities on a commodity exchange are regulated by provisions of certain laws, some of which have been dealt with in some other chapters of this book. There is, however, a

specific law designed to regulate the futures trading, a major business on an organised commodity exchange, namely, the Forward Contracts (Regulation) Act.

The Forward Contracts (Regulation) Act was passed by the Government of India in 1952 to enable it to regulate the functioning of the futures market in the national interest.

The Act defines the forward contract "as a contract for the delivery of goods at a future date and which is not a ready delivery contract". The ready delivery contract means, according to the Act, a contract which provides for the delivery of goods and the payment of a price, therefore, either immediately or within such period not exceeding eleven days after the date of the contract and subject to such conditions as the Central Government may, by notification in the Official Gazette, specify in respect of any goods, the period under such contract not being capable of extension by the mutual consent of the parties thereto or otherwise.

The salient features of the Act are given below.

1. It enables the regulating authority to take such action as may be considered desirable, in respect of specified commodities and specified areas: When Section 15 of the Act is applied to a commodity in an area by a Gazette of India Notification, forward contracts cannot be entered into in that commodity in that area otherwise than between members of a recognised association or through or with any such members.
2. Section 19 of the Act prohibits option trading in all commodities (option trading is a sale of purchase of a right to purchase or sell certain commodities within a fixed time at a price agreed upon at the time the option is purchased). This measure is intended to check the volume of speculation.
3. The Act ordinarily exempts non-transferable specific delivery (NTSD) contracts from its regulation, though provision has been made for their control by a notification by the Union Government.
4. The Act ordinarily covers transferable specific delivery (TSD) contracts and hedge contracts. However, if it is felt that these contracts can be left free from regulation; in any area or in any commodity, the Act permits the exemption of such contracts from the regulation, by a notification under the Act.
5. Section 17 of the Act empowers the Government to prohibit forward contracts in a particular commodity altogether by a notification.
6. The Act provides for the grant of recognition to associations concerned with forward trading, which is liable to be withdrawn if the Central Government considers it desirable to do so.
7. It provides that the regulation of forward markets should ordinarily be done by the governing bodies of recognised associations. But the Government has the power to supersede the governing body. It has the final say in amendments to the bye-laws and constitution of the recognised associations. It can also amend the constitution and bye-laws on its own initiative.
8. The Central Government is empowered under the Act to appoint not more than four members on the governing bodies of recognised associations.
9. The Act empowers the Central Government to call for periodical returns, annual reports or any other information from recognised associations, to hold an enquiry into the affairs of the association or any of its members.

10. Further, under the Act, the Government has the power to establish an Advisory Committee; has the power to delegate its powers exercisable under the Act, has the power to exempt any contract or contracts from any or all the provisions of the Act; and has the power to make rules.
11. The Act provides for a machinery for the supervision and regulation of the governing bodies of the associations. This machinery is known as the Forward Markets Commission.
12. By an amendment of the Act in 1960, all associations dealing in forward contracts were required to register themselves with the Forward Markets Commission, irrespective of whether they deal in hedge contracts, TSD contracts or NTSD contracts.

The Forward Markets Commission: In accordance with the terms of the Forward Contracts (Regulation) Act, the Central Government established the Forward Markets Commission in 1953. The Commission has both advisory and executive functions. As an advisory body, it advises the Central Government on the application of the various provisions of the Act and the recognition of associations. As an executive body, it gives directions to recognised associations and exercises such other powers as may be assigned to it by or under this Act.

The following are the functions of the Commissioner as set out in Section 4 of the Act.

1. To advise the Central Government on the recognition of, or the withdrawal of recognition from, any association or in respect of any other matter arising out of administration of the Act.
2. To keep forward markets under observation and to take such action in relation to them as it may consider necessary in exercise of the powers assigned to it by or under this Act.
3. To collect and, whenever the Commission thinks it necessary, to publish information on the trading conditions of the goods to which any of the provisions of this Act is made applicable, including information on supply, demand and prices, and to submit to the Central Government periodical reports on the operation of this Act and on the working of the forward markets relating to such goods.
4. To make recommendations, generally with a view to improving the organisation and working of forward market.
5. To undertake the inspection of the accounts and other documents of any recognised association or registered association or any member of such association, whenever it considers it necessary.
6. To perform such other duties and exercise such other powers as may be assigned to the Commission by or under this Act or may be prescribed.

The Forward Markets Commission has the following powers.

1. Power to approve amendments to the rules of recognised associations.
2. Power to direct rules to be made or amend or make rules.
3. Power to make or amend bye-laws of recognised associations.
4. Power to call upon a recognised association to furnish an explanation of its affairs of any of its members.
5. Power to suspend the business of a recognised association.

FMC to Merge with SEBI

Government has decided to merge the FMC with the Securities and Exchange Board of India (SEBI).

SUMMARY

Agriculture which generates about one-fourth of the GDP, one-fifth of the export earnings and on which over sixty per cent of the population depends, is regarded the most crucial sector of the Indian economy. In fact, rural India represents one of the largest potential markets in the world for many manufactured products.

The development strategy and the pattern of resource allocation, and growth rates of the agricultural sector have very important implications for business because of the forward and backward linkages between the primary (mostly agricultural), secondary (industrial) and tertiary (service) sectors.

The agricultural development strategy in Indian planning concentrated, broadly, mostly on:

- Expansion and development of infrastructure, inputs and services.
- Development of agricultural marketing.
- Providing price support.

Several measures have been taken by the Central and State governments to develop irrigation, transportation and input and produce storage facilities; improve availability of quality seeds and planting materials, and plant nutrients; and develop new varieties of seeds and plants. A lot of importance is given to agricultural research and extension services.

Agricultural credit is provided mainly by the cooperative structure, with its country-wide network of primary cooperatives, the commercial banks and the Regional Rural Banks (RRBs), are the three main agencies involved in the provision of credit for agriculture and allied sectors. The National Bank for Agriculture and Rural Development (NABARD) was established with a view to bringing about better coordination in the credit policies impinging on short-, medium- and long-term financing of agriculture and allied activities, including marketing, processing and shortage, as well as rural industries.

The agricultural price policy of the Government involves fixing, from time to time, *Minimum Support Price/Procurement Price* for certain commodities. The Commission for Agricultural Costs and Prices (CACP) recommends to the Government the prices that may be fixed for different agricultural commodities. While recommending the prices, the CACP is guided by the three objectives, *viz*., to ensure a remunerative price to farmers; to ensure the supply to the consumers at reasonable price; and to establish a structure of relative prices which achieves a desirable cropping pattern.

An efficient marketing system is essential to protect the interests of the producers, consumers and the economy as a whole. The important objectives of the Government measures to develop agricultural marketing are: (1) A suitable structure of support prices for various agricultural commodities adjusted from time to time in the light of the cost of production so as to ensure fair returns to the farmers. (2) Adequate arrangements for the procurement of agricultural produce at support prices if the prices fall below that level. (3) A well-spread-out and regulated infrastructure of marketing which will ensure a fair price to the producer in open market conditions and help eliminate the non-functional marketing margins of intermediaries. The cooperative sector has been assigned an important role in the marketing of agricultural inputs and outputs.

One of the important measures taken to develop agricultural marketing is the promotion of Commodity Exchanges. A Commodity Exchange is an organised market where transactions in the sale and purchase of commodities—primary articles like agricultural produce and minerals or manufactured articles—are carried out. In this market, business is transacted according to a prescribed set of rules, and participation in the business is limited to the registered members of an exchange. It is not necessary for the commodities to be physically exchanged; only the rights to ownership are.

Organised markets are an aid to the efficient functioning of an economy, for they help to reduce marketing risks, increase marketing productivity, impart liquidity, provide profitable investment opportunities, augment resources, and so on.

Commodity exchanges in India are known as *recognised associations* under the Forward Contracts (Regulation) Act, 1952.

The transaction in a Commodity Exchange can be classified as Spot Trading and Futures Trading. Spot trading, also known as *cash transaction* or *non-futures transaction*, is a transaction in which the commodity is bought or sold by private transactions involving specific lots and grades for a definite delivery date either for cash or on credit. The futures trading on a produce exchange refers to contracts for the future delivery of commodities. In futures trading, the commodities themselves are not brought to the futures or forward market; it is only the promises of future delivery, commonly called futures, that are traded.

The primary service of the futures market lies in its provision of a means of insurance against the risks of adverse price fluctuations between the time of the production of the commodity and its final utilisation. The insurance function is carried out by hedging or taking an opposite position on the futures market from that held in the spot market. This enables the market functionaries to charge low rates of commission for their services. The cost of marketing is thus reduced. A future market, by reducing market imperfections, helps to minimise price fluctuations. Price differences between different places are eliminated or minimised by arbitrage operations carried on by the speculators. A produce exchange collects all the data relevant to the commodity it deals in. A proper dissemination of market information helps to minimise upward or downward price swings, and enables the producers and consumers to sell and buy commodities at more competitive and reasonable prices.

While the futures market serves some very useful purpose, it is also susceptible to speculative manipulations which sometimes may turn out to be detrimental to the public interest, particularly of the farmers and consumers.

The thrust areas of agricultural development identified by the Ninth Plan (1997-2002) are; conservation of land, water and biological resources; rural infrastructure development; development of rainfed agriculture; development of minor irrigation; timely and adequate availability of inputs; increasing flow of credit; enhancing public sector investment; enhanced support for research; effective transfer of technology; support for marketing infrastructure; and export promotion.

Recognising the need for agricultural sector reforms as part of economic reforms, the Central Government announced on 28th July, 2000 a National Agriculture Policy which aims at catapulting agricultural growth to over 4 per cent per annum by 2005. This growth is to be achieved through a combination of measures including structural, institutional, agronomics and tax reforms. Privatisation of agriculture and price protection of farmers in the post-QR regime would be part of the Government's strategy to synergise agricultural growth. The focus of the new policy is on efficient use of resources and technology, adequate availability of credit to farmers and protecting them from seasonal and price fluctuations.

In view of dismantling of quantitative restrictions (QRs) on imports as per WTO agreement on agriculture, the Policy has recommended formulation of commodity-wise strategies and arrangements to protect farmers from adverse impact of undue price fluctuations in the world market and promote exports.

The Policy proposes to enlarge coverage of futures markets to minimise the wide fluctuations in commodity prices as also for hedging their risks. The policy hoped to achieve sustainable development of agriculture, create gainful employment and raise standards of living.

The Policy envisages evolving a "National Livestock Breeding Strategy" to meet the requirement of milk, meat, egg and livestock products and to enhance the role of draught animals as a source of energy for farming operations. Plant varieties would be protected through a legislation to encourage research and breeding of new varieties. Development of animal husbandry, poultry, dairy and aquaculture would receive top priority.

According to the Policy, high priority would be accorded to evolve new location-specific and economically viable improved varieties of farm and horticulture crops, livestock species and aquaculture. Domestic agriculture market would be liberalised.

It also endeavours to provide a package insurance policy for the farmers, right from sowing of crops to post-harvest operations, including market fluctuations in the price of agricultural produce.

REFERENCE

1. **Cited by R.N. Pratap, *Futures Trading in India* (Dissertation Submitted in Partial Fulfilment of the Master's Degree Examination of the University of Mysore, 1972).**

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Part 7

GLOBAL ENVIRONMENT

The ubiquitous liberalisation is resulting in the emergence of a “borderless world” for business. The last quarter of the twentieth century witnessed sweeping political and economic changes. The privatisation strategy heralded by Margaret Thatcher (a former Prime Minister) in the UK significantly enhanced the pride of place of the private enterprise in the developed economies. The economic changes ushered in People’s Republic of China in 1978 marked the beginning of revolutionary changes in the economic policies in the communist world. The crumbling of communism/socialism in the erstwhile USSR and Eastern Block at the end of the 1980s accelerated the pace of borderless expansion of business. Other developing countries too have substantially liberalised and reformed their economic regimes.

The World Trade Organisation (WTO) is a profound environmental factor in global business; its Principles and Agreements foster, monitor and regulate the emerging borderless business world. Encouraged by the above factors, cross-border investments have been surging and MNCs have been growing substantially. This *Part* presents a general picture of these factors and the Indian policy and regulation of international business and financial transactions.

Chapter 38

GATT/WTO AND GLOBAL LIBERALISATION

Structure

GATT

The Uruguay Round

Salient Features of UR Agreement

GATS

TRIMs

TRIPs

Evaluation of the Uruguay Round

Evaluation of WTO

Doha Declaration

WTO and Developing Countries

WTO and India

Summary

References

WTO principles and agreements are a very important component of the global business environment significantly impacting domestic as well as global business.

The global business environment is very significantly influenced by the World Trade Organisation (WTO) principles and agreements. They also affect the domestic environment. *For example,* India has had to substantially liberalise imports, including almost complete removal of quantitative import restrictions.

The liberalisation of imports implies that domestic firms have to face an increasing competition from foreign goods. Liberalisation of foreign investment can result in growing competition from local outfits of MNCs.

These liberalisations, on the other hand, also provides new opportunities for Indian firms as the foreign markets become more open for exports and investments.

The liberalisation also enables Indian firms to seek foreign equity participation and foreign technology. This could help them to expand their business or improve competitiveness.

Further, the liberalisation facilitates global sourcing by Indian firms so that they can improve their competitiveness. Indian suppliers can benefit from global sourcing by foreign firms.

Firms will have to be efficient and dynamic to survive the global competition. Inefficient firms may go out of business.

Consumers stand to benefit significantly from the liberalisation.

GATT

The General Agreement on Tariffs and Trade (GATT), the predecessor of WTO, was born in 1948 as result of the international desire to liberalise trade.

The Bretton Woods Conference of 1944, which had recommended the IMF and World Bank, had also recommended the establishment of an International Trade Organisation (ITO). Although the IMF and World Bank were established in 1946, the ITO charter was never ratified, because of objections that its enforcement provisions would interfere with the autonomy of domestic policy making. Instead, the GATT, which had been drawn up only as an interim agreement to fill the gap until the ITO charter was ratified, became the framework for international trading system since it came into being in 1948. The international trading system since 1948 was, at least in principle, guided by the rules and procedures agreed to by the signatories to the GATT which was an agreement signed by the contracting nations which were admitted on the basis of their willingness to accept the GATT disciplines.

The GATT was transformed into a World Trade Organisation (WTO) with effect from January, 1995. Thus, after about five decades, the original proposal of an International Trade Organisation took shape as the WTO. The WTO, which is a more powerful body than the GATT, has an enlarged role than the GATT.

The primary objective of GATT, the forerunner of WTO, was to expand international trade by liberalising trade so as to bring about all-round economic prosperity.

India is one of the founder members of the IMF, World Bank, GATT and the WTO.

Objectives

The Preamble to the GATT mentioned the following as its important objectives.

1. Raising standard of living.
2. Ensuring full employment and a large and steadily growing volume of real income and effective demand.
3. Developing full use of the resources of the world.
4. Expansion of production and international trade.

GATT embodied certain conventions and general principles governing international trade among countries that adhere to the agreement. The rules or conventions of GATT required that:

1. Any proposed change in the tariff, or other type of commercial policy of a member country should not be undertaken without consultation of other parties to the agreement.
2. The countries that adhere to GATT should work towards the reduction of tariffs and other barriers to international trade, which should be negotiated within the framework of GATT.

For the realisation of its objectives, GATT adopted the following principles:

1. *Non-discrimination:* The principle of non-discrimination requires that no member country shall discriminate between the members of GATT in the conduct of international trade. To ensure non-discrimination, the members of GATT agree to apply the principle of most favoured nation (MFN) to all import and export duties. This means that "each nation shall be treated as well as the most favoured nation." As far as quantitative restrictions are permitted, they too are to be administered without favour.

However, certain exceptions to this principle are allowed. For instance, GATT does not prohibit economic integration such as free trade areas or customs union, provided the purpose of such integration is "to facilitate trade between the constituent territories and not to raise barriers to the trade of other parties." The GATT also permits the members to adopt measures to counter dumping and export subsidies. However, the application of such measures shall be limited to the offending countries.

2. *Prohibition of Quantitative Restrictions:* GATT rules seek to prohibit quantitative restrictions as far as possible and limit restrictions on trade to the less rigid tariffs. However, certain exceptions to this prohibition are granted to countries confronted with balance of payments' difficulties and to developing countries. Further, import restrictions were allowed to apply to agricultural and fishery products if domestic production of these articles was subject to equally restrictive production or marketing controls.

3. *Consultation:* By providing a forum for continuing consultation, it sought to resolve disagreements through consultation. So far eight Rounds of trade negotiations were held under the auspices of the GATT. Each Round took several years. The Uruguay Round, the latest one, took more than seven years to conclude, as against the originally contemplated more than four years. This shows the complexity of the issues involved in the trade negotiations.

An Evaluation of GATT

The growing acceptance of GATT, despite its shortcomings, is evinced by the increase in the number of the signatories. When the GATT was signed in 1947, only 23 nations were party to it. It increased to 99 by the time of the Seventh Round and 117 countries participated in the next, *i.e.,* the Uruguay Round. In April 2008, there were 151 members with several more countries formally seeking accession to the WTO. The signatory countries account for about 90 per cent of the international trade indicating the potential of the WTO in bringing about an orderly development of the international trade.

One of the principal achievements of GATT was the establishment of a forum for continuing consultations. "Disputes that might otherwise have caused continuing hard feeling, reprisals, and even diplomatic rupture have been brought to the conference table and compromised".

GATT could achieve considerable trade liberalisation. There were, of course, several exceptions.

GATT achieved substantial trade liberalisation. But sectors which would have significantly benefited developing countries, like agriculture and textiles, were not liberalised.

Agricultural trade was clearly an exception to the liberalisation. Far from becoming freer, trade in agriculture became progressively more distorted by the support given to farmers (which took the form of severe barriers to imports and subsidies to exports) in the industrial nations.

Similarly, another exception was textiles. Trade in textiles was restricted by the Multifibre Arrangement (MFA). Under the MFA, imports of textile items to a number of developed countries were restricted by quotas.

Besides agriculture and textiles, two exceptions to the general trend of trade liberalisation have been trade of developing countries and economic integration. Developing countries with balance of payments problems have been generally exempted form the liberalisation. Even the Uruguay Round has granted such exemptions to developing countries.

Although the picture of trade liberalisation has to be qualified with such exceptions, the GATT achieved very commendable trade liberalisation. The average level of tariffs on manufactured products in industrial countries was brought down from about 40 per cent in 1947 to nearly three per cent after the Uruguay Round.

Indeed, the period of 1950-1973 is conspicuous by the splendid results of progressive trade liberalisation. In the 275 years since 1720, this period witnessed the highest average annual growth rates in output and international trade. These rates were substantially higher than for any other period. Indeed, the 1950s and 1960s are described as the golden decades of capitalism. The output levels of companies using newer and newer technologies in many cases were much larger than the domestic markets could absorb. Expansion of markets to other countries enabled even companies in other industries to increase their output. There was also a surge in international investments.

The progressive liberalisation of trade, however, suffered a setback since 1974. Although the elimination of Tariff Barriers continued, even the developed countries have substantially increased Non-Tariff Barriers since then.

The collapse of the Bretton Woods system in the early 1970s and the oil crisis made matters very difficult for many countries, both developing and developed, and as a result of these, demands for protection increased dramatically. The developing country exports have been hit very hard by the NTBs, as pointed out earlier in this chapter.

Further, the exports of developing countries gained significantly less from the GATT Rounds than did exports of the industrial nations. The trade liberalisation has been confined mostly to goods of interest to the developed countries. In case of agricultural commodities not only was that there was no liberalisation, but also there was an increase in protection. Manufactured products of interest to developing countries like textiles and clothing, footwear etc. have been subject to increasing non-tariff barriers. While the developed countries enjoy a more liberalised trading environment, the growing NTBs have been severely affecting the exports of developing countries. Ironically, the developed countries are increasing the protectionism when the developing countries are liberalising. This is indeed a sad commentary on the GATT and other multilateral organisations.

THE URUGUAY ROUND

Uruguay Round (UR) is the name by which the eighth Round of the multilateral trade negotiations (MTNs) held under the auspices of the GATT is popularly known because it was launched in Punta del Este in Uruguay, a developing country, in September 1986.

Because of the complexities of the issues involved and the conflicts of interests among the participating countries, the Uruguay Round could not be concluded in December 1990 as was

originally scheduled. When the negotiations dragged on, Arther Dunkel, the then Director General of GATT, presented a Draft Act embodying what he thought was the result of the Uruguay Round. This came to be popularly known as the Dunkel Draft. This was replaced by an enlarged and modified final text which was approved by delegations from the member countries of the GATT on 15th December, 1993. This Final Act was signed by ministers of 125 governments on 15th April, 1994. The results of the Uruguay Round are to be implemented within ten years since 1995. Different time periods were given for effecting the different agreements.

The first six Rounds of MTNs concentrated almost exclusively on reducing tariffs, while the Seventh Round (Tokyo Round — 1973-79) moved on to tackle non-tariff barriers (NTBs). The UR sought to broaden the scope of MTNs far wider by including new areas such as:

The Uruguay Round enormously expanded the scope of multilateral trade negotiations by including new areas like services, TRIPs and TRIMs.

- Trade in services
- Trade related aspects of intellectual property (TRIPs)
- Trade related investment measures (TRIMs).

Because of the inclusion of these new aspects in the GATT negotiations, the developing countries had serious apprehensions, about outcome of the Uruguay Round.

The Uruguay Round took up three basic subjects for discussion:

1. Reducing specific trade barriers and improving market access.
2. Strengthening GATT disciplines.
3. Problems of liberalisation of trade in services, trade related aspects of intellectual property rights (TRIPs) and trade related investment measures (TRIMs).

The most outstanding feature of the UR was the inclusion of the subjects in the 3rd item referred to above in the MTNs of GATT. The traditional concerns of the GATT were limited to international trade in goods. The UR went much beyond goods to services, technology, investment and information.

Some of the important features of the Uruguay Round Agreements are given below.

GATT AND WTO

Following the UR Agreement, GATT was converted from a provisional agreement into a formal international organisation called World Trade Organisation (WTO) with effect from January 1, 1995. WTO now serves as a single institutional framework encompassing GATT and all the results of the Uruguay Round. It is directed by a Ministerial Conference that will meet at least once every two years and its regular business is overseen by a General Council.

The old GATT system allowed, under what was known as the 'grandfather clause', existing domestic legislation to continue even if it violated a GATT agreement that a member country had accepted by being a signatory to GATT. The WTO, specially rules this out.

The WTO is GATT plus a lot more.

The situation, after the coming into effect of WTO may be described as *the GATT is dead, long live the GATT.*

Under the old system, there were two GATTs: *(i)* GATT the Agreement — *i.e.,* the agreement between contracting parties (governments) setting out the rules for conducting international trade; *(ii)* GATT the Organisation—an international organisation created to facilitate discussions and administration related to the Agreement (ad hoc, though, continued to exist until the establishment of the WTO). GATT the organisation, ceased to exist with the establishment of WTO; GATT the agreement, which always dealt with (and still does) trade in goods, continues to exist, in amended

form, as part of the WTO alongside two new agreements, *viz.*, General Agreement on Trade in Services (GATS) and General Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs). The old text is now called 'GATT 1947' and the updated version is called 'GATT 1994'. *In short.*

TABLE 38.1 : DIFFERENCE BETWEEN GATT AND WTO

GATT	*WTO*
GATT was ad hoc and provisional.	WTO and its agreements are permanent.
GATT had contracting parties.	WTO has members.
GATT system allowed existing domestic legislation to continue even if it violated a GATT agreement.	WTO does not permit this.
GATT was less powerful, dispute settlement system was slow and less efficient, its ruling could be easily blocked.	WTO is more powerful than GATT, dispute settlement mechanism is faster and more efficient, very difficult to block the rulings.

Functions

The WTO has the following five specific functions.

1. The WTO shall facilitate the implementation, administration and operation and further the objectives of the Multilateral Trade Agreements and shall also provide the framework for the implementation, administration and operation of Plurilateral Trade Agreements.
2. The WTO shall provide the forum for negotiations among its members concerning their multilateral trade relations in matters dealt with under the Agreements.
3. The WTO shall administer the 'Understanding on Rules and Procedures Governing the Settlement of Disputes'.
4. The WTO shall administer the 'Trade Review Mechanism'.
5. With a view to achieving greater coherence in global economic policy making, the WTO shall cooperate, as appropriate, with the IMF and IBRD and its affiliated agencies.

The General Council will serve four main functions:

1. To supervise on a regular basis, the operations of the revised agreements and ministerial declarations relating to: *(a)* goods, *(b)* services and *(c)* TRIPs;
2. To act as a Dispute Settlement Body;
3. To serve as a Trade Review Mechanism; and
4. To establish Goods Council, Services Council and TRIPs Council, as subsidiary bodies.

The WTO is a more powerful body with enlarged functions than the GATT and is envisaged to play a major role in the world economic affairs.

To become a member of the WTO, a country must completely accept the results of the Uruguay Round.

SALIENT FEATURES OF UR AGREEMENT[1]

Liberalisation of Trade in Manufactures

Liberalisation of trade in manufactures is sought to be achieved mostly by reduction of tariffs and phasing out of non-tariff barriers.

Tariff Barriers: The major liberalisations in respect of trade in manufactures, regarding tariffs, are:

1. Expansion of tariff bindings
2. Reduction in the tariff rates
3. Expansion of duty-free access

The UR Agreement envisages substantial tariff reductions in both industrial and developing countries.

The main liberalisations by industrial countries include the expansion of tariff bindings (*i.e.,* commitment not to exceed a particular level of tariff) to cover 99 per cent of imports, the expansion of duty-free access from 20 to 43 per cent of imports, and the reduction of trade weighted average tariff by 40 per cent, from 6.2 to 3.7 per cent.

However, the gains to developing countries from the tariff cuts by industrial countries is less impressive. The reduction in the average tariffs on their exports to industrial markets is 30 per cent and the labour-intensive manufactures (textiles, clothing, leather goods) and certain processed primary products (fish products) which are regarded as sensitive have below average tariff cuts.

In industrial countries, tariffs will be eliminated in several sectors like steel, pharmaceuticals and wood and wood products.

Developing countries agreed to bind their tariffs on 61 per cent of their imports of industrial products, compared with 13 per cent before the UR Round. They also offered to reduce their trade-weighted average bound tariff on imports from industrial countries by 28 per cent, from 15 to 11 per cent. The offers of tariff reduction on manufactures by developing countries are estimated to amount to over a third of the world total. The expansion of tariff binding by the developing countries, which rules out future increases in tariffs, is regarded as a significant achievement.

India has bound tariffs at 40 per cent (where they were above 40 per cent in 1993-94) on industrial raw materials, components and capital goods and at 25 per cent in other cases. After the UR Agreement comes into force, about 68 per cent of India's tariff lines will be bound (compared to five per cent earlier). In comparison, many developing countries in Asia and Latin America have bound between 90 and 100 per cent of their tariff lines at levels comparable to, or lower than, India's bindings.

Non-tariff Barriers: In the area of NTBs, the Agreements to abolish voluntary export restraints (VERs) and to phase out the Multifibre Arrangements (MFA) are regarded as landmark achievements for developing countries.

The phasing out of the existing VERs within four years and the MFA within ten years would scale back the coverage of NTBs on developing countries' trade from 18 per cent of their 1992 exports. As trade in derestricted product lines would tend to grow faster than other trade, this coverage could fall to 4.2 per cent by 2005.

A very significant feature of the UR Agreement is the liberalisation of textiles trade which significantly benefit several developing countries including India.

The UR Agreement seeks to phased out the MFA by 2005. According to some estimates, the phasing out of MFA would contribute about 20 per cent of the total welfare gains from the UR. The largest gains will go to the MFA importers who will be able to import basic clothing and textiles from the more efficient suppliers in ASEAN, China, South Asia and other regions. By 2005, the total benefits to the European Community, the US and Canada are estimated at $56 billion per year at 1992 prices. Income gains of over $13 billion are projected for highly competitive exporters such as China, Indonesia, Thailand and South-Asian exporters, despite the loss of quota rents provided under the MFA. Some less competitive exporters will suffer from the loss of their preferential access to industrial country markets unless they are able to increase their efficiency, and some currently unrestricted importers will lose as the exports currently diverted toward them by restrictions elsewhere can flow freely to the other markets.

Liberalisation of Agricultural Trade

As mentioned earlier, one of the salient features of the UR was the inclusion, for the first time, of agriculture in the MTN. The exclusion of agriculture from the previous Rounds and its effective exemption from the GATT discipline made agriculture a highly protected sector in the developed countries. The depressing impact of this on world prices prevented efficient producers from realising the benefits of their comparative advantage. Developing country exports suffered a lot.

The important aspects of the UR Agreement on agriculture include:

1. Tariffication
2. Tariff binding
3. Tariff cuts
4. Reduction in subsidies and domestic support.

Tariffication and Tariff Cuts: Tariffication means the replacement of existing non-tariff restrictions on trade such as import quotas by such tariffs as would provide substantially the same level of protection.

From the first year of the Agreement's implementation, nearly all border protection is to be bound by tariffs, which (in principle) are to be no higher than the tariff equivalent of the protection levels prevailing in the base periods.

Industrial countries are then to reduce their tariff bindings by an average of 36 per cent within six years (from 1995) while all developing countries but the poorest are required to reduce tariffs by an average of 24 per cent over a period of ten years. Least developed countries are not required to make any commitment for reduction of tariffs on agricultural products.

On agricultural tariffs, developing countries have the flexibility of indicating maximum ceiling binding. India has indicated ceiling bindings of 100 per cent on primary products and 300 per cent on edible oils.

Subsidies and Domestic Support Policies: The UR Agreement deals with three categories of subsidies.

1. *Prohibited subsidies* – those contingent upon export performance or the use of domestic instead of imported goods.

2. *Actionable subsidies* – those that have demonstrably adverse effects on other member countries.

3. *Non-actionable subsidies* including those provided (with stipulated limitations) to industrial research and pro-competitive development activity to disadvantaged regions, or to existing facilities to adapt themselves to new environmental requirements.

The UR Agreement sought to significantly curtail subsidies.

The Agreement also puts restrictions on the use of countervailing measures against competitors' subsidies. To prevent undue hardships, developing countries and countries in transition from centrally planned to market economies are allowed extra time to bring the subsidies into conformity with the new rules.

While industrial economies are required to reduce, over six years, the volume of subsidised agricultural exports by at least 21 per cent and the value of subsidies at least by 36 per cent, the respective figures for developing countries are 14 per cent and 24 per cent. All countries are bound not to introduce new subsidies.

The UR agreement has brought the domestic support policies also under the multilateral trade discipline. However, domestic support measures that have almost a minimal impact on trade ("green box" policies) such as general government services in the areas of research, disease control, infrastructure and food security as also certain direct payments such as certain income support policies, structural adjustment assistance, payment under environmental programmes and regional assistance programmes are exempted. The non-exempted types of subsidies included in the aggregate measure of support (AMS) required to be reduced include assistance in the form of production-limiting subsidies and assistance given for growth of agriculture and rural development like procurement at support prices and subsidies on inputs and credit. However, even these subsidies are required to be reduced only if their total amount as a proportion of the value of agricultural production exceeds five per cent in case of developed countries and 10 per cent in case of developing countries. If the non-exempted subsidies are above these limits, they are required to be reduced by 20 per cent in case of developed countries and by 13.3 per cent in developing countries by 1999.

According to Government of India, India's total AMS is negative (without taking into account exemptions available on input subsidies to low income and resource poor farmers) and there are no reduction commitments. Nor does India have any minimum market access commitments in agriculture. (The UR Agreement provides for the establishment of minimum access tariff quotas, at reduced tariff rates, where the access is less than 3 per cent of the domestic consumption. The minimum access tariff quotas are to be expanded to five per cent over the implementation period).

Assistance for 'food security" such as the food subsidy under the public distribution system (PDS) will be exempted to the extent they confine to the poor.

Non-agricultural Export Subsidies

Countries whose per capita income is less than $1000 are not bound to phase out export subsidies. (India's per capita income in 2000 was only $460). However, even such countries will have to phase out export subsidies on products where the share in the world exports is 3.25 per cent or more in two consecutive years. This is applicable to India in respect of exports of diamonds.

GATS

The General Agreement on Trade in Services (GATS) which extends multilateral rules and disciplines to services is regarded as a landmark achievement of the UR, although it achieved only little in terms of immediate liberalisation.

Because of the special characteristics and the socio-economic and political implications of certain services, they have been generally subject to various types of national restrictions. Protective measures include visa requirements, investment regulations, restrictions on repatriation, marketing regulations, restrictions on employment of foreigners, compulsions to use local facilities etc. Heavily protected services in different countries include banking and insurance; transportation; television, radio, film and other forms of communication; and so on.

The GATS defines services as the supply of a service from the territory of one member (country) into the territory of any other member; in the territory of one member to the service consumer of any other member; by a service supplier of one member, through commercial presence in the territory of any other member; or by a service supplier of one member, through presence of natural persons of a member in the territory of any other member.

An important feature of the UR Round was the initiation of liberalisation of trade in services.

In short, the GATS covers four modes of international delivery of services.

1. Cross-border supply (transborder data flows, transportation services)
2. Commercial presence (provision of services abroad through FDI or representative offices).
3. Consumption abroad (tourism)
4. Movement of personnel (entry and temporary stay of foreign consultants)

While industrial countries have offered market access commitment of some kind on over half (about 54 per cent) of their service activities, developing countries did so only on less than one-fifth (about 17 per cent) of their service categories. Tourism and travel-related services are the only activities in which a substantial number of developing countries made commitments.

The framework of GATS includes basic obligation of all member countries on international trade in services, including financial services, telecommunications, transport, audio-visual, tourism, and professional services, as well as movement of workers.

Among the obligations is a most favoured nation (MFN) obligation that essentially prevents countries from discriminating among foreign suppliers of services.

Another obligation is the transparency requirements according to which each member country shall promptly publish all its relevant laws and regulations pertaining to services including international agreements pertaining to trade in services to which the member is a signatory. Further, each member shall also respond promptly to all requests for specific information, by any other member, pertaining to any aspect of the service covered by the GATS. Each member shall also establish one or more enquiry points to provide specific information to other members. However, no member needs to provide any confidential information, the disclosure of which would impede law enforcement, or otherwise be contrary to public interest, or which would prejudice legitimate commercial interests of particular enterprise, public or private.

The GATS lays down that increasing participation of developing countries in world trade shall be facilitated through negotiated commitments on access to technology, improvements in access to distribution channels and information networks and the liberalisation of market access in sectors and modes of supply of export interest to them.

With reference to domestic regulation, the Agreement lays down that all measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner. There would be a requirement that parties establish ways and means for prompt reviews of administrative decisions relating to the supply of services.

It is recognised that particular pressures on the balance of payments of a member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, *inter alia*, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition.

A member country may, therefore, apply restrictions on international transfers and payments for current transactions under certain circumstances envisaged under the GATS. In the event of serious balance of payments and external financial difficulties or threat thereof, a member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments including on payments or transfers for transactions related to such commitments.

The commitments of member countries under the GATS also include national treatment (that is, to treat foreign suppliers of services like domestic suppliers) and provision of market access.

The Agreement on Trade in Services also establishes the basis for progressive liberalisation of trade in services through successive rounds of negotiations, which also applies to other agreements under the Final Act.

As stated earlier, the fear of the developing countries is that the liberalisation of trade in services will lead to the domination of the services sector of the developing countries by the multinationals of the industrialised countries. As a matter of fact, the trade in services is already dominated by the developed countries. The developing countries are net importers of services and their deficit has been growing. The apprehension is that a liberalisation of trade in services will accentuate the problem.

Although many services are labour-intensive and, therefore, the developing countries should be expected to have an advantage here, there have been several constraints in benefiting from this advantage. These include technical, organisational, financial and legal. Moreover, immigration laws of developed countries restrict the manpower flow from the developing to developed countries. This severely limits the scope of developing countries in benefiting from their comparative advantage. It may be noted that the industrial countries did not like to bring this issue in the Uruguay Round.

Although developing countries have great potentials to benefit from liberalisation of services trade, they have several handicaps.

TRIMs

Trade Related Investment Measures (TRIMs) refers to certain conditions or restrictions imposed by a government in respect of foreign investment in the country. TRIMs were widely employed by developing countries.

The Agreement on TRIMs provides that no contracting party shall apply any TRIM which is inconsistent with the WTO Articles. An illustrative list identifies the following TRIMs as inconsistent.

1. Local content requirement (*i.e.,* a certain amount of local inputs be used in products)
2. Trade balancing requirement (*i.e.,* imports shall not exceed a certain proportion of exports)
3. Trade and foreign exchange balancing requirements
4. Domestic sales requirements (*i.e.,* a company shall sell a certain proportion of its output locally)

The Agreement requires the notification of all WTO-inconsistent TRIMs and their phasing out within two, five and seven years by industrial, developing and least developed countries, respectively. Transition period can be extended for developing and least developed countries if they face difficulties in eliminating TRIMs.

A number of TRIMs were employed in India prior to the liberalisation ushered in 1991; many of them have been phased out since then.

TRIPs

One of the most controversial outcomes of the UR is the Agreement on Trade Related Aspects of Intellectual Property Rights including Trade in Counterfeit Goods (TRIPs). TRIPs along with TRIMs and services were called the "new issues" negotiated in the Uruguay Round. (See the Chapter on *Patents and Trade Marks* for details regarding TRIPs).

Anti-dumping Measures

The UR Agreement provides greater clarity and more detailed rules concerning the method of determining dumping and injury, the procedure to be followed in anti-dumping investigations, and the duration of anti-dumping measures. It also clarifies the role of dispute settlement panels in conflicts relating to anti-dumping actions taken by national authorities.

A product is regarded as dumped when its export price is less than the normal price in the exporting country or its cost of production plus a reasonable amount for administrative, selling and any other costs and for profits.

The anti-dumping action system now is more systematic and transparent.

Anti-dumping measures can be employed only if dumped imports are shown to cause serious damage to the domestic industry in the importing country. Further, anti-dumping measures are not allowed if the 'margin of dumping' (*i.e.,* the price differences) is *de minimis* (defined as 2 per cent of the export price of the product) or the volume of dumped imports is negligible (less than 3 per cent of imports of the product in question).

Safeguard Actions

Members may take safeguard actions, *i.e.,* import restrictions to protect a domestic industry from the negative effects of an unforeseen import surge, if a domestic industry is threatened with serious injury. The UR Agreement, however, prohibits the use of such actions where they constitute grey area measures, including voluntary export restraints, orderly marketing arrangements or other similar measures applied on either exports or imports. The existing grey area measures are to be phased out by 1999. Further, the Agreement provides for discipline on the use of all safeguard measures, including time limits, requirements for safeguard investigation, and non-discrimination (generally) among sources of supply.

Safeguard measures would not be applicable to developing countries where their share in the member country's imports of the product concerned is relatively small.

EVALUATION OF THE URUGUAY ROUND

The Uruguay Round was by far the most complex and controversial one. The fact that it took more than seven years to complete the negotiations as against the originally contemplated more than four years indicates the complexities involved. It is the inclusion of new areas like TRIPs, TRIMs, services and the attempts to liberalise agricultural trade and the elimination of NTBs like MFA that increased the complexity of the negotiations.

The success of the UR Agreement will depend upon the spirit with which it will be translated into practice. The tariffication of trade barriers was claimed to be a significant success of the UR. However, because of the way the NTBs were converted into tariffs, the so-called dirty tariffication, many of the tariff bindings exceeded the protection rate applying during the base period (which itself was one of generally high level of protection), some by as much as 200 per cent.

As in the case of the previous Rounds, most of the gains of the trade liberalisation accrue to developed economics. Many LDCs would even suffer.

Several estimates of the gains from the UR Agreement are available. They vary widely. According to some estimates, the real world income (in constant 1992 US dollar) will increase by between $212 billion and $274 billion in 2005. Further, such annual increases will follow. This amounts to around one per cent of world GDP. According to a GATT study, the gain will be as high as $510 billion.

Most of the gains will accrue to the developed countries. Some developing countries in the category of least developed countries and net food importers are expected to lose because of the Uruguay Round package.

According to some estimates, the increase in real income will be roughly 1.6 per cent of GDP for the European Union, 0.2 per cent for the US and 0.9 for Japan. As a single country, the largest gain in absolute terms will accrue to the US (between $28 and $67 billion). It will be between $27 and $42 billion for Japan, between $61 and $98 billion for the EU and between $36 and $78 billion for the developing countries. The gains would amount to about 2.5 per cent of the GDP for China, 0.5 per cent for India, 0.6 per cent for South Africa and 0.3 per cent for Brazil.

The GATT had estimates that world trade would increase by 12 per cent (on top of the normal growth rate), if the UR package is completely implemented. In constant 1992 US dollars,

this represents an increase of $745 billion. The value of world exports (including services) will increase by around 10 per cent. Exports of North America will increase by 8 per cent and European Union by 10.3 per cent. Some of the largest projected increases in world trade are in areas that are of interest to developing countries. For instance, world trade in textiles is projected to grow by 34 per cent, that in clothing by 60 per cent and that in agricultural, forestry and fishery products by 20 per cent.

According to the estimates made by the World Bank, OECD and the GATT Secretariat, the income effects of the implementation of UR package will add between $213 to 274 billion annually to world income. The GATT Secretariat's estimate of the overall trade impact is that the level of merchandise trade in goods will be higher by $745 billion in the year 2005, than it would otherwise have been. The largest increase will be in the areas of clothing (60 per cent), agriculture, forestry and fishery products (20 per cent) and processed food and beverages (19 per cent). Since India's existing potential export competitiveness lies to a significant extent in these product groups, India could be expected to obtain gains in these sectors.

It was estimated that cuts in protection on total merchandise trade will increase real incomes in developing countries by $55 to 90 billion (or 1.2 to 2 per cent of their GDP in 1992) while the gains to the world as a whole will be in the order of $200 billion.

EVALUATION OF WTO

WTO has come to play a very important role in the global, and thereby, national economies. National economic policies are significantly influenced by the principles, policies and agreements of WTO. Because of this, there are severe criticisms against WTO, particularly in the developing countries. In fact, WTO has both positive and negative impacts. The growing acceptance of *GATT*/WTO despite their shortcomings, is evinced by the increase in the number of member countries. When the GATT was signed, in 1947, only 23 nations were party to it. The membership of the WTO which was 128 in July 1995 stood at 162 at the end of May 2016 (of which 118 are developing countries) and a number of nations more have been negotiating membership. It is interesting to note that the People's Republic of China, which was one of the original signatories of the GATT quit it in the late 1940s following the assumption of power by the communist party, but got admitted to the WTO, after prolonged negations, with effect from January 1, 2002. The WTO members now account for about 95 per cent of the international trade indicating the potential of the WTO in bringing about an orderly development of the international trade.

The growing membership of WTO, particularly by the former communist and socialist countries, is an indication of the role of WTO in the global economy.

Benefits of WTO

1. GATT/WTO has made significant achievements in reducing the tariff and non-tariff barriers to trade. Developing countries too have been benefiting significantly out of it.
2. The liberalisation of investments has been fostering economic growth of a number of countries.
3. The liberalisation of trade and investment has been resulting in increase in competition, efficiency of resource utilisation, improvement in quality and productivity and fall in prices and acceleration of economic development.
4. WTO provides a forum for multilateral discussion of economic relations between nations.
5. It has a system in place to settle trade disputes between nations.

In 1948, GATT members accounted for 60 per cent of global exports and 53 per cent of imports. In 2006, WTO members did 94 per cent of exports and 96 per cent of imports.

6. WTO has a mechanism to deal with violation of trade agreements.
7. WTO does considerable research related to global trade and disseminates a wealth of information.

Drawbacks/Criticisms

As mentioned above, the WTO has been subjected to a number of criticisms. Important drawbacks/criticisms include the following:

1. Negotiations and decision-making in the WTO are dominated by the developed countries.
2. Many developing countries do not have the financial and knowledge resources to effectively participate in the WTO discussions and negotiations.
3. Because of the dependence of developing countries on the developed ones, the developed countries are able to resort to arms-twisting tactics.
4. Many of the policy liberalisations are done without considering the vulnerability of the developing countries and the possible adverse effect on them.
5. The WTO has not been successful in imposing the organisation's disciplines on the developed countries.
6. The developing countries have, in general, been getting a raw deal from the WTO.

It may also be noted that it has become a trend to blame WTO even for matters for which it is not responsible.

It is necessary that the developing countries do their homework properly before they go to the negotiating table, stand united to protect their common interests and formulate and implement strategies to combat the threats and to take advantage of the opportunities of the emerging world order.

The tragedy, however, is that not only that the developed countries are not earnestly implementing the provisions of the UR Agreement which will benefit the developing countries, but also they tend to become more protectionist in several respects. The irony is that while the developing countries have been increasingly opening up their markets, the developed countries have been increasing the barriers to the developing countries in several respects.

Joseph E. Stiglitz, a Nobel laureate and former chief economist and senior vice-president of World Bank (had also been on the Council of Economic Advisors under President Clinton) observes that "the level of pain in developing countries created in the process of globalisation and development as it has been guided by the IMF and the international economic organisations has been far greater than necessary. The backlash against globalisation draws its force not only from the perceived damage done to developing countries by policies driven by ideology but also from the inequities in the global trading system. Today, few—apart from those with vested interests who benefit from keeping out the goods produced by the poor countries—defend the hypocrisy of pretending to help developing countries by forcing them to open up their markets to the goods of the advanced industrial countries while keeping their own markets protected, policies that make the rich richer and the poor more impoverished—and increasingly angry."[2]

DOHA DECLARATION

The Fourth session of the Ministerial Conference of the WTO was held in Doha (Qatar) in November 2001, in which Ministers from the 142 member countries participated, provided the mandate for negotiations on a range of subjects and other work, including issues concerning the implementation of the present agreements. The Ministerial attracted a lot of attention because of the conflict of interests of the developed and developing countries. The negotiations included those on agriculture and services, which began in early 2000. The Fifth Ministerial Conference in Cancun, Mexico, in September 2003, was intended as a stock-taking meeting where members would agree on how to complete the rest of the negotiations. But the meeting was soured by discord on agricultural issues, including cotton, and ended in deadlock on the "Singapore issues".

At Doha, the developed countries wanted a new round of multilateral trade negotiation to be launched soon, covering what are known as the *Singapore Issues* (a list of seven items which were proposed at the meeting in Singapore in 1996 for future negotiations. These included: investment, competition policy, trade facilitation, transparency in government procurement, environment, agriculture, anti-trade related aspects of intellectual property rights (TRIPs).

Developing countries like India, on the other hand, held that the *Implementation Issues* should be resolved before a new Round. India had almost single-handedly fight against the developed countries.

The Doha meet concluded by drawing up the 'Doha Development Agenda' for new trade liberalisation talks; with India approving the ministerial declaration only after it was satisfied that the conference Chairman's statements had addressed the country's concerns in the four Singapore issues of foreign investment, competition policies, transparency in government procurement and trade facilitation.

Although, the developed nations, as expected, won the upper hand. India's bold stand has had a commendable impact. Because of India's refusal to approve the agenda unless, it was modified, the Chairman of the meeting announced that an explicit consensus would be required at the fifth ministerial conference in 2003, before negotiations could begin on the highly controversial Singapore issues. It is an indication that when the strong position taken by a single developing country can have such positive effects, collective action by the developing countries can have profound impact.

The Doha Ministerial adopted three major declarations: *(i)* on the negotiating agenda for the new WTO round, *(ii)* on some 40 implementation concerns of the developing countries and *(iii)* on the political statement dealing with patents and public health.

One remarkable achievement of the Doha Ministerial for developing countries is that in the case of TRIPs and public health, it allowed waiver of the patent law to face a national emergency. Now, it will be possible for developing countries to set aside the patent laws if they have to face epidemics such as malaria, tuberculosis, and AIDS. Each country has been given the freedom to define a national emergency.

The Doha declaration on TRIPs and Public Health was a milestone that recognised that intellectual property rights were subservient to public health concerns. It clearly stated that the TRIPS agreement does not and should not prevent members from taking measures to protect public health. It specifically recognises the flexibility that countries have to use compulsory licensing for local production. The declaration also set a timetable of December 2002 to find a solution for countries that did not have adequate manufacturing capacity. But negotiations ran aground—reopening them is urgent.[3]

According to the Doha declaration, WTO will continue to make positive efforts designed to ensure that developing countries, and especially the least-developed among them, secure a share in the growth of world trade commensurate with the needs of their economic development. It emphasised the importance of enhanced market access, balanced rules, and well targeted, sustainably financed technical assistance and capacity-building programmes.

In agriculture, it is conceded by all countries that subsidies need to be reduced and should be ultimately phased out. However, in the case of food security concerns, exception is permitted. All forms of export subsidies will be phased out. This is big problem for the developed countries which have been providing mounting subsidies.

The success or failure of developing countries will depend on to what extent India can muster the support of other developing countries to fight for their common cause as well as how well it will do its own homework to be effective at the negotiation table.

BALI PACKAGE

The 9th Ministerial Conference of the WTO was held in Bali (Indonesia) in December 2013. In this Ministerial, all the 159 members of the WTO agreed on a package of measures which represents a positive step towards concluding the Doha Round of trade negotiations, which began in 2001.

The “Bali Package” which is the first set of agreements struck since the WTO was created in 1995, embodies a series of decisions aimed at streamlining trade, allowing developing countries more options for providing food secutity, boosting least-developed countries’ trade and helping development more generally.

The “Bali Package” consists of a selection of issues from the broader Doha Round negotiations. it comprises 10 ministerial decisions/declarations covering, the following three broad areas, which are described as the three pillars of the Bali Package:

Trade Facilitation

Agricultural Issues

Development Issues

Trade Facilitation Trade Facilitation Agreement aims to streamline trade by cutting “red tape” and simplifying customs procedures. The Agreement aims at simplifying not only the documentation required to clear goods, but also the procedures employed by border agencies. Focusing on the biggest risks allows border agencies to speed up the flow of goods across the border, and increases the collection of duties. It has been described as a classic ‘win-win’ subject for developing and developed countries, since there should be no losers. It contains special provisions for developing countries to help them implement the Agreement. Benefits to the world economy are estimated to be between US$ 400 billion and US$ 1 trillion.

Agricultural Issues On agriculture, it was decided to give temporary protection to food stockholding programmes used for food security purposes and agreed to “exercise utmost restraint” in using all forms of export subsidy and other measures with similar effects. It was agreed to improve how tariff rate quotas are managed and to add some rural livelihood and land-use programmes of special interest to developing countries to the list of those that can be freely subsidized. They also committed to making progress in addressing cotton within the agriculture negotiations. On development, it was decided to establish a monitoring mechanism to analyse and review all aspects of the implementation of “special and differential treatment” provisions for developing countries contained in multilateral WTO agreements. They also took a number of decisions relating to least-developed countries (LDCs). These included improving the transparency of preferential rules of origin so that LDCs can better use the preferences accorded to them, and improving the implementation of duty-free and quota-free market access for imports from LDCs. Ministers also addressed the putting into operation of the waiver allowing WTO members to grant preferential market access to LDC services and service suppliers.

Development Issues On development, it was decided to establish a monitoring mechanism to analyse and review all aspects of the implementation of "special and differential treatment" provisions for developing countries contained in multilateral WTO agreements. They also took a number of decisions relating to least-developed countries (LDCs). These included improving the transparency of preferential rules of origin so that LDCs can better use the preferences accorded to them, and improving the implementation of duty-free and quota-free market access for imports from LDCs. Ministers also addressed the putting into operation of the waiver allowing WTO members to grant preferential market access to LDC services and service suppliers.

WTO AND DEVELOPING COUNTRIES

As in the case of the previous Rounds, the developing countries, in general, are dissatisfied with the outcome of the Uruguay Round.

Do Developing Countries Suffer in the WTO System?

The *Wall Street Journal* has reported that while the US and the EC are getting the best pieces of the world trade pie, the developing countries are getting the crumbs.

It is true that the Uruguay Round mostly benefits the developed countries. That does not mean that developing countries like India are losing — their gain is limited as compared to that of the developed countries. Certain indiscriminate liberalisations indeed harm the interests of the developing countries, particularly the most disadvantaged among them like the LDCs and further liberalisation by developed countries is needed for the developing countries to take advantage of globalisation.

Special Consideration

Some of the areas like TRIPs, TRIMs and services have been very sensitive as far as the developing countries are concerned as the Uruguay Round Agreements in them mean that the developing countries will have to lower the protection against competition from the unequal developed economies. However, as in the previous Rounds, the UR also gives special considerations to developing countries, particularly to the least developed countries and to those with balance of payments problems. The Agreement, however, lays down that member countries imposing trade restrictions for balance of payment purposes should do so in a way that causes minimum disruption to international trade and quantitative restrictions should be avoided as far as possible.

The Hong Kong Ministerial Meet held in December 2005 also has recognised the need for special consideration for developing countries.

The problems of developing countries need a more serious consideration by the WTO.

Agricultural Trade Liberalisation

Indeed, it would be the developed countries who would suffer most by liberalisation of the agricultural sector. But to argue that the developed countries should completely liberalise agriculture without any reciprocity on part of the developing countries is clearly illogical. As a matter of fact, the UR proposals in respect of agriculture, as in several other cases, give special consideration to the developing countries. Developed countries will, however, be hit hard. For example, agricultural subsidies in the European countries have been of the order of 30 to 50 per cent.

While the liberalisation of agricultural trade and the increase in agricultural prices due to cut in producer subsidies in the developed countries would benefit agricultural exporters, the

The gains of trade liberalisation to developing countries is constrained by the reluctance of developed countries to honour their liberalisation commitments.

increase in food prices due to cut in subsidies may adversely affect the food importers. More than 100 of the developing nations are reported to be net food importers. However, the increase in food prices should be expected to make food production in these countries more competitive leading to an increase in production. It may be noted here that it has been alleged that the subsidisation of production and export of farm production in the developed countries would have the effect of discouraging their production in the developing countries where farmers have not been able to compete with the imported stuff bearing artificially low price because of the subsidies. It is estimated that since subsidised agricultural exports cannot be dumped on the world market, international agricultural prices could go up by as much as 10 per cent.

Textiles Trade Liberalisation

International trade in textiles was estimated to be worth $240 billion a year. Estimates are that after the phasing out of MFA, world exports of textiles may go up by $25 billion a year. With a 2.2 per cent share in the world textile trade, India's share in the additional exports could be $0.55 billion. But the real gain will depend on the country's ability to compete with countries like China, Hong Kong, Taiwan, South Korea, etc. which are considered leaders in the textile trade.

Services Trade Liberalisation

Developing countries were very apprehensive about the proposal to liberalise trade in services. However, fortunately for them, the differences of opinion between the US and EC on this issue left the service sector largely unaffected.

Dissimilar Effects

The effect of the UR is not the same on all countries. For example, a measure which favourably affects one developed country may unfavourably affect another developed country. Further, the extent of the favourable or unfavourable impact may also vary. It is, therefore, quite natural that conflicts of interest have occurred both among developed and developing countries. Latin American countries were perhaps not very interested in liberalising the trade in textiles because they calculated that if they could gain a direct entry to the NAFTA through some regional arrangement, it would provide them an edge over competitors like India and Pakistan.

Some studies also show that Sub-Saharan Africa, Indonesia and some Caribbean islands will be poorer as a result of the UR Agreement. However, if liberalisation leads to higher productivity, they would also gain.

No country is, therefore, entirely pleased with the UR proposals. "The surest proof of the success of the Uruguay Round is that no country is entirely happy at the outcome." Although India is quite dissatisfied that the textile trade is not adequately liberalised, some people in the US are angry over the liberalisation move, alleging that two million jobs in the US would now hang in balance.

As the Foreign Minister of Uruguay remarked, all nations which signed the Uruguay Round Trade Agreement have "a sense of shared dissatisfaction." As the *GATT* Director General Peter Southerland stated, the signing of the Uruguay Round Trade Pact does not mean the end of disputes. Southerland remarked that it marked the start of disputes. There will be disputes between developed and developing countries, between developing countries and between developed countries. "There are more than 5 billion people competing for their share of the pie, and that makes conflicts all the more inevitable."

Unequal Participation

Although it was expected that significant benefits would accrue to the developing countries from the UR Agreement, they have been encountering many roadblocks.

The developing countries are disadvantaged in the WTO system because of their inability to effectively participate in the negotiation process. They are not able to understand the implications and possible impacts of different proposals and agreements because of their analytical deficiencies. According to Dubey, "most of the agreements and understandings reached during the Uruguay Round trade negotiations are unequal and unbalanced from the point of view of developing countries. This was mainly because of the weak bargaining position of these countries, their general state of unpreparedness for the negotiations, their dearth of skilled manpower and financial resources to participate effectively, and the lack of transparency in the negotiating process. Some of the agreements are inherently unequal and unbalanced."[4]

Developing countries suffer from lack of intellectual and financial capability to meaningfully participate in the discussions and negotiations.

Besides, lack of earnestness on the part of the governments is also responsible for the suffering of the developing countries. For example, the delay in taking protective measures in respect of geographical indications by Government of India is responsible for the *basmati* rice issue and the like.

An IMF Publication observes that while small and poor countries have acquired a very significant say in decision-making in the WTO, their ability to participate in the "reciprocity game" at the heart of the WTO remains limited. These countries also pose a challenge for the WTO because their interest in the broader trade liberalisation agenda is more limited as a result of their existing preferential access to rich country markets.[5]

One of the underlying reasons for the developing countries not benefiting much out of WTO is that "it is a mercantilist institution in the sense that countries trade off one another's protection—you give me better access to your market, and I'll give you better access to my market. The currency for these negotiations is market size. However, the small and poor countries don't have much to offer either individually or collectively to the rest of the world in terms of market access."[6]

So, their influence derives not from this traditional coinage of the WTO but from the fact that the WTO is a very democratic institution. Each country has one vote and to make a major.

Implementation Issues

Developed countries have resorted to covert measures to deny the developing countries the legitimate benefits of the proposed trade liberalisations.

Dubey points out that, subsidies normally maintained by developed countries have been made non-actionable, while several of those given by developing countries in pursuit of an export-led development strategy have either been prohibited or put in the actionable category. Subsidies to farmers maintained by major developed countries have, instead of coming down, gone up primarily because these countries were able to switch over to subsidies permissible under the Agreement on Agriculture, before the commencement of its implementation.[7] Liberalisation of textiles trade has hailed as a boon for the developing countries. However, here also the developing countries have been deceived because developed importing countries have sought to comply with the targets of liberalisation set out in the Agreement on Textiles and Clothing (ATC) by taking credit for the items already outside restriction.[8] .

The developing countries are virtually deceived in several cases as the UR Agreements have not been implemented in letter and spirit by the developed countries.

As an UNCTAD Report points out, rich countries, despite their commitment in the TRIPS agreement, have taken no real steps to share their technology in the interests of reducing poverty. The TRIPs agreement includes provisions for technology transfers, but with few details and no discussion on implementation. The TRIPs agreement does not provide intellectual property protection

for indigenous knowledge such as those used in traditional medicine. The TRIPs agreement introduces a global minimum standard for promoting invention. Intellectual property regimes are intended to balance the two social goals of promoting inventions and promoting the use of inventions. Thus, the TRIPs agreement incorporates provisions in the interests of users, such as compulsory licensing or parallel imports that give governments flexibility to allow local manufacturing or imports of goods under patents. But the wording of these provisions is so vague that they are difficult to apply—so clarifying them would be a first step.[9]

Another way rich countries tilt the playing field for trade seems, on its face, to have little to do with trade. Rich countries, to varying degrees, pay large subsidies to their domestic food producers. These subsidies are so large—totalling $311 billion a year—that they affect world market prices of agricultural goods, causing direct harm to poor countries. EU-subsidised exports have contributed to the decline of the dairy industries in Brazil and Jamaica and the sugar industry in South Africa." West African cotton producers have increased the efficiency of their cotton sector, achieving competitive production costs. But they cannot compete against subsidised farmers in rich countries. Annual agricultural subsidies in rich countries considerably exceed the national income of all of Sub-Saharan Africa.[10]

Developing countries have identified various instances of inequalities and imbalances in the Uruguay Round Agreements and submitted a large number of formal proposals for rectifying them. These proposals have been known as the implementation issues. It is argued that the implementation issues should be urgently resolved and any new round of MTN shall be taken up only after that. However, the developed countries want the new round of MTN soon.

Lack of sincerity and compassion on the part of the developed countries has made the WTO a rather unfair system.

"The implementation issues are not a spanner thrown by a group of developing countries to ape a new round of trade negotiations. Their attempt to resolve them is designed to safeguard their most vital trading interests and to restore a modicum of balance in WTO agreements after an unfortunately belated realisation that developing countries were short-changed in the Uruguay Round negotiations. What is at stake is the very credibility of the international trading system in the eyes of the developing countries. Resolution of the implementation issues is the only way to restore credibility."[11]

Conclusion

One of the achievements of the UR is the making of the rules and regulations more transparent, thus making trade harassment and unilateral actions more difficult. The results of the UR will be implemented by the newly set up World Trading Organisation (WTO) making dispute settlement and arbitration easier.

Because of the unequal participation and lack of bargaining power, the developing countries have not been getting a fair deal from the WTO and other international organisations. To make matters worse, as observed earlier, while the developing countries have been increasingly opening up their markets, the developed countries have been increasing protection and denying justice to the developing countries in several respects. As Stiglitz candidly observes, "the international institutions must undertake the changes that will enable them to play the role they should be playing to make globalisation work, and work not just for the well off and the industrial countries, but for the poor and the developing nations. The developed world needs to do its part to reform the international institutions that govern globalisation. We set up these institutions and we need to work to fix them. If we are to address the legitimate concerns of those who have expressed a discontent with globalisation, if we are to make globalisation work for the billions of people for whom it has not, if we are to make globalisation with a human face succeed, then our voices must be raised. We cannot, we should not, stand idly by."[12]

WTO AND INDIA

The Uruguay Round Agreements and WTO have come in for scathing criticisms in India. Many politicians and others have argued that India should withdraw from the WTO. Most of the criticisms are either baseless or due to lack of knowledge of the international trading environment, and misinformation, or are just meant to oppose the government by the opposition parties.

Should India Quit WTO?

Accepting the demand of some of the critics, that India should withdraw from the WTO will be a great blunder that the nation can commit. By being a part of WTO, India enjoys the most favoured nation (MFN) status with all the other members of the WTO. Opting out of the system would mean an infinitely laborious task of entering into bilateral negotiations with each and every one of the trading partners which would amount to "having one's arms twisted bilaterally by the US, the EC and Japan, turn by turn, on everything from intellectual property rights to NPT, human rights and environmentally clean technologies for packaging."[13] It may be noted at this juncture that China got readmitted to the system after a long wait and lobbying.

One major controversy pertains to the agricultural subsidies. Much hue and cry have been raised in India about this factor. However, it needs to be mentioned that the Agreement would not adversely affect India's agricultural subsidies and its agriculture exports. Developing countries were expected to largely benefit because of the lowering of the agricultural protection by the developed countries, in spite of the fact that the wish of the developing countries that the major Western nations would totally drop subsidies for their producers, substantially lower tariffs, and open markets did not materialise. However, the developed nations, in general, have not brought about the expected liberalisation.

India's Trade Gain

Assuming that India's market share in world exports improves to one per cent, and that she is able to take advantage of the opportunities that are created, the trade gains may consequently be placed at $2.7 billion exports per year. More generous estimates range from $3.5 to $7 billion worth of extra exports.

India's gain from trade liberalisation has been constrained by her limited participation in global trade.

However, India's gain will be much less than those of several other developing countries like China and the newly industrialised economies because: *(i)* India's share in the world trade is very low. *(ii)* The foreign trade-DGP ratio of India is low. The gain will also depend on the rate of growth of India's exports.

Compliance Measures

India has taken several measures to comply with the TRIPs Agreement. On copyrights and related rights, the Agreement requires compliance with the provisions of *Bern Convention to* which India is a signatory and the new Copyright Act of India already meets the requirements of the TRIPs Agreement. Trade and Merchandise Marks Act of 1958 was replaced by a new Act, namely, The Trade Marks Act, 1999, so as to provide for the protection of service marks also.

For the protection of Geographical Indications of Goods, a *sui generis* legislation, *viz.,* the Geographical Indications of Goods (Registration and Protection) Act, 1999 has been enacted in order to comply with the requirements under the TRIPs Agreement and to protect products of Indian origin as well. The Act primarily intends to protect the valuable geographical indications of our country. The protection under the Act is available only to the geographical indication registered under the Act and to the authorised users. The Act permits any association of persons or producers or any organisation or authority established by law representing the interest of the

producers of goods to register a geographical indication. It may be possible to argue that the holders of the traditional knowledge in goods produced and sold using geographical indication can register and protect their traditional knowledge under this law.

The Indian Parliament has passed the Protection of Plant Varieties and Farmers' Rights Act, 2001 with the objective of giving a significant thrust to agricultural growth by providing an effective system for the protection of plant varieties and farmers' rights. This is expected to stimulate investments for research and development both in the public and the private sectors for the development of new plant varieties by ensuring appropriate returns on such investment. The Indian legislation acknowledges that the conservation, exploration, collection, characterisation, evaluation of plant genetic resources for food and agriculture are essential to meet the goals of national food and nutritional security as also for sustainable development of agriculture for the present and future generations. It also acknowledges that the plant genetic resources for food and agriculture are the raw material indispensable for crop genetic improvement. The concept of effective benefit sharing arrangement between the provider and the recipient of the plant genetic resources forms an integral part of our Act.

India has taken a number of measures to make its policies and laws WTO compliant.

India provides for the protection and enforcement of different fields of intellectual property through both specific national legislation as well as the Code of Civil Procedure and the Code of Criminal Procedure by way of civil remedies and criminal penalties. These provide effective deterrent to the infringement of IPRs. The criminal cases and civil suits for the infringement of IPRs lie in the judicial system for other cases.

The amended patent law contains of provisions for mandatory disclosure of source and geographical origin of the biological material used in the invention while applying for patents in India. Provisions have also been incorporated to include non-disclosure or wrongful disclosure of the same as grounds for opposition and for revocation of the patents, if granted. To protect traditional knowledge from being patented, provisions have also been incorporated in the law to include anticipation of invention by available local knowledge, including oral knowledge, as one of the grounds for opposition as also for revocation of patent. In order to further strengthen these provisions, a new provision has been added to exclude innovations which are basically traditional knowledge or aggregation or duplication of known properties of traditionally known component or components from being patented.

India is a party to the Connection on Biological Diversity (CBD), which came into force in December 1993. The CBD offers opportunities to India to realise the benefit of these resources. We have already introduced a Bill in the Parliament which is likely to be passed in the coming Winter Session of the Parliament in December 2002. The proposed legislation addresses the basic concerns of access to, collection and utilisation of biological and knowledge by foreigners and sharing of benefits arising out of such success.

Various suggestions have been advanced in India to extend protection to knowledge, innovations and practices. These include: *(i)* documentation of TK; *(ii)* registration and innovation patent system; and *(iii)* development of a *sui generis* system. It is sometimes believed that proper documentation of associated TK could help in checking bio-piracy. Documentation could be a double-edged sword. It is assumed that if the material/knowledge is documented, it can be made available to patent examiners the world over so that prior art in the case of inventions based on such materials/knowledge are/is readily available to them.

SUMMARY

The principles and Agreements of WTO have very significant impact on the business environment. Figure 38.1 provides a bird's eye view of the important impacts.

The salient features of the Uruguay Round Agreement are given below.

1. The Uruguay Round substantially expanded the scope of multilateral trade negotiation by including services, intellectual property rights (TRIPs) and trade related aspects of investment measures (TRIMs), as against only goods in the past.
2. With effect from January 1, 1995, GATT (which was temporary an ad hoc) was replaced by a permanent organisation, the WTO.
3. WTO is GATT plus a lot more. Under the GATT, there was only one major agreement—GATT. Under the WTO, there are agreements related to three major areas—GATT, GATS and TRIPs.
4. WTO is a more powerful and effective organisation than GATT. It has a more effective dispute settlement mechanism.
5. The Uruguay Round Agreement seeks to liberalise trade in manufactures by enlarging tariff bindings, reducing tariffs and removing tariffs.

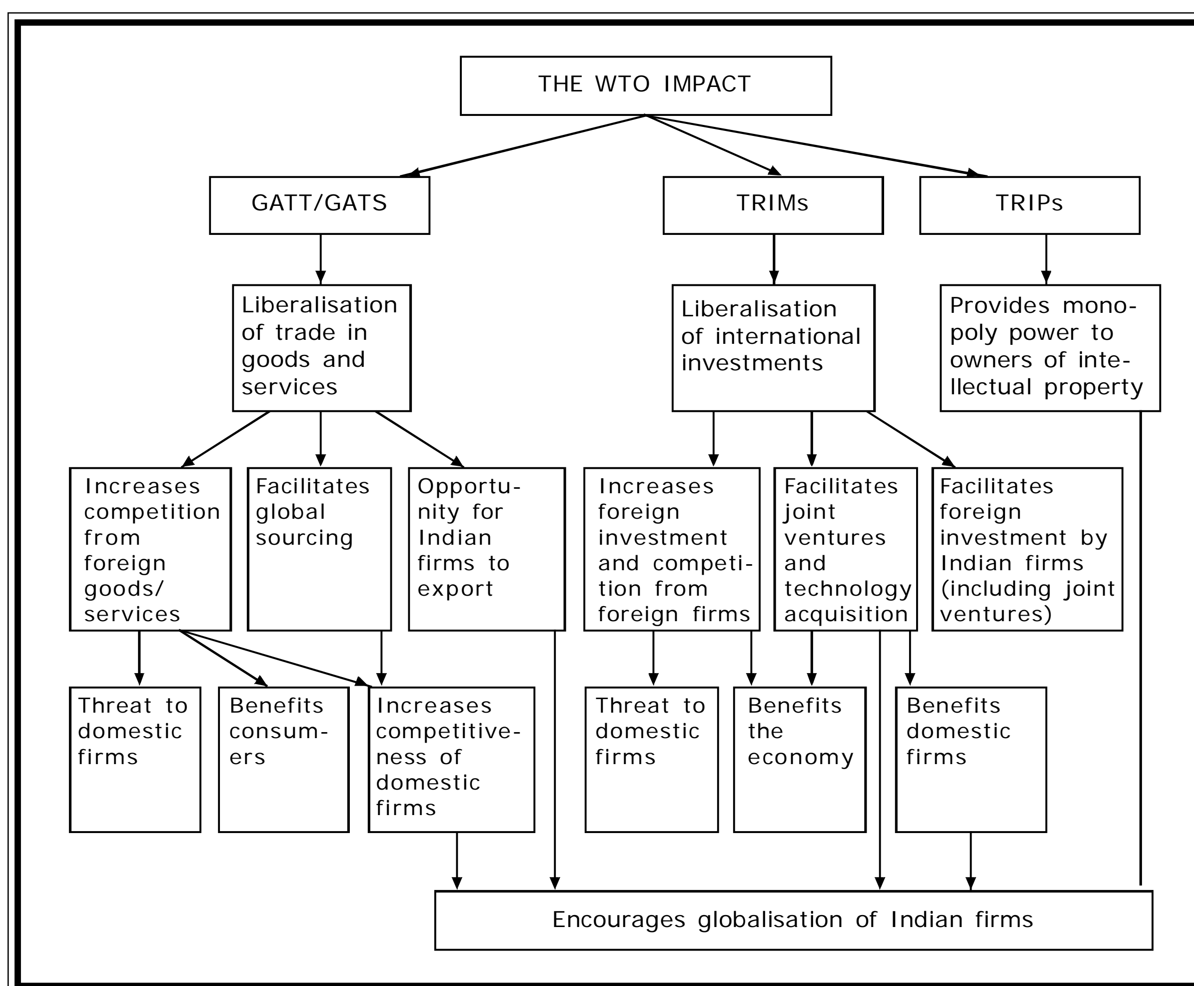

Fig. 38.1 : The WTO Impact

6. A significant achievement of the UR is the measures to liberalise trade in agriculture, which was a highly protected sector, particularly in the developed countries. These measures are tariffication, tariff bindings, tariff cuts and reduction in subsidies and domestic support.
7. All member countries are required to adopt product patent (as also process patent). India had only process patent for drugs, food and chemical substances for which the patent period was 7 years and 14 years for other products. Under the WTO regime, the patent period for all products is 20 years.
8. As under GATT, under WTO also developing countries, particularly least developed countries, are accorded a number of concessions and favours. Their liberalisation requirements are lower and they are allowed longer period to fulfil the liberalisation commitments. The WTO also calls upon the developed nations to grant special preferences to imports from developing countries. There are also some committees under the WTO to look after the interests and special needs of the developing countries.
9. There is a general complaint that the fruits of the liberalisation accrue mostly to the developed countries. It is pointed out that the industrialised countries, which make up only 20 per cent of the membership, will appropriate about 70 per cent of the additional income generated by the implementation of the UR agreements. The losers, mostly in Africa and Caribbean, are some of the poorest countries in the world. The developed countries gain substantially because of their higher level of participation in trade and because of the fact that significant part of liberalisations has been in respect of goods of interest to them. Liberalisation of trade in textiles, by phasing out MFA, however, will substantially benefit the developing countries.
10. Even after all UR concessions are fully implemented by the industrialised countries, significant trade barriers in the form of high tariff peaks (exceeding 12 per cent but in some cases reaching or exceeding 300 per cent) will continue to affect many exports from developing countries. The removal of such barriers needs to be given high priority. There are several other areas of critical importance to the developing countries.
11. Developing countries are terribly disadvantaged due to the *participation gap*.
12. India has taken several measures to comply with the TRIPs Agreement. These include amendments to some laws and new legislations.
13. Estimates of India's possible gain from the trade liberalisation vary very wide — between $2 billion and $7 billion a year. Although the liberalisation of trade in textiles will benefit the developing countries, India's gain will depend a lot on her competitive strength *vis-à-vis* other textile exporters.

India's gain from the trade liberalisation will be much less than that of many other developing countries, such as the South-East Asian economies and China, because India's share in the world trade is very low (less than one per cent) and her foreign trade-GDP ratio is very low.

(More elaborate and illustrative treatment of WTO is available in the new edition of the author's *International Business* Prentice Hall of India).

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Chapter 39

INTERNATIONAL INVESTMENTS

Structure

Types of Foreign Investment

Significance of Foreign Investment

Limitations and Dangers of Foreign Capital

Factors Affecting International Investment

Growth of FDI

Directional Trends

Sectoral Trends

Cross-border M&As

Foreign Investment in India

Foreign Investment by Indian Companies

Summary

References

The economic liberalisations that swept across the world, particularly since the late 1980s, have very significantly changed the environment for international investments. At the same time, the surging international capital flows, in its turn, are substantially impacting the business environment.

As Peter Drucker in his *Managing for the Future* observers, "increasingly world investment rather than world trade will be driving the international economy. Exchange rates, taxes, and legal rules will become more important than wage rates and tariffs."[1]

TYPES OF FOREIGN INVESTMENT

Broadly, there are two types of foreign investment, namely, *foreign direct investment* (FDI) and *portfolio investment*.

FDI refers to investment in a foreign country where the investor retains control over the investment. It typically takes the form of starting a subsidiary, acquiring a stake in an existing firm or starting a joint venture in the foreign country. Direct investment and management of the firms concerned normally go together.

If the investor has only a sort of property interest in investing the capital in buying equities, bonds, or other securities abroad, it is referred to as portfolio investment. That is, in the case of portfolio investments, the investor uses his capital in order to get a return on it, but has no much control over the use of the capital.

FDI is like proprietary capital and FPI is akin to stock market investment.

FDIs are governed by long-term considerations because these investments cannot be easily liquidated. Hence, factors like long-term political stability, government policy, industrial and economic prospects etc. influence the FDI decision, However, portfolio investments, which can be liquidated fairly easily, are influenced by short-term gains. Portfolio investments are generally much more sensitive than FDIs. Direct investors have direct responsibility with the promotion and management of the enterprise. Portfolio investors do not have such direct involvement with the promotion and management.

Since the economic liberalisation of 1991, there has been a surge in the FDI and portfolio investments in India.

There are mainly two routes of portfolio investments in India, *viz.,* by Foreign Institutional Investors (FIIs) like mutual funds and through Global Depository Receipts (GDRs), American Depository Receipts (ADRs) and Foreign Currency Convertible Bonds (FCCBs).

GDRs/ADRs and FCCBs are instruments issued by Indian companies in the foreign markets for mobilising foreign capital by facilitating portfolio investment by foreigners in Indian securities. Since 1992, Indian companies, satisfying certain conditions, are allowed to access foreign capital markets by Euro issues.

With reference to foreign investment in India, foreign investment may be classified as shown in Figure 39.1.

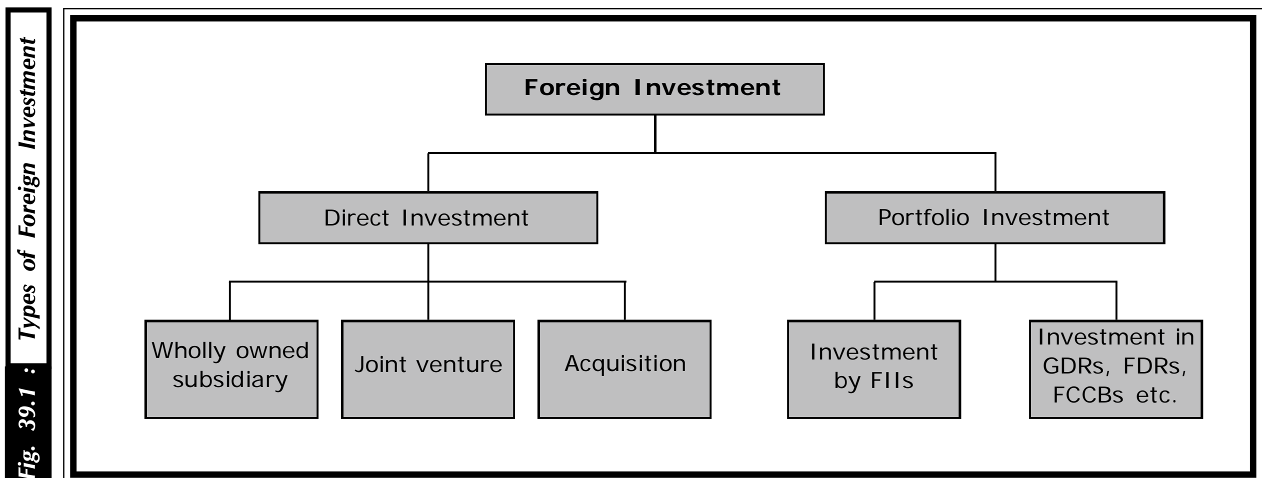

Fig. 39.1 : Types of Foreign Investment

SIGNIFICANCE OF FOREIGN INVESTMENT

Foreign investment is playing an increasing role in economic development. Economic reforms and the far-reaching political changes have resulted in very substantial changes in the international capital flows.

Foreign capital and technology can play a very important role in the socio-economic development of a nation. They have very significantly contributed to the development of the developed countries. Foreign capital and technology have been playing a significant role in the development of a number of developing countries. A classic example is China.

One of the ways by which foreign capital helps accelerate pace of economic growth is by facilitating essential imports required for carrying out development programmes, like capital goods, know-how, raw materials and other inputs and even consumer goods. The machinery, know-how and other inputs needed may not be indigenously available. Further, the demand spurt created by large investments may necessitate import of consumer goods. When the export earnings are insufficient to finance such vital imports, foreign capital could help reduce the foreign exchange gap.

Foreign investment may also help increase a country's exports and reduce the import requirements if such investments take place in export-oriented and import-competing industries. In the early years of the present decade, nearly half of the Chinese exports (which in absolute terms was about three times the total exports of India) were said to be the contribution of the foreign funded enterprises.

Following the analysis of Donald MacDougall and Paul Streeten, Gerald Meier observes[2] that, from the standpoint of national economic benefit, the essence of the case for encouraging an inflow of capital is that the increase in real income resulting from the act of investment is greater than the resultant increase in the income of the investor. If the value added to output by the foreign capital is greater than the amount appropriated by the investor, social returns exceed private returns. As long as foreign investment raises productivity, and this increase is not wholly appropriated by the investor, the greater product must be shared with others, and there must be some direct benefits to other income groups as mentioned below:

FDI can have social and economic benefits.

1. ***Domestic Labour:*** Domestic labour may get higher real wages because of the increase in productivity. There might also be an expansion of the employment opportunities.

2. ***Consumers:*** If foreign investment is cost-reducing in a particular industry, consumers of the product may gain through lower product prices. If the investment is product-improving or product-innovating, consumers benefit from better quality products or new products.

3. ***Government:*** The increase in production and foreign trade resulting from foreign capital might increase the fiscal revenue of the government.

4. ***External Economies:*** Foreign capital may bring in a number of indirect gains through the realisation of external economies. For instance, if foreign investment is used for the development of infrastructure, this could stimulate domestic investment in industrial and other sectors.

In the endogenous growth framework, the sources of growth attributed to capital flows comprise the spillovers associated with foreign capital in the form of technology, skills, and introduction of new products as well as the positive externalities in terms of higher efficiency of domestic financial markets, improved resource allocation and efficient financial intermediation by domestic financial institutions.[3]

Further advantages of foreign capital are mentioned under *Private Foreign Capital* below.

As indicated in the opening paragraph, foreign investment is playing an increasing role in economic development.

The changes in the composition of the capital flows and the substantial increase in the magnitude of some of the flows, like FDI, have remarkably changed the balance of payments and foreign exchange reserves position of several countries. The debt creating flows as a percentage of total flows in the BoP of India averaged as much as 97 per cent during the Seventh Plan (1985-90) but declined to less than 20 per cent by mid-1990s. Eventually, India began to experience a surplus on the BoP and a very remarkable improvement in the reserves position.

Foreign investment has assisted and is assisting the economic growth of many countries. As a World Bank report points out, for the developing countries FDI has the following advantages over the official development assistance (ODA):[4]

FDI has specific advantages over ODA.

1. FDI shifts the burden of risk of an investment from domestic to foreign investors.
2. Repayments are linked to profitability of the underlying investment, whereas under debt financing the borrowed funds must be serviced regardless of the project costs.
3. Further, it has also been observed that FDI is the only capital inflow that has been strongly associated with higher GDP growth since 1970.

The contribution of FDI to economic growth is highlighted by the fact that the ratio of FDI flow to domestic investment (gross capital formation) rose for most developed and developing countries in the past. Although the bulk of the FDI goes to developed countries, its share in their gross fixed capital formation (GFCF) is only about half of that in developing countries because of the massiveness of their GFCF.

Apart from potential gains though technology transfer, FDI has generated large employment opportunities in a number of countries.

Given the limitations of domestic savings, many developing countries will have to rely on foreign investment to accelerate economic growth. It may be noted that China has been able to maintain a high GDP growth rate for a long time because of a high savings rate and huge inflow of FDI.

Addressing a session on infrastructure at the seminar on *'Moving to the Market: Sustaining Reforms in India and Asia'* organised by the Confederation of Indian Industry (CII) and Asian Society, in New Delhi on March 9, 1997, Gordon Wu has observed that foreign investment brings four 'E's – efficiency, equity, experience and expertise. In return, there is a fifth 'E' – expatriation of profits.

Foreign Private Investment

Foreign investment can have multidimensional benefits.

Private foreign capital mostly takes the form of direct investment. Hence, we deal here with the direct foreign investment (private). The important advantages of foreign direct investment are the following:

1. It helps increase the investment level and thereby the income and employment in the host country.
2. Foreign investment may increase the tax revenue of the government.
3. Direct foreign investment facilitates transfer of technology to the recipient country.
4. It may kindle a managerial revolution in the recipient country through professional management and the employment of highly sophisticated management techniques.
5. Foreign capital may enable the country to increase its exports and reduce import requirements.
6. Foreign investments may stimulate domestic enterprise because, to support their own operations, the foreign investors may encourage and assist domestic suppliers and consuming industries.
7. Foreign investment may also help increase competition and break domestic monopolies.
8. If foreign investment improves the quality and reduces the cost of inputs, that would benefit the domestic industry.

LIMITATIONS AND DANGERS OF FOREIGN CAPITAL

Foreign capital, both private and official (governmental and institutional), have certain limitations. Certain additional risks are associated with the private foreign capital.

One of the important limitations to utilise the foreign capital is the *absorptive capacity* of the recipient country, *i.e.*, the capacity of the country to utilise the foreign capital effectively. Lack of infrastructural facilities, technical know-how, personnel, inputs, market, feasible projects, inefficiency or inadequacy of administrative machinery etc. are important factors that affect the absorptive capacity.

Sometimes 'strings' are attached to the official assistance—the recipient country may be pressurised to fall in line with the ideology or direction of the donor.

The following criticisms are levelled against foreign capital:

1. Private foreign capital tends to flow to the high profit areas rather than to the priority sectors.
2. The technologies brought in by the foreign investor may not be adapted to the consumption needs, size of the domestic market, resource availabilities, stage of development of the economy, etc.

3. Through their power and flexibility, the multinational corporations can evade or undermine economic autonomy and control, and their activities may be inimical to the national interests of particular countries.
4. Foreign investment, sometimes, have unfavourable effect on the Balance of Payments of a country because the drain of foreign exchange by way of royalty, dividend, etc., is more than the investment made by the foreign concern.
5. Foreign capital sometimes interferes in the national politics.
6. Foreign investors sometimes engage in unfair and unethical trade practices.
7. Sometimes, foreign investment can result in the dangerous situation of minimising/ eliminating competition and the creation of monopolies or oligopolistic structures.
8. FDI can also potentially displace domestic producers by pre-empting their investment opportunities.
9. Often, several costs are associated with encouraging foreign investment. Meier observes[5] that these costs may arise from special concessions offered by the host country, adverse effects on domestic saving, deterioration in the terms of trade, and problems of balance of payments adjustment.

Foreign investment can have many undesirable consequences if not properly monitored and regulated.

FACTORS AFFECTING INTERNATIONAL INVESTMENT

The theories of foreign investment described above have indicated several possible reasons for foreign investment. This section is a further extension of the important factors affecting international investment.

1. *Rate of Interest*: One of the most important stimuli to international capital movements is the difference in the rate of interest prevailing at different places. Capital has a tendency to move from a country with a low rate of interest to a country where it is higher, other things being equal, interest rates or foreign exchange rates.

2. *Speculation:* Short-term capital movements may be influenced also by speculation pertaining to anticipated changes in the interest rates or foreign exchanges rates.

3. *Profitability:* Private foreign capital movement is influenced by the profit motive. Hence, other things being equal, private capital will be attracted to countries where the return on investment is comparatively higher.

4. *Costs of Production:* Private capital movements are encouraged by lower costs of production in foreign countries. As Kreinin[6] points out, we may distinguish between two types of cost-reducing investment. The first arises from the need to obtain raw materials from abroad. Such materials may be either unavailable at home or obtainable only at extremely high costs, but they are essential for the production and sale of final products at home or abroad. Without them, profit opportunities would remain unexploited. Indeed, vast investments in the extractive industries are motivated by the fact that the capital must go where the resources are. The second type of cost-reducing investment pertains to costs of commodities other than materials, primarily labour.

5. *Economic Conditions:* Economic conditions, particularly the market potential and infrastructural facilities, influence private foreign investment. The size of the population and the income level of a country have an important bearing on the market opportunities.

6. *Government Policies:* Government policies, particularly towards foreign investment, foreign collaboration, remittances, profits, taxation, foreign exchange control, tariffs, and monetary, fiscal and other incentives, are important factors that may influence foreign investment in a country.

7. *Political Factors:* Political factors like political stability, nature of important political parties and relations with other countries also influence capital movements.

Host Country Economic Determinants

Traditionally, the economic determinants of inward FDI have been grouped, for analytical convenience, into three clusters, each of them reflecting the principal motivations of investing in foreign countries: *resources seeking; market seeking* and *efficiency seeking*.

Resources: Historically, the most important motivation of FDI has been the exploitation of natural resources. Dunning points out that in the nineteenth century, much of the FDI by European, United States and Japanese firms were promoted by the need to secure an economic and reliable source of minerals, primary products for the investing industrialising nations of Europe and North America. Up to the eve of the Second World War, about 60 per cent of the world stock of FDI was in natural resources. The post-war period, particularly since the 1960s and 1970s, witnessed a decline in the share of natural resources in the FDI. Besides, the decline in the importance of the primary sector in world output, this decline was caused by factors such the development of the indigenous enterprises in this sector. In a number of developing economies, the public sector came to play an important role in the resources based industries. Public sector efforts also included equity or technical collaborations with MNCs.[7]

Although, the share of the primary sector in FDI has declined, there has been a substantial increase of the FDI in this sector in absolute terms.

Host Country Determinants of FDI

Host country determinants

I. Policy framework for FDI
- economic, political and social stability
- rules regarding entry and operations
- standards of treatment of foreign affiliates
- policies on functioning and structure of markets (especially competition and M&A policies)
- international agreements on FDI privatisation policy
- trade policy (tariffs and NTBs) and coherence of FDI and trade policies
- tax policy

II. Economic determinants

III. Business facilitation
- investment promotion (including image-building and investment-generating activities and investment-facilitation services)
- investment incentives
- hassle costs (related to corruption, administrative efficiency, etc.)
- Social amenities (bilingual schools, quality of life, etc.
- after-investment services

Type of FDI classified by motives of TNCs	Principal economic determinants in host countries
A. Market-seeking	• market size and per capita income • market growth • access to regional and global markets • country-specific consumer preferences • structure of markets
B. Resource/ assets-seeking	• raw materials • low-cost unskilled labour • skilled labour • technological, innovatory and other created assets (*e.g.,* brand names), including as embodied in individuals, firms and clusters • physical infrastructure (ports, roads, power, telecommunication)
C. Efficiency-seeking	• cost of resources and assets listed under B, adjusted for productivity for labour resources • other input costs, *e.g.,* transport and communication costs to/from and within host economy and costs of other intermediate products • membership of a regional integration agreement conductive to the establishment of regional corporate networks

Fig. 39.2 : Host Country Determinants of FDI ***(Reproduced from: UNCTAD, World Investment Report,*** **1998)**

Markets: Another important traditional determinant of FDI has been market seeking. Markets protected from international competition by high tariffs or quotas triggered tariff jumping FDI. Dunning points out that market access became the predeterminant motive for investing in the manufacturing sector of developed countries between the two world wars and of developing countries in the 1960s and 1970s, during the heyday of import substitution industrialisation. This motive was paramount, *for example,* in the wave of United States' investments in Europe, especially in the United Kingdom, during the early post-war period and in Japanese investments in the United States after the mid-1980s, following voluntary export restrictions and the possibility of further protectionist measures in the automobile industry.[8]

The lion's share of FDI flow to the developing countries goes to the larger markets with comparatively good infrastructure and political stability in general.

The growing importance of the service sector has also been resulting in increasing FDI because of the fact that most services are not tradable and, therefore, the only way to deliver them to foreign markets is through establishment abroad. However, the highly regulated nature of the services sector has been a deterrent to the FDI flow in its full potential.

Efficiency: Another important motivation of FDI is efficiency seeking. Low cost of production, deriving mostly from cheap labour, is the driving force of many FDIs in developing countries. Export processing zones have been developed by developing countries mostly to take advantage of the efficiency seeing FDI flows.

It may be noted that the presence of any of the three determinants mentioned above alone need not attract FDI. *For example,* even if a country has natural resources or abundance of cheap labour, FDI would not take place in the absence of required infrastructural facilities to develop the industry or trade. Besides, several other factors like the political environment, government policies, bureaucratic culture, social climate etc. are also important determinants of FDI.

GROWTH OF FDI

Following the sweeping changes in the economic policy, foreign investment has been surging in many countries. Today, the worldwide FDI flows and stocks are about 20 times their size in the early 1980s.

Trends in Magnitude of Flows

Although foreign direct investment flows have their ups and downs, the long-term trend has been one of fast growth. For example, between 1970 and 2000, FDI inflows worldwide increased more than a hundred times. The growth has been the sharpest between 1990 and 2000 thanks to the universal liberalisation, privatisation and the surge in cross-border M&As by these developments. It was estimated at $1461 billion in 2013.

After peaking in 2000, the FDI flows had a downturn. The upward trend in inflows began again in 2004. FDI inflows peaked in 2007 ($2100 billion but was lower in subsequent years).

While the FDI flows had their ups and downs, the stock of FDI has increased tremendously over time. Worldwide FDI inward stock increased from $1779 billion in 1990 to $5810 in 2000 and further to $11999 billion in 2006. FDI inward stock as a percentage of GDP increased more than four times between 1990 and 2013, from 8.4 per cent to 34.3. For developing economies, these figures were 9.6 and 31.1.

Although the FDI flows show cyclical trends, the long-term trend has been one of fast growth. The universal economic liberalisation and privatisation have substantially boosted the foreign investment flows, both FDI and FPI.

The upward trend in FDI flow is punctuated in almost every 10 years.

Cyclical Behaviour FDI flows are characterised by cyclical behaviour. The decline in FDI flows after peaking in 2000 followed rapid increases during the late 1990s. As the *World Investment Reports* point out, there was a similar pattern during the late 1980s and early 1990s, and in 1982-1983. Thus, this is the third downward cycle in FDI, each punctuating a long upward trend in FDI every ten years or so.

Factors Affecting the Trend in FDI Flows

The swings in FDI flows reflect changes in several factors. The main ones are business cycles, stock market sentiment and M&As. These short-term factors (including factors such as the terrorist attack of September 11, 2000) work in tandem with longer-term factors, sometimes offsetting and at other times reinforcing them.

There is, on the other hand, a stable and positive relationship between global FDI flows and the level and growth of world GDP. Technological change, shrinking economic distance and new management methods favour international production. Their impact is, however, countered by cyclical fluctuations in income and growth. The decline in FDI in 2001 reflected a slowdown in the world economy. More than a dozen countries – including the world's three largest economies fell into recession.

On the supply side, FDI is affected by the availability of investible funds from corporate profits or loans, which is in turn affected by domestic economic conditions. On the demand side, growing overseas markets lead TNCs to invest, while depressed markets inhibit them. The more interdependent host and home economies become, and the more widely a recession or upswing spreads, the greater are the corresponding movements in global FDI.

Fluctuations in FDI flows are caused often by the fluctuations in the FDI flow to developed economies. Fluctuations are caused by several short-term and long-term factors: economic and corporate performances are most important among them.

Data for 1980-2001 show that a bulge in global FDI accompanies high economic growth, and a trough accompanies low growth. However, the relationship between GDP growth and FDI is not uniform across groups of economies. They go together in developed but not in developing countries. One explanation for the different patterns of FDI flows is that business cycles spread much faster across developed countries than others. A supplementary explanation may be that some countries (as in CEE) had been cut off from substantial FDI flows for so long that they have a lot of "catching up" to do – short-term cycles do not affect their attractiveness.

The rise in global FDI flows in 2006 was partly driven by increasing corporate profits worldwide and resulting higher stock prices that raised the value of cross-border mergers and acquisitions (M&As). M&As continued to account for a high share of FDI flows, but greenfield investment also increased, especially in developing and transition economies. As a result of higher corporate profits, reinvested earnings have become an important component of inward FDI. They accounted for an estimated 30 per cent of total inflows worldwide in 2006 and for almost 50 per cent in developing countries alone.

One of the important determinant of the FDI trend is the trend in cross-border M&A. For example, the dramatic increases in cross-border M&As led to record flows in 1999 and 2000. Cross-border M&As made its contribution to the decline in the FDI too.

DIRECTIONAL TRENDS

The major chunk of the FDI flows take place between the developed countries. For nearly three decades till the early 1990s, about three-quarters of the FDI have gone to the developed countries. Nearly two-thirds of the flows take place between the countries of the *Triad* – the US, the European Union and Japan. The share of developed countries in the FDI inflows and outflows declined in the recent years.

FDI is concentrated in a handful of countries — about a dozen countries receive nearly three-fourths of the global FDI flows. A higher degree of concentration is observed in respect of FDI flows to the developing world. In 2014, for example, China and Hong Kong alone received about 32 per cent of the inflows to developing economies.

More importantly, there are no signs that the concentration of international production across countries has been declining over time. However, in many least developed countries that have received only small amounts of FDI, such investment is important *vis-à-vis* the size of domestic investment. What remains a challenge for these countries is the ability to attract not only more, but also higher quality FDI — broadly defined as investment with strong links to the domestic economy, export orientation, advanced technology and skill or spillover effects.

Nearly two-thirds of the FDI flows take place between the developed economies. Both within the group of developed and developing countries, a small number accounts for the major share of the FDI.

The largest recipient of FDI has either been the UK or US. The US has been the largest foreign investor too. France has been one of the largest foreign investors. While UK also has been experiencing large FDI outflow, it has been much lower than the inflow to UK.

As Table 39.1 shows the share of developing countries in FDI has been fluctuating.

TABLE 39.1 : PERCENTAGE DISTRIBUTION OF FDI FLOWS

Country Grouping	*FDI Inflows*			*FDI Outflows*		
	2011	*2012*	*2014*	*2011*	*2012*	*2014*
Developed Economies	51.8	38.8	40.6	71.0	63.3	60.8
Developing Economies	42.6	54.8	55.5	24.7	32.7	34.6
Transition Economies	5.6	6.3	3.9	4.3	4.0	4.7

Source: UNCTAD, *World Investment Report, 2014 and 2015.*

Investment Pattern

An examination of the investment pattern of the major sources of FDI shows that they, generally, had a regional bias in their investment in the developing countries. The US investments were largely in Latin America. Japan's investments went mostly to the Asian neighbours. There has, however, been some significant changes in the Japanese investments recently. Much of the United Kingdom's investment has gone to the Commonwealth nations, and France had a favour for countries with past colonial ties, mainly Africa.

FDI streams show regional and sectoral/industry biases and historical links.

It has also been observed that direct investment is concentrated in particular economic sectors. For instance, investment by UK and German firms has been mainly in manufacturing while US and Japanese investment, although more evenly spread over the major economic sectors, has a bias towards manufacturing and primary industries; within manufacturing direct investment has been made mainly in transportation equipment, chemicals and machinery (which includes electronics).

The vast expansion of the investment opportunities across the world should be expected to encourage some changes in the directional pattern of the foreign investment flows.

Important Trends in FDI Inflow to Developing Countries

The share of the FDI going to the developing countries declined substantially from 25 per cent during 1980-85 to 17 per cent during 1986-90. There was, however, an increase in the absolute amount of FDI flows to the developing countries. The economic liberalisations in the developing countries have helped increase the FDI to them. During 2003-06, the share of developing countries in the global FDI inflow ranged between 26 and 39 per cent. In recent years, their share was more than half of the total. In 2014, 10 developing countries were among the top 20

recipients of FDI, compared to 7 in 2009. Even while the level of FDI inflow to developing countries rise, the fluctuations in the FDI flows to developed economies affect the share of developing countries.

FDI in developing countries has been larger than official inflows for every year since 1993. It was 10 times larger than bilateral official development assistance (ODA) in 2000; this contrasts with the latter half of the 1980s, when the two were about equal. Recently also, FDI has accounted for about 90 per cent of the total financial flows to developing countries.

Recent FDI flows to developing countries have been mostly market seeking, efficiency seeking and consolidation oriented (M&As).

Within the group of the developing countries, the relatively developed among them get the lion's share of the FDI. Very little FDI has taken place in low income economies leaving exceptions like China and India. In most cases, this has been due to the small size of the domestic market and other adverse factors like poor infrastructure, lack of skilled labour etc.

The lion's share of the FDI flows to the developing countries has been cornered by two regions, *viz.,* East Asia and the Pacific and Latin America while Sub-Saharan/Africa, and Middle East and North Africa got very low shares. The least developed countries, numbering 48, get a very insignificant share.

One traditional attraction of foreign investment, *viz.,* cheap labour, is becoming less important. Foreign investment today is not merely for exploitation of local resources. Foreign companies today evaluate the market potential and production and related facilities and their efficiencies, *inter alia*, for investment decision-making. Countries with large and growing markets, fairly developed infrastructures and efficient input supplies, conducive trade policies, favourable political environment, required type of manpower supplies etc. rank high for investment. An encouraging government policy alone is not sufficient. China has been able to attract huge FDI because its economic growth for quite some time now has been very good, it is one of the largest potential markets in the world, because of the statist policy of until recently it is virtually a virgin market for many products, the labour force is 'disciplined' by the State and China has favourable political and bureaucratic environment. Although India is not as attractive as China in terms of the above factors, its potential is enormous. FDI flows to India have, however, been discouraged by such factors as confusing political environment as reflected by the Enron controversy, agitation against certain multinationals etc. and bureaucratic problems. It may be recalled that the Motorola, disgusted by the administrative delays, has shifted to China a significant project originally earmarked for India. Countries which are at very low levels of development would not be attractive to foreign investors due to factors like constraints of domestic markets and absence of infrastructural and other input supplies of the quantity and quality needed to make the enterprises competitive.

Outward FDI from Developing Countries

FDI outflows from developing countries, although still small, has been growing very fast; South-South FDI flows have also been increasing significantly.

FDI outflows from developing economies have been significantly increasing, reflecting the recognition of firms that in a globalising world economy, they need a portfolio of locational assets to be competitive internationally. In fact, countries like Malaysia, the Republic of Korea and Singapore already have an established track record and some others such as Chile, Mexico and South Africa have become players relatively recently. Countries like Brazil, China and India are at the take-off stage. Their investments span all sectors and country groups and involve complex as well as simple industries. Annual FDI outflows from developing countries have grown very faster since the early 1990s. Outward FDI from developing countries increased from about 16 per cent of the world total in 2007 to 39 per cent in 2014. In 2014, nine of the top 20 international investors were developing countries, compared to six in 2013.[9]

FDI flows from developing countries seems to be growing faster than from developing countries to developed countries. The growing importance of South-South FDI indicates that developing countries are more financially integrated with one another than was previously believed. Thus, a typical developing country has access to more sources of investment than before. This is particularly important for small economies, as TNCs from the South, because of their comparative advantages, tend to invest in countries with similar or lower levels of development than their home countries.[10]

SECTORAL TRENDS

Although, FDI has grown over time in all three economic sectors – primary, manufacturing and services – the sectoral composition has undergone significant changes with marked shift towards services.[11]

The share of the primary sector in the total FDI has not fluctuated significantly in the last two decades.

Primary Sector: The primary sector's share in world FDI stock was less than 10 per cent in 1990 and 2006. However, in the case of FDI flows between 1989-1991 and 2001-02 the share of the primary sector did not decline: it rose from 7 per cent to 9 per cent. While nearly all FDI in the sector continues to originate from developed countries, developing countries – many of them rich in natural resources, but lacking internationally competitive national firms – attract considerable FDI (32 per cent of total primary sector FDI in 2002). Within the primary sector, mining, quarrying and petroleum dominate the primary sector FDI with over 90 per cent of inward FDI stock. During 2003-06, primary sector accounted for 13 per cent of FDI inflows, up from 7.5 per cent during 1989-91. It was 14 per cent in 2011.

The share of services in the FDI has increased sharply at the expense of manufacturing.

Manufacturing Sector: The share of manufacturing in global FDI stock worldwide fell from 42 per cent in 1990 to 30 per cent in 2005. Manufacturing FDI is increasingly geared to more capital- and knowledge-intensive activities because of two developments. There has been a decline in labour-intensive manufacturing in general, and the share of traditional manufacturing employment has also steadily declined. Technological changes leading to increasing replacement of labour by capital and knowledge has been a key element in the decline of labour-intensive FDI in manufacturing. Secondly, firms in more and more countries, especially developing countries, have developed their own ownership-specific advantages based on different factor endowments, particularly low-cost labour *vis-à-vis* developed countries. Its share in the global FDI inflow fell from 37 per cent during 1989-91 to 25 during 2003-05. It was 46 per cent in 2011.

Services Sector: During the period 1990-2002, while the global FDI stock in the primary sector nearly doubled and in the manufacturing sector increased nearly threefold, in the services sector it more than quadrupled. As a result of more rapid growth in this sector than in the other sectors, services accounted for about two-thirds of the global stock of inward FDI in 2005, compared to less than one-half in 1990 and only one-quarter in the early 1970s. It was 40 per cent in 2011. Services continue to receive the lion's share of the FDI.

CROSS-BORDER M&As

Cross-border mergers and acquisitions (M&As) has been the key driver of global FDI since the late 1980s. A very significant aspect of the recent FDI surge is that it is triggered to a large extent by cross-border M&As. For instance, the total value of cross-border M&As with value of over $1 billion each alone accounted for three-fourths of the value of global FDI inflows in 2000. During 2004-06, the share of cross-border M&As in global FDI inflow ranged between 54 and 78 per cent.

Cross-border M&As have been the prime mover of FDI. Fluctuations in M&As cause fluctuations in FDI flows.

Cross-border mergers and acquisitions *(M&A)* involve FDI in a host country by merging with or acquiring an existing local firm. In the latter case, the acquisition involves an equity stake of 10 per cent or more. The share of FDI accounted for by cross-border M&As is difficult to determine, since data sets are not directly comparable. First, the value of cross-border M&As include funds raised in local and international financial markets. *Second*, FDI data are reported on a net basis, using the balance-of-payments concept, while data on cross-border M&A purchases or sales report only the total value of the transaction. Finally, payments for cross-border M&As are not necessarily made in a single year but may be spread over a longer period.[12]

As an UN Report points out, one recent feature is that M&As among large or dominant TNCs, resulting in even larger TNCs, seem to impel other major TNCs to move towards restructuring or making similar deals with other TNCS. The pharmaceutical, automobiles, telecommunications and financial industries are typical example of industries in which such concentration can be observed. This trend significantly changes the industry structure. In the automobile industry, for example, the total number of major automobile makers may well decline to 5 to 10 by 2010, from the 1998 figure of 15. In the pharmaceutical industry, many markets are now controlled by a small number of firms. In both these industries, there have been a string of M&As. Major M&As in the pharmaceuticals include Glaxo-SmithKline Beecham, Pfizer Warner Lambert and Hoechst-Rhone.

The trend towards M&A is also accelerating the sale of non-core operations or affiliates by firms and the acquisition of similar operations from other firms (of divisions or affiliates, or firms that have similar businesses). This indicates a strategic shift by TNCs to focus on their core activities. Unlike in the 1980s, there were fewer deals among unrelated. In addition to strategic considerations of firms, liberalisation and deregulation are the other main factors behind the dramatic increases in M&As in both developed and developing countries.

Developed countries account for the lion's share of the mega mergers (nearly 90 per cent of the total). However, an upward trend in M&A sales by developing countries and countries in transition is noticeable. Among developing countries, majority M&A sales in South, East and South-East Asia have been increasing recently, in particular after the 1997 financial crisis. Latin America and Central and Eastern Europe also recorded significant increases in M&A sales.

Developing country firms have become increasingly active in foreign acquisitions.

There has been a substantial shift towards services in cross-border M&As as it became a widely used mode of TNC entry in such service industries as banking, telecommunications and water. While, in the late 1980s, services accounted for less than 40 per cent of global cross-border M&As, their share rose to more than 60 per cent by the end of the 1990s and was 58 per cent during 2002-06.

The liberalisation and deregulation of several vital industries in many countries across the world have given an impetus to cross-border M&As in both developed and developing countries. Increasing M&As in the service sector in general and financial industries in particular reflect the impact of liberalisation. Privatisation has been a very important stimulant to M&As. Banking, finance, insurance and telecommunication industries have been witnessing a spate of M&As.

FOREIGN INVESTMENT IN INDIA

The flow of direct foreign investment to India has been comparatively limited because of the type of industrial development strategy and the very cautious foreign investment policy followed by the nation.

Direct foreign investment (private) in India was adversely affected by the following factors.

1. The public sector was assigned a monopoly or dominant position in the most important industries and, therefore, the scope of private investment, both domestic and foreign, was limited.
2. When the public sector enterprises needed foreign technology or investment, there was a marked preference for the foreign government sources.
3. Government policy towards foreign capital was very selective. Foreign investment was normally permitted only in high technology industries in priority areas and export-oriented industries.
4. Foreign equity participation was normally subject to a ceiling or 40 per cent, although exceptions were allowed on merit.
5. Payment of dividends abroad, repatriation of capital, etc., as well as inward remittances were subject to stringent laws like the Foreign Exchange Regulation Act (FERA), 1973. These discouraged foreign investment.
6. Corporate taxation was high and tax laws and procedures were complex.
7. These factors either limited the scope of or discouraged the foreign investment in India.

Prior to 1991, government policies severely limited FDI inflow to India.

Government Policy

The following paragraphs give a very brief account of Government of India's policy towards foreign capital and technology. First, the salient features of the policy followed till the economic liberalisation introduced in July 1991 are given. This is followed by an account of the new policy.

India was following a very restrictive policy towards foreign capital and technology. Foreign collaboration was permitted only in fields of high priority and in areas where the import of foreign technology was considered necessary. In other areas, import of technology was considered on merits if substantial exports were guaranteed over a period of 5 to 10 years and if there were reasonable proposals for such exports. The government had issued lists of industries where:

(a) *(i)* Foreign investment may be permitted.

(ii) Only foreign technical collaboration (but no foreign investment) may be permitted.

(b) No foreign collaboration (financial or technical) was considered necessary.

The government policy on foreign equity participation was, thus, selective. Such participation had to be justified with regard to factors such as the nature of technology involved, whether it would promote exports which might not otherwise take place and the alternative terms available for securing the same or similar technological transfers. Foreign equity participation was limited to 40 per cent, although exceptions were allowed on merit. The foreign share capital was to be by way of cash without being linked to tied imports of machinery and equipment or to payments for know-how, trade marks, brand names, etc.

Technical collaborations were to be considered on the basis of annual royalty payments which were linked with the value of actual production. The percentage of royalty was dependent on the nature of technology. Whenever possible, the payment of fixed amount of royalty per unit of production was preferred. Royalty payments were limited to a period of 5 years.

The *Foreign Exchange Regulation Act* (FERA), 1973, served as a tool for implementing the national policy on foreign private investment in India. The FERA empowered the Reserve Bank of India to regulate or exercise direct control over the activities of foreign companies and foreign

nationals in India. A foreign company was defined as one (other than a banking company) which was not incorporated in India or in which non-resident interest was more than 40 per cent or any branch of such a company.

According to the FERA, non-residents (including Indian citizens), foreign citizens resident in India and foreign companies required the permission of the RBI to accept appointment as agents or technical management advisers in India, of any person or company, or permit the use of their trade marks.

The trading, commercial and industrial activities in India of persons resident abroad, foreign citizens in India and foreign companies were regulated by the FERA. They had to obtain permission from the RBI for carrying on in India any activity of a trading, commercial or industrial nature; opening branches/offices or other places of business in India acquiring any business undertaking in India; and purchasing shares of Indian companies.

RBI had given general permission for certain matters. For example, general permission was granted to foreign companies to acquire or hold any immovable property in India which was necessary for, or incidental to, any activity undertaken by them with the permission of the RBI.

The New Policy

The Industrial Policy Statement of July 24, 1991, which observes that while freeing the Indian economy from official controls, opportunities for promoting foreign investment in India should also be fully exploited has liberalised the Indian policy towards foreign investment and technology.

The current policy of Government of India is very liberal, compared to the past, towards foreign investment. The liberalisation process is continuing.

As pointed out earlier, in the pre-liberalisation era, foreign equity participation was restricted normally to 40 per cent and foreign investment and technology agreements needed prior approval. As against this, the new policy has allowed majority foreign equity with automatic approval in a large number of industries.

The new policy has also made the import of capital goods automatic provided the foreign exchange requirement for such import is ensured through foreign equity.

Salient features of initiatives under the new policy includes the following:

Foreign investment in most of the industries is now eligible for automatic approval route (*i.e.,* no prior approval of the government/RBI is required).

Until December 1996, only 36 industries as mentioned in the Annexure III of the Industrial Policy Statement of July 1991 were eligible for automatic approval of FDI up to 51 per cent of the total equity. The automatic route has subsequently been expanded very significantly and now there are different categories of industries on the basis of the ceiling of foreign equity participation.

There are two procedural routes for approval of technical collaborations: (1) Automatic approval by RBI is available for any proposal with lumpsum payment not exceeding US$2 million and royalty of up to five per cent on domestic sales and eight per cent on exports. (2) In all other cases, the Project Approval Board (PAB) considers the proposals and makes recommendations to the Industry Ministry regarding approval.

India has also joined the Multilateral Investment Agency in 1994.

With increased liberalisation, as at the end of 2007, equity caps on FDI existed only in limit sectors. These are a FM radio broadcasting (upto 20 per cent); insurance, defence production, petroleum refining in the PSUs, print and electronic media covering news and current affairs (upto 26 per cent); air transport services, asset reconstruction companies, cable network, direct to home (DTH), hardware for uplinking, HUB, etc. (upto 49 per cent); single brand retailing (upto

51 per cent); atomic minerals, private sector banking, telecom services, establishment and operation of satellites (upto 74 per cent). FDI is prohibited in retail trading (except for single brand product retailing), gambilng and betting, lottery and atomic energy. The FDI policy of India continued to be more and more liberalised in phases and the liberalisation has become more pronounced under the Narendra Modi government.

FII Investments

The Indian stock market was opened up to FII investment in 1992-93 and since then there has been a significant increase in the portfolio investment by FIIs.

FIIs include hedge funds, insurance companies, pension funds and mutual funds. India is one of the largest recipients of portfolio investments among EMEs.

According to the IMF definition, portfolio investment refers to cross-border transactions and positions involving debt or equity securities, other than those included in direct investment or reserve assets.

In India, FIIs cover overseas pension funds, mutual funds, investment trusts, asset management companies, nominee companies, banks, institutional portfolio managers, university funds, endowments, foundations, charitable trusts, charitable societies, trustees or power of attorney holders incorporated or established outside India proposing to make proprietary investments or investments on behalf of a broad-based fund (*i.e.*, fund having more than 20 investors with no single investor holding more than 10 per cent of the shares or units of the fund). India is one of the largest recipients of portfolio inflows among emerging market economies (EMEs).

The Regulations on Foreign Institutional Investors, which were notified on November 14, 1995, contains various provisions relating to definition of FIIs, eligibility criteria, investment restrictions, procedures of registration and general obligations and responsibilities of FIIs.

According to the Regulations, FIIs may invest only in:

(a) Securities in the primary and secondary markets including shares, debentures and warrants of companies listed on a recognised stock exchange in India, and

(b) Units of schemes floated by domestic mutual funds including Unit Trust of India, whether listed on a recognised stock exchange or not.

Joint ventures between a variety of domestic and foreign securities firms have been approved in the stock broking, merchant banking, assets management and other non-bank financial services sectors. The overall effect of FII investment and financial joint ventures has been the introduction of international practices and systems to the Indian Securities industry.

FIIs are permitted to invest in a company upto an aggregate of 24 per cent of equity, which can be increased to 40 per cent subject to approval by the Board of Directors and a Special Resolution of the General Body.

In 1996-97, Government liberalised the FII investment policy, allowing them to invest in unlisted companies and in corporate and government securities.

FII investment has become an important determinant of the stock market trends in India.

FDI inflow as a percentage of gross fixed capital formation of India increased from less than 2 per cent during 1990-2006 to nearly 6 per cent in 2007 but was less than 5 per cent in 2013.

Euro/ADR Issues

As mentioned earlier, since 1992-93, Indian companies satisfying certain conditions, are allowed to access foreign capital markets by Euro-issues of Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs).

"A Depository Receipt is basically a negotiable certificate, denominated in US dollars, that represents a non-US company's publicly traded local currency (Indian Rupee) equity shares. DRs are created when the local currency shares of an Indian company (for example) are delivered to the depository's local custodian bank, against which the Depository Bank (such as the Bank of New York) issues DRs in US dollars. The Depository Receipts may trade freely in the overseas markets like any other dollar denominated security, either on a foreign stock exchange, or in the over-the-counter market, or among a restricted group such as qualified institutional buyers".[13]

The prefix global implies that the ADRs are marketed globally rather than in a specific country or market.

Companies with good track record of three years may avail of Euro-issues for approved purposes. According to the revised guidelines issued in November 1995, companies investing in infrastructure projects, including power, petroleum exploration and refining, telecommunications, ports, roads and airports are exempted from the condition of 'three-year track record'. It is expected to help companies in the infrastructure sectors to access cheap overseas funds.

Earlier, companies had to keep the funds raised through Euro-issues in foreign currency deposits with banks and public financial institutions in India to be converted into Indian rupees as and when required for expenditure on approved end uses up to 25 per cent of the Euro-issue proceedings for meeting corporate restructuring and working capital requirements. Companies are also permitted to raise funds through issue of Foreign Currency Convertible Bonds (FCCBs) and ADRs.

Mergers and Acquisitions

The liberalisation – the privatisation, delicensing, liberalisation of foreign investment policy, scrapping of MRTP restrictions on M&A *et al.* – and the SEBI Takeover Code have opened the doors for cross-border M&As in India. Foreign MNCs have been using M&A as a market entry strategy and competitive strategy. Several MNCs have acquired the partner's stake in their joint ventures or have hiked the stake in the joint ventures and subsidiaries.

Definitional Change

In the past, items like reinvested earnings used to be excluded from the estimation of FDI in India. However, in June 2003, Government has aligned the methodology of compilation of FDI with the international best practices and India now follows the internationally accepted definition of FDI. In line with international best practices, FDI includes both equity capital, reinvested earnings (retained earnings of FDI companies) and 'other direct capital' (inter-corporate debt transactions between related entities). Data on equity capital include equity of unincorporated entities (mainly foreign bank branches in India and Indian bank branches operating abroad), besides equity of incorporated bodies.

An Evaluation of the New Policy

Although the liberalisation has increased the inflow of foreign capital to India, it had been much lower than several other developing countries had been receiving. Until recently, the FDI inflow was nowhere near the annual target of $10 billion set by the Government long ago. This was because of the poor infrastructure, high cost of several factors and the unconducive policy

and procedural environment in several respects. However, recently, there has been spurt in the FDI inflow to India, going up from $25 billion in 2007 to $42 billion in 2008. See Table 39.2. India's share in global FDI increased from about one per cent in 2007 to 3 per cent in 2009.

BOX 39.1 : INDIA VS. OTHER NATIONS

There are distinct signs, nevertheless, that domestic capital is getting restless and itching to go abroad. Quite a few manufacturing companies are looking to China and Latin America to relocate production. Many more are sourcing components or built up units from cheaper manufacturing centres overseas. When asked why, these firms respond by saying that costs overseas are lower than those in India. These include borrowing costs, the price of real estate and initial capital that large manufacturing projects require. It is well known that China which has no market for land, gives real estate away to investors in return for a stake in the venture. In China, land isn`t free, as is popularly assumed but is paid for in future dividend streams, not as upfront capital spending. These are big advantages over India. What`s more important, China, Latin America and parts of eastern Europe that nave now opened up to overseas investments have other advantages over India – skilled manpower, better infrastructure, fewer babus – as a manufacturing centre.

It is pointed out that one drawback of the Indian foreign investment policy is the lack of focus. For instance, on FDI, there`s been no clear policy focus to attract investments in specific sectors or specified regions or even specific companies. Countries following such routes have been fairly successful in attracting FDI. Take China. Focusing on a particular region and decentralisation has proved beneficial for countries like China and Malaysia. China improved its infrastructure and changed its labour laws for the southern coastal areas like Shanghai and Shenzhen. Now, it is introducing incentives for cities like Wuhan and Chengdu in the hinterland that have been largely ignored in the past.

Bureaucratic hurdles need to be removed too. The implementation phase often proves to be the toughest for foreign investors. Once these companies get their FIPB or RBI clearances, they still need to obtain between 41 and 61 clearances from various government departments, before they can start their projects. According to an official in the industry ministry, "FIPB clearance is the easiest. It`s when companies start dealing at the district level with fire and labour inspectors that things turn sour". Compare that with China where once the investment has been cleared, a government official is entrusted with the task obtaining all other clearances from both central and provincial departments.

Courtesy: *"Outward bound", The Economic Times (Editorial), 12 June, 2001 and Anjuli Bhargava and Alam Srinivas, "Where is the Money", Businessworld, 23 April, 2001.*

There are many ardent critics of foreign investment and technology. Foreign investment and technology is not without problems. However, the opening up of the economies of a number of nations for foreign companies and the several measures they have taken to woo foreign companies are a clear indicators of the positive contribution foreign capital and technology can make.

Important Sectors/Industries of Investment: One important criticism of the liberalisation of foreign investment has been that foreign investment would take place mostly in non-priority sectors. However, lion's share of the foreign investment in India since the liberalisation has gone to priority sectors. Now, several of the priority industries, including the infrastructural sector, which were earlier exclusively reserved for the public sector, is opened to foreign investment. From January 1991 to September 2006, the following sectors/industries accounted for about 60 per cent of the FDI: Electrical equipment (including computer software and electronics); telecommunications; energy; transportation; services sector; chemicals (other than fertilisers); Drugs and Pharmaceuticals; food processing; and metallurgical industries. The services sector attracts a large share of the FDI inflows.

FDI to India has been market seeking, efficiency seeking and resource seeking.

Regional Dispersion: The inward FDI is highly concentrated in a few areas. Two regions – Delhi (consisting of Delhi, Part of UP and Haryana) and Mumbai (consisting of Maharashtra, Dadra and Nagar Haveli, Daman and Diu) attract a large share of the FDI inflow to India. Karnataka, Tamil Nadu, Pondicherry and Andhra Pradesh also receive large FDI.

TABLE 39.2 : INDIA : FDI INFLOWS AND OUTFLOWS (Billions of dollars)						
Type of FDI Flow	*2005-2007 (Pre-crisis annual average)*	*2010*	*2011*	*2012*	*2013*	*2014*
Inward	17.77	27.43	36.19	24.20	28.20	34.4
Outward	11.50	15.93	12.46	8.49	1.68	9.8
Source: UNCTAD, *World Investment Report*, 2014 and 2015.						

Sources of FDI to India: Country-wise, Mauritius and the UK are the major FDI investors in India. Large flows from Mauritius could be attributed to its use by investors in other countries for channeling FDI flows into India. Other important sources FDI into India are the US, the Netherlands, Singapore, France, Japan, Switzerland and South Korea.

Attractiveness of India as an Investment Destination: Although there is a lot of talk about the procedural simplification, foreign companies still find the procedures very perplexing and unbearably time-consuming. China's FDI procedures are easier, and decisions can be taken rapidly. According to a Government of India Publication, China has more flexible labour laws, a better labour climate and better entry and exit procedures for business. A confidence tracking survey in 2002 indicated that China was the top FDI destination, displacing the United States for the first time in the investment plans of the TNCs surveyed. India came 15th. However, recently, there was a surge in FDI flow to India and among the developing countries, India has emerged as the second most preferred FDI destination. China continues to be the most preferred destination. India's share in global FDI inflow is very low compared to China.

India is now regarded a very attractive destination for FDI.

In 2014, India was the 9th largest recipient of FDI, compared to 8th in 2009.

FOREIGN INVESTMENT BY INDIAN COMPANIES

Until 1991, Indian companies made very little investment abroad. Although Government of India's policy had been one of encouraging foreign investment by Indian companies, subject to certain conditions, several factors like the domestic economic policy and the domestic economic situation were deterrents to foreign investment by Indian companies.

By restricting the areas of operation and growth, the government policy seriously constrained the potential of Indian companies to make a foray into the foreign countries through investment. Added to this was the attraction of the protected domestic market which was, in many cases, a seller's market and this made the Indian companies to ignore the foreign markets.

Indian companies have established subsidiaries and joint ventures in a number of countries in different manufacturing industries and service sectors.

Spurt in FDI Outflow: Foreign investment, both in greenfield enterprises and mergers and acquisitions (M&A), is clearly a part of the globalisation strategy of many Indian companies. Recently, there has been a spurt in FDI by Indian companies.

In 2014, India invested $9.8 billion abroad.

Strategic M&As have been finding favour with corporate India too. M&As by Indian companies involving foreign firms fall into three categories, *viz.,* acquisition of foreign firms, acquisition of MNC affiliates in India and acquisition of foreign brands.

Overseas direct investment from India jumped from $1.5 billon in 2003-04 to $4.5 billion during 2005-06 and further to $19 billion during 2008, reflecting large overseas acquisition deals by Indian corporates. It fell thereafter. See Table 39.2.

FDI Destinations: An UNCTAD Report observes that India also stands out among Asian investors, not so much because of its recent and significant increase in outward FDI and because of its potential to be a large outward investor, but because of the new trend set by some of its information technology (IT) firms. Most Indian outward FDI is in manufacturing (about 55 per cent), but non-financial services also account for a significant share (25 per cent). FDI in IT services in particular has begun to grow rapidly. The growing technological capabilities of Indian firms and their rising exports, particularly in IT services and pharmaceuticals, are driving the FDI growth. Access to markets, distribution networks, foreign technology and strategic assets such as brand names, are the main motivations. Securing natural resources is also becoming an important driver for FDI in the oil and gas industries and mining.[14]

Recently, there has been a spurt in corporate India's foreign investment. There were several spectacular overseas acquisitions.

The most important destination for Indian FDI has been the developed countries. Indian companies have been making greenfield and brownfield investments in developing countries also.

SUMMARY

Encouraged by the favourable business environment fostered by the global liberalisation, the international private capital flows have been increasing rapidly. Cross-border M&As have been the major driver of the recent surge in the FDI.

Foreign capital now contributes a significant share of the domestic investment, employment generation, industrial production and exports in a number of economies, including China.

Broadly, there are the following two types of foreign investment;

- Foreign direct investment (FDI) where the investor has control over/participation in the management of the firm.
- Portfolio investment where the investor has only a sort of property interest in investing the capital in buying equities, bonds, or other securities abroad. In the case of portfolio investments, the investor uses his capital in order to get a return on it, but has no much control over the use of the capital. The major portfolio investment in the Indian capital market is by the foreign institutional investors (FIIs).

Broadly there are three economic motives of FDI, *viz.*, resources seeking (*e.g.,* exploiting the natural resources of the host country); market seeking (*i.e.,* to exploit the market opportunities of the host countries) and efficiency seeking (like low cost of production deriving from cheap labour).

The presence of any (or even all) of these determinants alone need not attract FDI. Several other factors like the political environment, government policies, bureaucratic culture, social climate, infrastructural facilities etc. are also important determinants of FDI.

Although the international capital flows to the developing countries have increased substantially in the last one decade or so, they are still predominantly between the developed countries. A small number of countries account for the lion's share of the international capital inflows to the developing world.

Although India has substantially liberalised its foreign investment policy, the FDI inflows had been much below the targets. India had not been getting even one-tenth the size of FDI flow to

China. Even the cumulative FDI flow to India between 1991 and 2007 was less than the annual flow to China. Bureaucratic problems, certain unfavourable government attitudes, poor infrastructure, labour factors, high input costs etc. are regarded as the major reasons.

After a spurt in the inward and outward FDI flow of India, there was decline, particularly of outflows in the early years of this decade, as Table 39.2 shows.

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Chapter 40

MULTINATIONAL CORPORATIONS

Structure

Introduction

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INTRODUCTION

The dynamics of the business environment fostered by the drastic political changes in the erstwhile communist and socialist countries and the economic liberalisation across the world has enormously expanded the opportunities for the multinational corporations, also known by such names as international corporation, transnational corporation, global corporation (or firm, company or enterprise) etc.

The rapidity with which the MNCs are growing is indicated by the fact that while according to the *World Investment Report 1997* there were about 45000 MNCs with some 2.8 lakh affiliates, according to the *World Investment Report 2011* there were more than one lakh of them with about 9 lakh affiliates. Only one-third of these affiliates were in the developed countries. China was host to about 36 per cent of the total number of affiliates.

The MNCs account for a significant share of the world's industrial investment, production, employment and trade. See Box 40.1.

BOX 40.1 : THE PROWESS OF MNCS

International production by Transnational Corporations (TNCs), now numbering some 63,000 parent firms with around 800,000 foreign affiliates and a plethora of inter-firm arrangements, spans virtually all countries and economic activities, rendering it a formidable force in today`s world economy.

The world`s top 100 (non-financial) TNCs, based almost exclusively in developed countries, are the principal drivers of international production. The $2 trillion in assets of their foreign affiliates accounted for about one-eighth of the total assets of all foreign affiliates worldwide in 1998. The foreign affiliates of the top 100 TNCs employ over 6 million persons, and their foreign sales are of the order of $2 trillion. They are concentrated mainly in electronics and electrical equipment, automobiles, petroleum, chemicals and pharmaceuticals.

Despite the prominence of the top 100, the universe of TNCs is quite diverse, and includes a growing number of small and medium-sized enterprises, TNCs from countries in Central and Eastern Europe that have only recently begun to engage in international production, and large TNCs based in the developing world. Although less transnational overall than the world`s top 100 TNCs, some of the developing-country TNCs are quite sizeable–witness, for example, the size of the foreign assets ($8 billion) of Petroleos de Venezuela, the largest TNC from the developing world and the only developing-country firm to appear in the top 100 list.

Evidence on the expansion of international production over the past two decades abounds. Gross product associated with international production and foreign affiliate sales worldwide, two measures of international production, increased faster than global GDP and global exports, respectively. Sales of foreign affiliates worldwide ($34.5 trillion in 2013, $3 trillion in 1980) are now nearly 50 per cent higher than the global exports, and the gross product associated with international production is about one-tenth of global GDP, compared with one-twentieth in 1982.

Courtesy: *UNDP, World Investment Report, 2000, 2011 and 2014.*

Although the multinational corporation took birth in the early 1860s, it was after the Second World War that multinationals have grown rapidly. In the early days, the United States was the home of most of the MNCs. Now, there are a large number of Chinese, Japanese and European multinationals. There has been a fast increase of developing country firms in the Fortune 500. In 2014, China had 95, South Koria 17 and Ind 8 companies in the list.

MNCs of the US are more focused, *i.e.*, they confine their business to one industry or product category. In fact, several American MNCs which attempted diversification, mostly by the acquisitions route, reverted to focus, after bitter experiences with the diversification. Compared with the US MNCs, most European companies have a much broader product line. Japanese companies, generally, have product lines that are much too broad. Of the top ten corporation in the US, only one (General Electric) is a classic conglomerate, while in Japan eight are

conglomerates and only two are not (Toyota Motor and Nippon Telegraph and Telephone). Similarly, the Korean corporations are far too diversified. Recent trends indicate that the diversified corporations have many odds against them and the focus strategy is more successful.

DEFINITION AND MEANING

As the concept of multinationality has several dimensions, there is no single universally agreed definition of the term multinational corporation. According to an ILO Report, "the essential nature of the multinational enterprises lies in the fact that its managerial headquarters are located in one country (referred to for convenience as the ("home country") while the enterprise carries out operations in a number of other countries as well ("host countries").[1] Obviously, what is meant is "a corporation that controls production facilities in more than one country, such facilities having been acquired through the process of foreign direct investment. Firms that participate in international business, however large they may be, solely by exporting or by licensing technology are not multinational enterprises."[2]

The ratio of foreign investment, production, sales and employment and the number of countries of business are important criteria to regard a firm as multinational.

Among the various other benchmarks sometimes used to define 'multinationality' are that the company in question must:[3]

- Produce (rather than just distribute) abroad as well as in the headquarters country
- Operate in a certain minimum number of nations (six for example)
- Derive some minimum percentage of its income from foreign operations (*e.g.,* 25 per cent)
- Have a certain minimum ratio of foreign to total number of employees, or of foreign total value of assets
- Possess a management team with geocentric orientations
- Directly control foreign investments (as opposed simply to holding shares in foreign companies).

The definitions of the terms transnational corporation (used to mean the same thing as MNC and similar terms) foreign affiliate, subsidiary and branch given in the UN's *World Investment Report* are as follows.

Transnational Corporations are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A *parent enterprise* is deemed as an enterprise that controls assets of other entities in countries other than its home country, usually by owning *a* certain equity capital state. An equity capital stake of 10 per cent or more of the ordinary shares or voting power for an incorporated enterprise, or its equivalent for an unincorporated enterprise, is normally considered as a threshold for the control of assets. (In some countries, such as Germany and United Kingdom, the threshold is a stake of 20 per cent or more.)

A *Foreign Affiliate* is an incorporated or unincorporated enterprise in which an investor, who is resident in another economy, owns a stake that permits a lasting interest in the management of that enterprise (an equity stake of 10 per cent for an incorporated enterprise or its equivalent for an unincorporated enterprise. In the *World Investment Report,* subsidiary enterprise, a subsidiary enterprise, associate enterprise and branches are all referred to as *foreign affiliates.*

A *Subsidiary* is an incorporated enterprise in the host country in which another entity directly owns more than a half of the shareholders' voting power and has the right to appoint or remove a majority of the members of the administrative, management or supervisory body.

An *Associate* is an incorporated enterprise in the host country in which an investor owns a total of at least 10 per cent, but not more than a half, of the shareholders' voting power.

A *Branch* is a wholly or jointly owned unincorporated enterprise in the host country which is one of the following: *(i)* a permanent establishment or office of the foreign Investor; *(ii)* an unincorporated partnership or joint venture between the foreign direct investor and one or more third parties; *(iii)* land, structures (except structures owned by government entities), and/or immovable equipment and objects directly owned by a foreign resident; *(iv)* mobile equipment such as ships, aircraft, gas or oil-drilling rigs operating within a country other than that of the foreign investor for at least one year.

As the *World Investment Report 1999* observes, transnational corporations (TNCs) establish, under the common governance of their headquarters, international production systems in which factors of production move, to a greater or lesser extent, among units located in different countries. These systems increasingly cover a variety of activities, ranging from research and development (R&D) to manufacturing to service functions such as accounting, advertising, marketing and training, dispersed over host country locations and integrated to produce final goods or services. They are also increasingly being established, especially in developed countries, through mergers between existing firms from different countries or the acquisition of existing enterprises in countries by firms from others. Once internationally dispersed production units under common governance are established, mobile and location bound factors of production to which a TNC has access in home and host countries (and sometimes even third countries) are combined in each unit in ways and for production that contribute the most to the firm's economic and strategic objectives. From the perspective of factor use – as distinct from that of location as host or home country for enterprises engaged in international production – all of the production that takes place in these TNC production systems (in parent firms or home country units as well as foreign affiliates or host country units) constitutes international production.

ORGANISATIONAL MODELS

Terms such as international corporation, multinational corporation, transnational corporation and global corporation are often used as synonyms. However, several multinationals have evolved into certain advanced stage of transnational organisation and operations that it becomes necessary to draw some distinction between these terms.

Organisational modes are distinguished on the basis of configuration of resources, extent of centralisation/decentralisation and attitude towards foreign business.

However, the interpretations of these terms given by different authors are not same. Sometimes the differences arise from the differences in the context.

With reference to the configuration of resources and responsibilities, parent subsidiary relationship and the mentality towards the overseas operations, the salient characteristics of these corporations pointed out by Bartlett and Ghoshal are highlighted below.[4] Some of these descriptions are at variance with those given by some other authors. The following account, however, is very useful in understanding the distinctive features of these different types of organisations. In other sections of this book, these terms are used interchangeably.

Multinational Corporation: This was the type of the corporation popular when many European companies internationalised during the pre-war (1920s and 1930s) when the trade barriers were very high. According to Bartlett and Ghoshal, the multinational organisation is defined by the following characteristics: a decentralised federation of assets and responsibilities, a management process defined by simple financial control systems overlaid on informal personal coordination, and a dominant strategic mentality that viewed the company's worldwide operations as a portfolio of national businesses. In a multinational organisation, the decisions, obviously, are decentralised.

International Organisation Model: This organisation structure, was predominant in the case of the American companies which internationalised in the early post-war years.

In the international organisation, the structural configuration of which is described as coordinated federation, many assets, resources, responsibilities and decisions are decentralised but controlled from the headquarters. The overseas operations are regarded essentially as appendages to a central domestic corporation. In this model, the headquarters transfers knowledge and expertise to overseas environments that were less advanced in technology or market development. While local subsidiaries are often free to adapt the new products or strategies, their dependence on the parent company for new products, processes, or ideas dictated a great deal more coordination and control by the headquarters than in the classical multinational organisation.

Global Organisational Model: The Japanese companies which internationalised since the mid-1960s through the 1970s and 1980s adopted global organisation model. The global configuration is based on centralisation of assets, resources and responsibilities; overseas operations are used to reach foreign markets in order to build global scale. The role of local subsidiaries is to assemble and sell products and to implement plans and policies developed at headquarters. Compared with subsidiaries in multinational or international organisations, they have much less freedom to create new products or strategies or even to modify existing ones.

In the global model, management treats overseas operations as delivery pipelines to a unified global market, is described as a centralised hub.

The rapid decline in tariffs, coupled with dramatic improvements in transportation and communication of this period made a truly export-based strategy feasible.

The global organisation model, where authority and decision-making are centralised and subsidiaries are used basically as implementing agencies, is described as a centralised hub.

Transnational: The transnational organisation and model seeks to eliminate some of the drawbacks of the other models. It endeavours to achieve global competitiveness through, *inter alia*, multinational flexibility and worldwide learning.

In a transnational, the specialised resources and capabilities are dispersed among the various operating units globally. These units are interdependent and integrated and have large flows of components, products, resources, people and information among them. An important feature of the transnational, therefore, is the complex process of coordination and cooperation in an environment of decision-making.

DOMINANCE OF MNCs

The GNI of most nations is smaller than the annual sales turnover of giant MNCs.

The global liberalisation has paved the way for fast expansion and growth of the MNCs.

The following paragraphs excerpted from the *World Investment Reports 2000* and *2003* provide some indications of the economic dominance of the multinationals.

Many countries and economic activities are dominated by MNCs, rendering them a formidable force in today's world economy. According to UNCTAD's *World Investment Report 2009*, there were more than 82,000 multinationals in the world with over 8 lakh foreign affiliates.

TABLE 40.1 : FORTUNE 500 INDIAN COMPANIES, 2014

Fortune 500 Rank in terms of Turnover				*Company*	*Country Rank 2014*	*Industry Type*
2014	*2013*	*2012*	*2011*			
96	88	83	98	Indian Oil	1	**Petroleum**
114	107	99	134	RIL	2	Petroleum
242	229	225	271	BPCL	3	Petroleum
284	260	267	335	HPCL	4	Petroleum
287	316	314	358	Tata Motors*	5	**Automobile**
303	298	285	291	SBI	6	Banking
424	369	357	360	ONGC	7	Petroleum
486	471	401	369	Tata Steel	8	Iron & Steel

TABLE 40.2 : HOW COUNTRIES STACK UP

Country	*No. of Fortune 500 Companies in 2013*
USA	128
China	95
Japan	57

TABLE 40.3 : TOP TEN GLOBAL FORTUNE 500 COMPANIES, 2014

Rank	*Company*	*Country*	*Industry*	*Revenue in USD*
1	Walmart	United States	Retail	$476.3 billion
2	Royal Dutch Shell	Netherlands United Kingdom†	Petroleum	$459.6 billion
3	Sinopec	China	Petroleum	$457.2 billion
4	China National Petroleum Corporation	China	Petroleum	$432.0 billion
5	ExxonMobil Companies	United States	Petroleum	$407.7 billion
6	BP	United Kingdom	Petroleum	$396.2 billion
7	States Grid Corporation of China	China	Power	$333.4 billion
8	Volkswagen	Germany	Automobiles	$261.5 billion
9	Toyota	Japan	Automobiles	$256.5 billion
10	Glencore	Switzerland	Commodities	$232.7 billion

† *Fortune* had previously listed Shell as a Dutch company, but as of the 2013 listing, it is listed as British/Dutch.

The size of large TNCs is sometimes compared to that of countries' economies, as an indicator of the influence that the former have in the world economy. According to one comparison of the sales volume of firms with the GDP of countries, the sales of the top 200 firms accounted for 27.5 per cent of world GDP in 1999. Of the 50 largest "economies", 14 were TNCs and 36 were countries.

Their economic impact can be measured in different ways. In 2010, foreign affiliates accounted for about 68 million employees, compared to 21 million in 1990; their sales of almost $33 trillion were more than double the world exports in 2010, compared to 1990 when both were roughly equal; and the stock of outward foreign direct investment (FDD, increased from $1.7 trillion to $6.6 trillion over the same period. Foreign affiliates now account for one-tenth of world GDP and one-third of world exports. Moreover, if the value of worldwide TNC activities associated with non-equity relationships (*e.g.,* international subcontracting, licensing, contract manufacturers) is considered, TNCs would account for even larger shares in these global aggregates.

In 2006, a number of large MNCs like General Motors, Ford, Vodafone and Coca Cola incurred losses.

The universe of TNCs is quite diverse, and includes a growing number of small- and medium-sized enterprises, TNCs from countries in Central and Eastern Europe that have only recently begun to engage in international production, and large TNCs based in the developing world. Although less transnational overall than the world's top 100 TNCs, some of the developing country TNCs are quite sizeable — witness, *for example,* the size of the foreign assets ($8 billion) of Petroleos de Venezuela, the largest TNC from the developing world and the only developing country firm to appear in the top 100 list.

Evidence on the expansion of international production over the past two decades abounds. Gross product associated with international production and foreign affiliate sales worldwide, two measures of international production, increased faster than global GDP and global exports, respectively. Sales of foreign affiliates worldwide ($33 trillion in 2010, $3 trillion in 1980) are now much higher than global exports, and the gross product associated with international production is more than one-tenth of global GDP, compared with one-twentieth in 1982.

The economic clout of the MNCs is indicated by the fact that the GDP of most of the countries is smaller than the value of the annual sales turnover of the multinational giants. The value of the annual sales of Wal-Mart Stores in 2014 was about $476 billion. Only a very small number of developing countries like India, China, Mexico, Brazil, Russia, Argentina, Indonesia and Republic of Korea had GDP which was higher than this figure. There were also several developed countries whose value of GDP was less than this.

In 2014, China had the largest number (3) in the top 10 fortune 500 companies and 7 of the 23 newly listed companies were chinese.

MNCs AND INTERNATIONAL TRADE

Peter Drucker remarks that multinationalism and expanding world trade are two sides of the same coin.[6] He points out that the period of most rapid growth of multinationals – the fifties and sixties – was the period of most rapid growth of multinational trade. Indeed, during this period, the world trading economy grew faster – at an annual rate of 15 per cent or so in most years – than even the fastest growing domestic economy, that of Japan.[7]

It is estimated that between one-fourth and one-third of manufactured goods now moving in world trade are being shipped from one branch to another of the MNCs; that is, they are intra-company shipments. The sale of foreign subsidiaries in the host countries in which they are located are three to four times as large as total world exports.[8]

There was a very significant increase in the export intensity (*i.e.,* the percentage of exports to total sales) of the foreign affiliates of many MNCs. The export intensity of foreign affiliates of US MNCs, *for example*, increased from less than 20 per cent in the mid-sixties to over 40 per cent in the early 1990s for all economies; it doubled from about 20 to 40 per cent in the case of developed economies; jumped from about six to 22 per cent in the case of the Latin American affiliates and from 23 to 64 per cent for developing Asia. The average export intensity of all the affiliates has, however, remained between 21-24 per cent for a long time. In the case of India, however, it has very low. More than 40 per cent of the total exports of China is done by MNC affiliates. The export contribution of foreign affiliates in China is far larger than the total exports of India.

Exports by foreign affiliates of MNCs account for nearly one-third of the global exports.

Apart from trade in commodities, other transactions also take place extensively between the different parts of these enterprises – *for example*, the granting of loans, the licensing of technology and the provision of services. In all such transactions, transfer prices may be settled which are different from the price which would have been the case between independent parties operating at arm's length. Such differences may reflect the legitimate concerns of the companies but are also capable of being used in order to shift profits from high to low tax countries or to get around exchange or price controls or customs duties. As the Brandt Commission observes, the ability of multinationals to manipulate financial flows by the use of artificial transfer prices is bound to be a matter of concern to Governments. The monitoring and control of transfer prices involves inter-Governmental cooperation and measures to secure due disclosure of relevant information by companies. This is necessary to make effective tax laws covering transfer prices which exist in many countries. Intra-firm trade also opens up the possibility for corporations to impose restrictive business practices within their own organisation; they can limit the exports of their affiliates; allocate their markets between nations or restrict the use of their technology or that developed by their affiliates. Such practices, although best pursued in the best business interests of the companies, may conflict with the developmental objectives and national interests of host countries.[9]

MERITS OF MNCs

As the Preface to the ILO Report on *Multinational Enterprises and Social Policy* observes, "for some, the multinational companies are an invaluable dynamic force and instrument for wider distribution of capital, technology and employment; for others, they are monsters which our present institutions, national or international, cannot adequately control, a law to themselves with no reasonable concept, the public interest or social policy can accept."[10]

The important arguments in favour of and against the MNCs are mentioned below.

MNCs, it is claimed, help the host countries in the following ways:

1. MNCs help increase the investment level and thereby the income and employment in host country.
2. The transnational corporations have become vehicles for the transfer technology, especially to the developing countries.
3. They also kindle a managerial revolution in the host countries through professional management and the employment of highly sophisticated management techniques.
4. The MNCs enable the host countries to increase their exports and decrease their import requirements.
5. They work to equalise the cost of factors of production around the world.

MNCs can help accelerate economic growth in different ways.

6. MNCs provide an efficient means of integrating national economies.
7. The enormous resources of the multinational enterprises enable them to have very efficient research and development systems. Thus, they make a commendable contribution to inventions and innovations.
8. MNCs also stimulate domestic enterprise because to support their own operations, the MNCs may encourage and assist domestic suppliers.
9. MNCs help increase competition and break domestic monopolies.

DEMERITS OF MNCs

MNCs' global strategies and exploitative mindset can have inimical impacts and impair national interests.

MNCs have, however, been subject to a number of criticisms, like those mentioned below.

1. As Leonard Gomes points out, the MNC's technology is designed for worldwide profit maximisation, not the development needs of poor countries, in particular employment needs and relative factor scarcities in these countries. In general, it is asserted, the imported technologies are not adapted to: *(a)* the consumption needs, *(b)* the size of domestic markets, *(c)* resource availabilities, and *(d)* stage of development of many of the LDCs.[11]
2. Through their power and flexibility, MNCs can evade or undermine national economic autonomy and control, and their activities may be inimical to the national interests of particular countries.
3. MNCs may destroy competition and acquire monopoly powers.
4. The tremendous power of the global corporations poses the risk that they may threaten the sovereignty of the nations in which they do business. On political involvement, MNCs have been accused on occasion of:[12] supporting repressive regimes; paying bribes to secure political influence; not respecting human rights; paying protection money to terrorist groups; and, destabilising national governments of which they do not approve.
5. MNCs retard growth of employment in the home country.
6. The transnational corporations cause fast depletion of some of the non-renewable natural resources in the host country. They have also been accused of the following environmental problems:[13] polluting the environment; not paying compensation for the environmental damages; causing harmful changes in the local living conditions; and, paying little regard to the risks of accidents causing major environmental catastrophes.
7. The *transfer pricing* enables MNCs to avoid taxes by manipulating prices on intra-company transactions.
8. The MNCs have been criticised for their business strategies and practices in the host countries. They undermine local cultures and traditions, change the consumption habits for their benefit against the long-term interests of the local community, promote conspicuous consumption, dump harmful products in the developing countries etc.

MNCs are all set to proliferate the global economy.

PERSPECTIVE

Future holds out an enormous scope for the growth of MNCs. The changes in the economic environment in a large number of countries indicate this. For instance, the number of bilateral treaties that promote and/or protect FDI has increased markedly in recent times.

A United Nation's Report described several developments that points to a rapidly changing context for economic growth, along with a growing role for transnational corporations in that process. These include:[14]

1. Increasing emphasis on market forces and a growing role for the private sector in nearly all developing countries.
2. Rapidly changing technologies that are transforming the nature of organisation and location of international production.
3. The globalisation of firms and industries;
4. The rise of services to constitute the largest single sector in the world economy; and
5. Regional economic integration, which involve both the world's largest economies as well as selected developing countries.

The proliferation of MNCs make norms governing their activities all the more important.

CODE OF CONDUCT

It is widely felt that there must be a code of conduct to guide and regulate the MNCs.

According to the Brandt Commission, the principal elements of an international regime for investment should include:

1. A framework to allow developing countries as well as transnational corporations to benefit from direct investments on terms contractually agreed upon. Home countries should not restrict investment or the transfer of technology abroad, and should desist from other restrictive practices such as export controls or market, not restrict current transfers such as profits, royalties and dividends, or the repatriation of capital, so long as they are on terms which were agreed when the investment was originally approved or subsequently negotiated.
2. Legislation promoted and coordinated in home and host countries, to regulate the activities of transnational corporations in such matters as ethical behaviour, disclosure of information, restrictive business practices, cartels, anti-competitive practices and labour standards. International codes and guidelines are a useful step in that direction.
3. Cooperation by Governments in their tax policies to monitor transfer pricing and to eliminate the resort to tax havens.
4. Fiscal and other incentives and policies towards foreign investment to be harmonised among host developing countries, particularly at regional and sub-regional levels, to avoid the undermining of the tax base and competitive positions of host countries.
5. An international procedure for discussions and consultations on measures affecting direct investment and the activities of transnational corporations.

The Code of Conduct for MNCs, drawn up by the Commission on Transnational Corporations, set up by the UN's Economic and Social Council, required MNCs, *inter alia,* to:

- Respect the national sovereignty of host countries and observe their domestic laws, regulations and administrative practices
- Adhere to host nations' economic goals, development objectives and socio-cultural values
- Respect human rights
- Not interfere in internal political affairs or in inter-governmental relations
- Not engage in corrupt practices
- Apply good practice in relation to payment of taxes, abstention from involvement in anti-competitive practices, consumer and environmental protection and the treatment of employees
- Disclose relevant information to host country governments.

According to the 1976 declaration of the OECD Code of Practice on MNC operations, MNCs should contribute positively to economic and social progress within host nations. Its main provisions were that MNCs should:

- Contribute to host countries' science and technology objectives by permitting the rapid diffusion of technologies
- Not behave in manners likely to restrict competition by abusing dominant positions or market power
- Provide full information for tax purposes
- Consult with employee representatives regarding major changes in operations, avoid unfair discrimination in employment and provide reasonable working conditions
- Consider the host nation's balance of payments objectives when taking decisions
- Regularly make public significant information on financial and operational matters, host countries themselves should, the Code insists, possess the absolute right to nationalise foreign-owned assets within their frontiers, but must pay proper compensation.

It is very interesting to note that the demands by developing countries that the Code become legally binding were rejected by the UN General Assembly, at the behest of economically advanced countries.

MULTINATIONALS IN INDIA

The economic liberalisation has enormously increased the scope of MNCs in India.

Comparatively very little foreign investment has taken place in India due to several reasons, as stated in the previous chapter (like the dominant role assigned to the public sector in the industrial policy and the restrictive Government policy towards foreign investment). Some multinationals, Coca Cola and IBM, even left India in the late 1970s as the Government conditions were unacceptable to them.

A common criticism against the MNCs is that they tend to invest in the low priority and high profit sectors in the developing countries, ignoring the national priorities. However, in India, the Government policy confined the foreign investment to the priority areas like high technology and heavy investment sectors of national importance and export sectors. Firms which had been established in non-priority areas prior to the implementation of this policy have, however, been allowed to continue in those sectors.

The controversial Foreign Exchange Regulation Act (FERA), 1973 required the foreign companies in India to dilute the foreign equity holding to 40 per cent (exceptions were allowed in certain cases like high technology and export-oriented sectors).

An often-heard criticism is that multinationals drain the foreign exchange resources of the developing countries. However, Aiyar's study indicates that, contrary to the popular belief, foreign companies are less of a drain on foreign exchange reserves than Indian ones. He also points out that the public sector has a higher propensity to use foreign exchange on a net basis than multinationals. In fact, the foreign exchange outgo of the public sector alone is greater than the entire trade deficit of the country.[15]

It is not a right approach to estimate the net impact of multinationals on the foreign exchange reserves by taking the net foreign exchange outflow or inflow. If a multinational is operating in an import substitution industry, the net effect on the foreign exchange reserves could be favourable even if there is a net foreign exchange outflow by the company.

The current business environment is giving a considerable impetus for MNC's investment in India.

Multinationals in several developing countries make substantial contribution to export earnings. The performance in the case of India has, however, been very dismal. This is attributed mostly to the Government policy. "We have consistently followed policies in India that discriminate against export production and in favour of production for the local market. In this milieu, it has not made sense for the Indian private sector or public sector to focus on exports. Naturally, it has not made sense for foreign companies either. In 1947, foreign companies did not have an anti-export image. Indeed, the most prominent ones were engaged in the export of tea and jute manufactures. Only after Jawaharlal Nehru decided to emphasise import substitution at the expense of exports did foreign (and Indian) companies shun exports.[16]

Although export promotion has been pursued since the Third Plan, the highly protected domestic market and the unrealistic exchange rate made the domestic market much more attractive than exports. However, since the mid-1980s with the economic liberalisation that increased domestic competition and the steady depreciation of the rupee, exports began to become attractive and several foreign companies and companies with foreign participation, as well as Indian companies, have become serious about exports. This was reflected in the acceleration of the export growth.

Since the economic liberalisation ushered in 1991, many multinationals in different lines of business have entered the Indian market. A number of multinationals which were in India prior to this have expanded their business.

SUMMARY

The transnational corporations (TNCs), with their large number of foreign affiliates and a plethora of inter-firm arrangements, spans virtually to all countries and economic activities, rendering it a formidable force in today's world economy.

There is no universally accepted definition of the term, multinational corporation. As an ILO Report observes, "the essential nature of the multinational enterprises lies in the fact that its managerial headquarters are located in one country (referred to for convenience as the ("home country") while the enterprise carries out operations in a number of other countries as well ("host countries"). Obviously, what is meant is a corporation that controls production facilities in more than one country, such facilities having been acquired through the process of foreign direct investment. Firms that participate in international business, however large they may be, solely by exporting or by licensing technology are not multinational enterprises."

MNCs have been spreading and growing across the globe very rapidly. Although the MNCs from the developed countries still dominate the scene, more and more MNCs are emerging from the developing countries.

The world's top 100 (non-financial) TNCs, based almost exclusively in developed countries, are the principal drivers of international production. The universe of TNCs, however, is quite diverse, and includes a growing number of small and medium-sized enterprises.

As a result of the liberalisations, MNCs have been spreading fast in the developing countries. Most of the foreign affiliates of the MNCs are in the developing countries, China alone hosting about one-third of the total number.

MNCs help the host countries to increase domestic investment and employment generation, boost exports, transfer technology and accelerate economic growth.

While the host countries can reap several benefits from the MNCs, these giants pose many problems particularly to the developing countries. They may destroy domestic firms through unfair competition, acquire market dominance through acquisition of domestic firms or other means. The MNC's technology which is designed for worldwide profit maximisation may not adapt to the consumption needs, the size of domestic markets, resource availabilities, and the stage of development of many of the developing countries. They may cause fast depletion of some of the non-renewable natural resources in the host country. The transfer pricing may be so designed as to avoid or minimise taxes. All these emphasise the need for a code of conduct for the MNCs and an effective competition policy and law in the host countries. Several MNCs are also accused of political manoeuvering and neglect of human rights.

The liberalisation has paved the way for easy entry and growth of MNCs in India. At the same time, a number of Indian firms have been becoming multinational.

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Chapter 41

GLOBALISATION

Structure

Globalisation of World Economy

Globalisation of Business

Features of Current Globalisation

Stages of Globalisation

Essential Conditions for Globalisation

Foreign Market Entry Strategies

Pros and Cons of Globalisation

Policy Options

Globalisation of Indian Business

Conclusion

Summary

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The IMF defines globalisation as "the growing economic interdependence of countries worldwide through increasing volume and variety of cross-border transactions in goods and services and of international capital flows, and also through the more rapid and widespread diffusion of technology." As Mitchell succinctly puts it, "globalisation for better or worse, has changed the way the world does business. Though still in its early stages, it is all but unstoppable. The challenge that individuals and businesses face is learning how to live with it, manage it, and take advantage of the benefits it offers."[1]

Globalisation is the process of integration of economies across the world through cross-border flow of factors, products, and information.

In his *Management Challenges for the 21st Century*, Peter Drucker cautions: "All institutions have to make *global competitiveness* a strategic goal. No institution, whether a business, a university or a hospital, can hope to survive, let alone to succeed, unless it measures up to the standards set by the leaders in its field, any place in the world."[2]

We may consider globalisation at two levels, *viz.,* at the macro level (*i.e.,* globalisation of the world economy) and at the micro level (*i.e.,* globalisation of the business and the firm).

Globalisation of the world economy is achieved, quite obviously, by globalising the national economies. Globalisation of the economies and globalisation of business are very much interdependent.

GLOBALISATION OF WORLD ECONOMY

The world economy has been emerging as a global or transnational economy. A global or transnational economy is one which transcends the national borders unhindered by artificial restrictions like Government restrictions on trade and factor movements. Globalisation is a process of development of the world into a single integrated economic unit.

The Transnational economy is different from the international economy. The international economy is characterised by the existence of different national economies, the economic relations between them being regulated by the national Governments. The transnational economy is a borderless world economy characterised by free flow of trade and factors of production across national borders.

Drucker in his *New Realities* observes that in the early or mid-seventies — with OPEC and President Nixon's floating of the dollar — the world economy changed from being international to transnational. According to Drucker, the transnational economy is characterised by, *inter alia*, the following features.[3]

1. The transnational economy is shaped mainly by money flows rather than by trade in goods and services. These money flows have their own dynamics. The monetary and fiscal policies of sovereign Governments increasingly react to events in the international money and capital markets rather than actively shape them.
2. In the transnational economy, management has emerged as the decisive factor of production and the traditional factors of production, land and labour, have increasingly become secondary. Money and capital markets too have been increasingly becoming transnational and universally obtainable. Drucker, therefore, argues that it is management on which competitive position has to be based.
3. In the transnational economy, the goal is market maximisation and not profit maximisation.
4. Trade, which increasingly follows investment, is becoming a function of investment.
5. The decision-making power is shifting from the national state to the region (*i.e.,* the regional blocs like the European Community, North American Free Trade Agreement, etc.)

6. There is a genuine — and almost autonomous — world economy of money, credit and investment flows. It is organised by information which no longer knows national boundaries.
7. Finally, there is a growing pervasiveness of the transnational corporations which see the entire world as a single market for production and marketing of goods and services.

There are, thus, many factors which tend to promote the transnationalisation of the world economy. The multilateral trade negotiations under the auspices of GATT/WTO have been liberalising trade and investment.

A growing proportion of the world output is traded internationally and the faster growth of trade, than the GDP, is bringing about world economic integration. This economic integration is reinforced by the massive cross-border capital flows. The progress of the regional blocs increasingly integrate the regional economies.

BOX 41.1 : DRIVERS OF GLOBALISATION

In general, globalisation represents the increasing integration of the world economy, based on five interrelated drivers of change:

- *International trade (lower trade barriers and more competition)*
- *Financial flows (foreign direct investment, technology transfers/licensing, portfolio investment, and debt)*
- *Communications (traditional media and the Internet)*
- *Technological advances in transportation, electronics, bioengineering and related fields*
- *Population mobility, especially of labour*

Each of these drivers of change has accelerated in recent years and each reinforces the other.

Courtesy: John D. Sullivan, *"Preparing in the Global Economy", Economic Reform Today, No. 1, 2000.*

GLOBALISATION OF BUSINESS

Meaning and Dimensions

Globalisation in its true sense is a way of corporate life necessitated, facilitated and nourished by the transnationalisation of the world economy and developed by corporate strategies. Globalisation is an attitude of mind – it is a mind-set which views the entire world as a single market so that the corporate strategy is based on the dynamics of the global business environment. International marketing or international investment does not amount to globalisation unless it is the result of such a global orientation.

Corporate strategies of MNCs are influenced by global business environment.

Globalisation encompasses the following:

- Doing, or planning to expand, business globally.
- Giving up the distinction between the domestic market and foreign market and developing a global outlook of the business.
- Locating the production and other physical facilities on a consideration of the global business dynamics, irrespective of national considerations.
- Basing product development and production planning on the global market considerations.

- Global sourcing of factors of production, *i.e.,* raw materials, components, machinery/ technology, finance etc., are obtained from the best source anywhere in the world.
- Global orientation of organisational structure and management culture.

Companies which have adopted a global outlook stop "thinking of themselves as national marketers who venture abroad and start thinking of themselves as global marketers. The top management and staff are involved in the planning of worldwide manufacturing facilities, marketing policies, financial flows and logistical systems. The global operating units report directly to the chief executive or executive committee, not to the head of an international division. Executives are trained in worldwide operations, not just domestic or international. Management is recruited from many countries, components and supplies are purchased where they can be obtained at the least cost, and investments are made where the anticipated returns are the greatest."[4]

A truly global corporation views the entire world as a single market – it does not differentiate between domestic market and foreign markets. In other words, there is nothing like a home market and foreign market – there is only one market, the global market.

As Kenichi Ohmae observes in his well-known book *The Borderless World,* a global corporation develops a genuine equidistance of perspective. That is, managers with a truly global orientation consciously try to set plans and build organisations as if they view all key customers equidistant from the corporate centre. *For example,* the managers of Honda, which has operations in several parts of the world, do not think or act as if the company were divided between Japanese and overseas operations. Indeed, the every word "overseas" has no place in Honda's vocabulary because the corporation sees itself as equidistant from all its key customers. At Casio, the top managers gather information directly from each of their primary markets and then sit down together once a month to lay out revised plans for global product development.[5]

Multinationals develop integrated international production logistics and marketing system. The *production sharing* between various units in different countries. *For example*, about two-thirds of Toyota's total business is outside Japan. More than half of its vehicles sold overseas is manufactured overseas and the remaining exported from Japan. Toyota has established integrated manufacturing systems in all three of its main markets — North America, Europe and Asia. Plants in China, Indonesia, Malaysia, Philippines, Taiwan and Thailand turned out nearly one-third of the company's overseas production. These manufacturing units are interlinked by flows of components/parts, production planning etc. To cite a different example, Mazda's sports car, *MX-5 Miata*, was designed in California, had its prototype created in England, was assembled in Michigan and Mexico, using advanced electronic components invented in New Jersey and fabricated in Japan, financed from Tokyo and New York, and marketed globally. The *global sourcing*, described in *Chapter 1,* throws light on some other aspect of global integration.

FEATURES OF CURRENT GLOBALISATION

Globalisation, of course, is not a new phenomenon. The period 1870 to 1913 experienced a growing trend toward globalisation. The new phase of globalisation which started around the mid-20th century became very widespread, more pronounced and overcharging since the late 1980s by gathering more momentum from the political and economic changes that swept across the communist countries, the economic reforms in other countries, the latest multilateral trade agreement which seeks to substantially liberalise international trade and investment and the technological and communication revolutions.

There are a number of dynamic factors covering markets, firms, international organisations and their principles and rules and technology which make current phase of globalisation different from the past.

There are several similarities and differences between the two phases of globalisation. The *Human Development Report*, 1999, mentions the following as the new features of the current phase of globalisation.

New Markets

- Growing global markets in services—banking, insurance, transport.
- New financial markets—deregulated, globally linked, working around the clock, with action at a distance in real time, with new instruments such as derivatives.
- Deregulation of anti-trust laws and proliferation of mergers and acquisitions.
- Global consumer markets with global brands.

New Actors

- Multinational corporations integrating their production and marketing, dominating food production.
- The World Trade Organisation — the first multilateral organisation with authority to enforce national governments' compliance with rules.
- An international criminal court system in the making.
- A booming international network of NGOs.
- Regional blocs proliferating and gaining importance—European Union, Association of South-East Asian Nations, Mercosur, North American Free Trade Association, Southern African Development Community, among many others.
- More policy coordination groups—G-7, G40, G-22, G-77, OECD.

New Rules and Norms

- Market economic policies spreading around the world, with greater privatisation and liberalisation than in earlier decades.
- Widespread adoption of democracy as the choice of political regime.
- Human rights conventions and instruments building up in both coverage and number of signatories—and growing awareness among people around the world.
- Consensus goals and action agenda for development.
- Conventions and agreements on the global environment—biodiversity, ozone layer, disposal of hazardous wastes, desertification, climate change.
- Multilateral agreements in trade, taking on such new agendas as environmental and social conditions.
- New multilateral agreements—for services, intellectual property, communications—more binding on national governments than any previous agreements.
- The Multilateral Agreement on Investment under debate.

New (Faster and Cheaper) Tools of Communication

- Internet and electronic communications linking many people simultaneously.
- Cellular phones.

- Fax machines.
- Faster and cheaper transport by air, rail and road.
- Computer-aided design.

STAGES OF GLOBALISATION

Normally, a firm passes through different stages of development before it becomes a truly global corporation. Typically, a domestic firm starts its international business by exporting. Later, it may establish joint ventures or subsidiaries abroad. From an international firm, it may then develop into a multinational firm and finally into a global one.

A domestic firm normally passes through different stages of strategic orientation to become a truly transnational corporation.

Ohmae identifies[6] five different stages in the development of a firm into a global corporation. The first stage is the arm's length service activity of essentially domestic company which moves into new markets overseas by linking up with local dealers and distributors. In stage two, the company takes over these activities on its own. In the next stage, the domestic-based company begins to carry out its own manufacturing, marketing and sales in the key foreign markets. In stage four, the company moves to a full insider position in these markets, supported by a complete business system including R&D and engineering. This stage calls on the managers to replicate in a new environment the hardware, systems and operational approaches that have worked so well at home. It forces them to extend the reach of domestic headquarters, which now has to provide support functions such as personnel and finance, to all overseas activities. Although stage four, the headquarters mentality continues to dominate. Different local operations are linked, their relation to each other established by their relation to the centre.

In the fifth stage, the company moves toward a genuinely global mode of operation. In this context, Ohmae points out that a company's ability to serve local customers in markets around the globe in ways that are truly responsive to their needs as well as to the global character of its industry depends on its ability to strike a new organisational balance. What is called for is what Akio Morita of Sony has termed *global localisation*, a new orientation that simultaneously looks in both directions.

Getting to stage five, however, means venturing onto new ground altogether. Ohmae argues that to make this organisational transition, a company must denationalise their operations and create a system of values shared by corporate managers around the globe to replace the glue a nation-based orientation once provided.

Ohmae further observes[7] that today's global corporations are nationalityless because consumers have become less nationalistic. True global corporations serve the interests of customers, not Governments. They do not exploit local situations and then repatriate all the profits back home, leaving each local area poorer for their having been there. They invest, they train, they pay taxes, they build up infrastructure and they provide good value to customers in all the countries where they do business. IBM Japan, for instance, has provided employment to about 20,000 Japanese and over the past decade has provided three times more tax revenue to the Japanese Government than has the Japanese company Fujitsu.[8]

Many firms across the world has ambitious plans to become global.

ESSENTIAL CONDITIONS FOR GLOBALISATION

There are a number of environmental and organisational prerequisites for globalisation.

There are, however, some essential conditions to be satisfied on the part of the domestic economy as well as the firm for successful globalisation of the business. They are:

Business Freedom: There should not be unnecessary Government restrictions which come in the way of globalisation, like import restriction, restrictions on sourcing finance or other factors from abroad, foreign investments etc. That is why the economic liberalisation is regarded as a first step towards facilitating globalisation.

Facilities: The extent to which an enterprise can develop globally from home country base depends on the facilities available like the infrastructural facilities.

Government Support: Although unnecessary government interference is a hindrance to globalisation, government support can encourage globalisation. Government support may take the form of policy and procedural reforms, development of common facilities like infrastructural facilities, R&D support, financial market reforms and so on.

Resources: Resources is one of the important factors which often decides the ability of a firm to globalise. Resourceful companies may find it easier to thrust ahead in the global market. Resources include finance, technology, R&D capabilities, managerial expertise, company and brand image, human resource etc. It should, however, be noted that many small firms have been very successful in international business because of one or other advantage they possess.

Competitiveness: The competitive advantage of the company is a very important determinant of success in global business. A firm may derive competitive advantage from any one or more of the factors such as low costs and price, product quality, product differentiation, technological superiority, after-sales service, marketing strength etc. Sometimes, small firms may have an edge over others in certain aspects or times of business.

Orientation: A global orientation on the part of the business firms and suitable globalisation strategies are essential for globalisation.

FOREIGN MARKET ENTRY STRATEGIES

Market entry strategy is influenced by the firm and product characteristics and the domestic and international market characteristics.

One of the most important strategic decisions in international business is the mode of entering the foreign market. On the one extreme, a company may do the complete manufacturing of the product domestically and export it to the foreign market. On the other extreme, a company may do, by itself, the complete manufacturing of the product to be marketed in the foreign market there itself. There are several alternatives in between these two extremes. The choice of the most suitable alternative is based on the relevant factors related to the company and the foreign market.

In some cases, the alternatives available may also be limited. *For example*, the policy of some governments may not be very positive towards foreign investments. Several governments have a definite preference for joint ventures over complete foreign ownership. In some cases, the government may prefer foreign investment leading to import substitution to perpetual import of a product. Thus, in some cases, government policies may rule out the best alternative if the environment were free.

Important foreign market entry strategies are the following:

1. Exporting
2. Licensing/franchising
3. Contract manufacturing
4. Management contract
5. Assembly operations
6. Fully owned manufacturing facilities
7. Joint venturing
8. Countertrade
9. Mergers and acquisitions
10. Strategic alliance
11. Third country location

Exporting

Exporting, the most traditional mode of entering the foreign market, is quite a common one even now. International trade has been growing much faster than the world output resulting in greater world economic integration.

Exporting is the appropriate strategy when one of more of the following conditions prevail.

1. The volume of foreign business is not large enough to justify production in the foreign market.
2. Cost of production in the foreign market is high.
3. The foreign market is characterised by production bottlenecks like infrastructural problems, problems with materials supplies etc.
4. There are political or other risks of investment in the foreign country.
5. The company has no permanent interest in the foreign market concerned or that there is no guarantee of the market available for a long period.
6. Foreign investment is not favoured by the foreign country concerned.
7. Licensing or contract manufacturing is not a better alternative.

Exporting is more attractive than other modes particularly when underutilised capacity exists. Even when there is no excess capacity, expansion of the existing facility may sometimes be easier and less costly than setting up production facilities abroad. Further, many governments, as in India, provide incentives for establishing facilities for export production.

The alternatives to making in foreign countries by the international marketer for marketing the goods in the foreign countries are licensing and contract manufacturing. Although these have certain advantages, there are also certain risks. Hence, if a company does not want to go in for licensing or contract manufacturing, the only avenue open is exporting.

Although exporting may turn out to be the best alternative under a given set of conditions or environmental factors, there are several sets of conditions which make exporting less attractive than one or more of other alternatives. Policies of some foreign governments discriminate against

The ratio of domestic production to export has been rising.

imports; in some cases import is even banned. It may be noted that hostility against imports have been encouraging substitution of exports by production in the foreign markets. A number of foreign companies have set up production facilities in the European Community to overcome the import barriers. Japanese transplants in North America have also been caused to a considerable extent by the hostility towards imports.

Besides, in a number of a cases, cost considerations make foreign production or assembly preferable to other entry strategies. Further, exporting marks the first stage in the evolution of international business of many companies. As the international business grows or as the environment changes or to expand the business, it may become necessary to change the strategies.

Licensing and Franchising

Licensing and Franchising, which involve minimal commitment of resources and effort on the part of the international marketer, are easy ways of entering the foreign markets.

Under international licensing, a firm in one country (the licensor) permits a firm in another country (the licensee) to use its intellectual property (such as patents, trade marks, copyrights, technology, technical know-how, marketing skill or some other specific skill). The monetary benefit to the licensor is the royalty or fees which licensee pays. In many countries, such fees or royalties are regulated by the government; it does not exceed five per cent of the sales in many developing countries.

A licensing agreement may also be one of *cross licensing*, wherein there is a mutual exchange of knowledge and/or patents. In cross licensing, a cash payment may or may not be involved.

Franchising is "a form of licensing in which a parent company (the franchiser) grants another independent entity (the franchisee) the right to do business in a prescribed manner. This right can take the form of selling the franchisor's products, using its name, production and marketing techniques, or general business approach."[9] One of the common forms of franchising involves the franchisor supplying an important ingredient (part, material etc.) for the finished product, like the *Coca–Cola* supplying the syrup to the bottlers.

Usually, franchising involves a combination of many of the elements mentioned above. The major forms of franchising are *manufacturer-retailer* systems (such as automobile dealership), *manufacturer-wholesaler systems* (such as soft drink companies), and *service firm-retailer systems* (such as lodging services and fast food outlets).

International franchising/licensing have grown substantially.

International licensing/franchising have grown very substantially. Czinkota and Ronkainen succinctly describe their attractiveness or reasons for popularity:

"As an entry strategy, it requires neither capital investment nor knowledge and marketing strength in foreign markets. By earning royalty income, it provides an opportunity to exploit research and development already committed to licensing reduces risk of exposure to government intervention in that the licensee is typically a local company that can provide leverage against government action. Licensing will help to avoid host country regulations that are more prevalent in equity ventures. Licensing may also serve as a stage in the internationalisation of the firm by providing a means by which foreign markets can be tested without major involvement or capital or management time."[10]

Another advantage of licensing is that it may be employed as a pre-emptive strategy against competitors by combing the foreign markets before the competitors could enter. Thus, the General Electric of USA by licensing its advanced gas turbine technology to foreign producers who were potential competitors could eliminate possible competition from them.

Licensing has been used by many companies also to harvest their obsolete products. This strategy has been employed, in particular, in developing countries.

When the market is closed by the host country regulations either to imports or to foreign investment, licensing may provide a viable opportunity to enter such a market.

From the point of view of the licensee, licensing provides the great advantage of entering the market with a proven product/technology or marketing intangible without having to run the risk of R&D failures. It also reduces the investment requirements.

One of the important risks of licensing is that the licensor would be developing a potential competitor; the licensee would become a competitor after the expiry of the licensing agreement. The licensee may even develop capabilities to introduce better products. The skill of the Japanese in product improvement is well known. Licensees in the developing countries might gain an edge over the licensor, after the term of the license, because of their low cost of labour which would enable them to compete with the erstwhile licensor in his own home market as well as in the foreign markets. Some companies are, therefore, hesitant to enter into licensing agreements.

Contract Manufacturing

Under contract manufacturing, a company doing international marketing contracts with firms in foreign countries to manufacture or assemble the products while retaining the responsibility of marketing the product. This is a common practice in international business.

Contract manufacturing has the following advantages.

1. The company does not have to commit resource for setting up production facilities.
2. It frees the company from the risks of investing in foreign countries.
3. If idle production capacity is readily available in the foreign country, it enables the marketer to get started immediately.
4. In many cases, the cost of the product obtained by contract manufacturing is lower than if it were manufactured by the international firm. *For example,* the product cost in the small-scale sector is much lower than in the large-scale sector for many products because of the lower wages, lower overheads, and tax concessions. Moreover, if excess capacities are available with existing units, it may even be possible to get the product supplied on the marginal cost basis.
5. Contract manufacturing also has the advantage that it is a less risky way to start with. If the business does not pick up sufficiently, dropping it is easy; but if the company had established its own production facilities, the exit would be difficult. Moreover, contract manufacturing may enable the international firm to enlist national support.

The important attractiveness of contract manufacturing is the ease of entry and exit.

Contract manufacturing, however, has the following disadvantages.

1. In some cases, there will be the loss of potential profits from manufacturing.
2. Less control over the manufacturing process.
3. Contract manufacturing also has the risk of developing potential competitors.
4. It would not be suitable in cases of high-tech products and cases which involve technical secrets etc.

Management Contracting

Under the management contract, the firm providing the management know-how may not have any equity stake in the enterprise being managed. In short, in a management contract, the supplier brings together a package of skills that will provide an integrated service to the client without incurring the risk and benefit of ownership Thus, as Kotler observes, management contracting is a low-risk method of getting into a foreign market and it starts yielding income right from the beginning. The arrangement is especially attractive if the contracting firm is given an option to purchase some shares in the managed company within a stated period."[11]

Management contract could, sometimes, bring in additional benefits for the managing company. It may obtain the business of exporting or selling otherwise of the products of the managed company or supplying the inputs required by the managed company.

Management contract enables a firm to commercialise existing know-how that has been built up with significant investments and frequently the impact of fluctuations in business volumes can be reduced by making use of experienced personnel who otherwise would have to be laid off.[12]

Management contracts, obviously, have clear benefits for the clients. "They can provide organisational skills not available locally, expertise that is immediately available rather than built up, and management assistance in the form of support services that would be difficult and costly to replicate locally."[13]

Management contracts have disadvantages under certain conditions. As Kotler observes, the arrangement is not sensible if the company can put its scarce management talent to better use, or if there are greater profits to be made by undertaking the whole venture. Management contract may prevent a company from setting up its own operations for a particular period.

One possible risk from the point of view of the client is overdependence and loss of control. The client should enable itself to steadily develop its own capabilities.

Some Indian companies – Tata Tea, Harrisons Malayalam and AVT – have contracts to manage a number of plantations in Sri Lanka. Tata Tea also has a joint venture in Sri Lanka namely Estate Management Services Pvt. Ltd.

Turnkey Contracts

Turnkey contracts are common in international business in the supply, erection and commissioning of plants, as in the case of oil refineries, steel mills, cement and fertiliser plants etc.; construction projects and franchising agreements.

"A turnkey operation is an agreement by the seller to supply a buyer with a facility fully equipped and ready to be operated by the buyer's personnel, who will be trained by the seller. The term is sometimes used in fast food franchising when a franchiser agrees to select a store site, build the store, equip it, train the franchisee and employees and sometimes arrange for the financing".[14]

Many turnkey contracts involve government/public sector as buyer (or seller in some cases).

A turnkey contractor may subcontract different phases/parts of the project.

Wholly Owned Manufacturing Facilities

Companies with long-term and substantial interest in the foreign market normally establish fully owned manufacturing facilities there. As Drucker points out, "it is simply not possible to maintain substantial market standing in an important area unless one has a physical presence as a producer."[15]

Establishment of manufacturing facilities abroad has several advantages. It provides the firm with complete control over production and quality. It does not have the risk of developing potential competitors as in the case of licensing and contract manufacturing.

Wholly owned manufacturing facility has several disadvantages too. In some cases, the cost of production is high in the foreign market. There may also be problems such as restrictions regarding the types of technology, non-availability of skilled labour, production bottlenecks due to infrastructural problems etc. If the market size is small, a separate production unit for the market may be uneconomical. Foreign investment also entails political risks.

A number of factors like trade barriers, differences in the production and other costs, government policies etc. encourage the establishment of production facilities in the foreign markets.

Fully owned enterprises may not be allowed or favoured in some countries, particularly in low priority areas.

Moreover, this method demands sufficient financial and managerial resources on the part of the company.

Assembly Operations

As Miracle and Albaum point out, a manufacturer who wants many of the advantages that are associated with overseas manufacturing facilities and yet does not want to go that far may find it desirable to establish overseas assembly facilities in selected markets. In a sense, the establishment of an assembly operation represents a cross between exporting and overseas manufacturing.[16]

Having assembly facilities in foreign markets is very ideal when there are economies of scale in the manufacture of parts and components and when assembly operations are labour-intensive and labour is cheap in the foreign country. It may be noted that a number of US manufacturers ship the parts and components to the developing countries, get the product assembled there and bring it back home. The US tariff law also encourages this. Thus, even products meant to be marketed domestically are assembled abroad.

Assembling the product meant for the foreign market in the foreign market itself has certain other advantages, besides the cost advantage. The import duty is normally low on parts and components than on the finished product. Assembly operations would satisfy the 'local content' demand, at least to some extent. Because of the employment generation, the foreign government's attitude will be more favourable than towards the import of the finished product.

Another advantage is that the investment to be made in the foreign country is very small in comparison with that required for establishing complete manufacturing facilities. The political risks of foreign investment is, thus, not much.

Joint Ventures

Joint venture is a very common strategy of entering the foreign market. In the widest sense, any form of association which implies collaboration for more than a transitory period is a joint venture (pure trading operations are not included in this concept). Such a broad definition encompasses many diverse types of joint overseas operations, *viz.*,

1. Sharing of ownership and management in an enterprise.
2. Licensing/franchising agreements.
3. Contract manufacturing.
4. Management contracts.

Three of the above have already been discussed in the preceding sections. The following paragraphs are confined to the first category referred to above, *i.e.,* joint ownership ventures. What is often meant by the term joint venture is joint ownership venture.

The essential feature of a joint ownership venture is that the ownership and management are shared between a foreign firm and a local firm. In some cases, there are more than two parties involved.

A joint ownership venture may be brought about by a foreign investor buying an interest in a local company, a local firm acquiring an interest in an existing foreign firm or by both the foreign and local entrepreneurs jointly forming a new enterprise.

It is also a common practice to split the local interest between a partner and various public participation (including public sector firms or industrial development organisations). Such a strategy may enable the international firm to retain much control despite a minority holding as the power of the remaining shares is spread out. Further, equity holding by the public would help the enterprise get some public support. Partnership with government organisation may help to obtain favourable treatment from the government.

In countries where fully foreign owned firms are not allowed or favoured, joint venture is the alternative if the international marketer is interested in establishing an enterprise in the foreign market. Many foreign companies entered the communist, socialist and other developing countries by joint venturing.

One important advantage of joint venturing is that it permits a firm with limited resources to enter more foreign markets than might be possible under a policy of forming wholly owned subsidiaries.

In some cases, it is also possible to swap know-how (such as patent rights for equity) in forming joint venture as a means of securing ownership in foreign operations.

Partnership with local firms has certain specific advantages. The local partner would be in a better position to deal with the government and the publics. Further, there would not be much public hostility when there is a local partner; it would be much less when there is equity holding by the government sector and the public.

A right local partner for a joint venture can have a major impact on a firm's competitiveness because such a partner can serve as a cultural bridge between the manufacturer and the market. *For example*, several successful foreign affiliated companies have demonstrated how the right partnership can strongly enhance a firm's competitive edge and its ability to adapt to and cope with the idiosyncrasies of the Japanese market.[17]

A joint venture can succeed only if both the partners have something definite to offer to the advantage of the other, and reap definite advantages, and have mutual trust and respect.

Third Country Location

Third country location is sometimes used as an entry strategy. When there are no commercial transactions between two nations because of political reasons or when direct transactions between two nations are difficult due to political reasons or the like, a firm in one of these nations which wants to enter the other market will have to operate from a third country base. *For example,* Taiwanese entrepreneurs found it easy to enter People's Republic of China through bases in Hong Kong.

Third country location may also be helpful to take advantage of the friendly trade relations between the third country and the foreign market concerned. Thus, *for example,* Rank Xerox found it convenient to enter the erstwhile USSR through its Indian joint venture Modi Xerox.

There are several cases of countries not having direct commercial transactions. *For example*, it was true of Israel and Arab Countries. In the past, Government of India did not permit trade with South Africa and Mauritius.

Sometimes, commercial reasons encourage third country location. *For example,* several Japanese companies established production facilities in developing countries to circumvent the non-tariff barriers (like quotas, voluntary export restraints and orderly marketing arrangement) to imports to countries like the United States and also to avail of the preferential treatment accorded by the developed countries to the imports from the developing countries.

Further, third country location may be resorted to reduce cost of production and thereby to increase price competitiveness to facilitate market entry or for improving/maintaining the market position. The incentives offered by governments, particularly of the developing countries, for investment and exports encourage such third country location. The export processing zones are particularly attractive in this respect.

Mergers and Acquisitions

M&As is a very powerful globalisation strategy employed by Indian forms.

Mergers and acquisitions (M&A) have been a very important market entry strategy as well as expansion strategy. A number of Indian companies have also used this entry strategy. Mergers and acquisitions have certain specific advantages.

It provides instant access to markets and distribution network. As one of the most difficult areas in international marketing is the distribution, this is often a very important consideration for M&A. Another important objective of M&A is to obtain access to new technology or a patent right.

M&A also has the advantage of reducing the competition.

Mergers and acquisitions may also give rise to some problems which arise mostly because of the deficiencies of the evaluation of the case for acquisition. Sometimes the cost of acquisition may be unrealistically high. Further, when an enterprise is taken over, all its problems are also acquired with it. The success of the enterprise will naturally depend on the success in solving the problems. See the section *Cross-border M&As* in the Chapter on *International Investments* for more information.

Strategic Alliance

International strategic alliances are popular in diverse industries and business functions.

Strategic alliance has been becoming more and more popular in international business. Also known by such names as entente and coalition, this strategy seeks to enhance the long-term competitive advantage of the firm by forming alliance with its competitors, existing or potential in critical areas, instead of competing with each other. "The goals are to leverage critical capabilities, increase the flow of innovation and increase flexibility in responding to market and technological changes."[18]

Strategic alliance is also sometimes used as a market entry strategy. *For example,* a firm may enter a foreign market by forming an alliance with a firm in the foreign market for marketing or distributing the former's products. A US pharmaceutical firm may use the sales promotion and distribution infrastructure of a Japanese pharmaceutical firm to sell its products in Japan. In return, the Japanese firm can use the same strategy for the sale of its products in the US market.

Strategic alliance, more than an entry strategy, is a competitive strategy.

There are different types of alliances according to purpose or structure. Based on the description of the generic forms of coalitions by Michael Porter and Mark Fuller, Magsaysay classifies alliances according to purpose as follows.[19]

1. *Technology development alliances* like research consortia, simultaneous engineering agreements, licensing or joint development agreements.
2. *Marketing, sales and service alliances* in which a company makes use of the marketing infrastructure etc., of another company, in the foreign market, for its products. This may help easy penetration of the foreign market and pre-emption of potential competitors.
3. *Multiple activity alliance* which involves the combining of two or more types of alliances. While marketing alliances are often single country alliances, as international firms take on different allies in each country, technology development and operations alliances are usually multi-country since these kinds of activities can be employed over several countries.
4. *Multiple activity alliance* involves the combining of two or more types of alliances. While marketing alliances are often single country alliances, as international firms take on different allies in each country, technology development and operations alliances are usually multi-country since these kinds of activities can be employed over several countries.

Strategic alliances also differ according to how they are structured. They can be equity based (joint ventures) or non-equity based. Non-equity based alliances such as technology transfer agreements, licensing agreements, marketing agreements etc., are proving to be more dynamic, more constructive and more strategic, according to Magsaysay.

As indicated above, several areas of business – from R&D to distribution – provide scope for alliance. Whether it is in R&D, manufacturing or marketing, an important objective of the collaboration is to maximise marginal contribution to fixed cost.

Countertrade

Countertrade is barter type bilateral trade in which exports and imports are mutually linked.

Although the major reason for the substantial growth of countertrade is its use as a strategy to increase exports, particularly by the developing countries, countertrade has been successfully used by a number of companies as an entry strategy. *For example*, Pepsi Co gained entry to the USSR by employing this strategy.

Countertrade is a form of international trade in which certain export and import transactions are directly linked with each other and in which import of goods are paid for by export of goods, instead of money payments.

In the modern economies, most transactions involve monetary payments and receipts, either immediate or deferred. As against this, "countertrade refers to a variety of unconventional international trade practices which link exchange of goods – directly or indirectly — in an attempt to dispense with currency transactions."[20]

Forms of Countertrade: Countertrade takes several forms. The following are the most common among them.

Barter: Barter refers to direct exchange of goods of equal value, with no money and no third party involved in it. *For example*, a countertrade deal between the Minerals and Metals Trading Corporation of India (MMTC) and a Yugoslavian company involved import of 50,000 tonnes of rails of the value of about $38 million by the MMTC and the purchase by the Yugoslavian company of iron ore concentrates and pellets of the same value.

Buyback: Under the buyback agreement, the supplier of plant, equipment or technology agrees to purchase goods manufactured with that equipment, or technology. Under the buyback scheme, the full payment may be made in kind or a part may be made in kind and the balance in cash. Thus, a ₹ 20 crore buyback agreement with the Soviet Union provided for the import of 200 sophisticated looms by the National Textiles Corporation. The buyback ratio was 75 per cent.

Compensation Deal: Under this arrangement, the seller receives a part of the payment in cash and the rest in products.

Counterpurchase: Under the counterpurchase agreement, the seller receives the full payment in cash but agrees to spend an equivalent amount of money in that country within a specified period. A classic example of this kind of an agreement was Pepsi Cola's trade with the USSR. Pepsi Cola got paid in Rubles for the sale of its concentrates in the USSR but spent this amount for purchase of Russian products like Vodka and Wine.

Countertrade has been growing with government patronage. It may be noted that the South Commission has advocated countertrade as a useful mechanism for overcoming difficulties of payments, export credit, and foreign exchange which might otherwise be serious obstacles to the expansion of trade between developing countries. As the Commission points out, so far the bulk of countertrade between developing countries has been conducted mostly through intermediaries in the industrial countries. It is the developed countries who have benefited most from this type of trade, and they obviously have no interest in helping the indirect trading partners in the LCDs to establish direct contacts and develop durable trading relationships. Therefore, the developing countries need to organise themselves of countertrade as this can also pave the way for the growth of more conventional trading relations.

Reasons for the Growth of Countertrade: There have been several reasons for the countertrade to become popular. Obviously, the countries or companies concerned have encouraged or involved in countertrade due to certain specific advantages, although some of the benefits may be purely temporary.

1. Countertrade was very common between the communist countries. It also became popular in respect of trade between the Communist Bloc and many developing countries because many developing countries were eagerly looking towards this bloc for increasing their exports, among other things, and this naturally led to the acceptance of the trade practice preferred by these centrally planned economies.
2. Countertrade became popular in the East-West trade mainly due to the foreign exchange problems faced by the East Bloc. Pepsi Cola is just one example of a multinational corporation which made considerable international business with the USSR by countertrade.
3. When the foreign exchange problem became more severe for the developing countries following the oil price hikes, they began to actively pursue countertrade in a frantic bid to increase their exports by all means.
4. Many companies in the advanced countries have resorted to countertrade for various reasons like selling obsolete products, increasing the sale of capital goods, increasing the aggregate business etc. Countertrade has also been resorted to by several companies to mitigate the effects of recession. Such recessionary situations in the capital goods industries in the advanced countries gave the developing countries an opportunity to push their exports by tying the imports of capital goods with exports by countertrade.
5. The results of the above survey also suggest that countertrade enables firms to penetrate difficult markets, to increase sales volume and to achieve fuller capacity utilisation. It has also been revealed that countertrade enables firms to dispose of declining products, which is particularly important given the very rapid pace of technological advance.
6. Some countries have also made the countertrade a means to increase sales through disguised undercutting of the cartel prices (*for example,* the oil price fixed by the OPEC).

7. Having realised the potential of increasing the business by engaging in countertrade, many international trading corporations became active in the countertrade. Their trading with many countries enabled them even to take up such complex transactions as the case of Daimler Benz cited earlier.

Drawbacks

Countertrade dampens multilaterism, distorts trade flows and injures long-term interests of participants.

Although countertrade has several justifications, particularly in the short run, it suffers from a number of disadvantages and problems, particularly in the long run.

Firstly, countertrade encourages bilateralism at the expense of multilateralism.

Secondly, it adversely affects export market development.

Thirdly, although several developing countries regard countertrade as an easy route to export, they often stand to lose in terms of price. For instance, Poland bought Libyan oil at a discount and sold it at a higher price on the Rotterdam spot market.

Fourthly, it very adversely affects competition.

More details of some of the foreign market entry strategies are available in the author's *International Marketing* (Himalaya Publishing House) and *International Business* (Wheeler Publishing).

PROS AND CONS OF GLOBALISATION

While globalisation has several benefits, it has a number of problems.

While developing countries which, in the past, were against globalisation, have wide opened their doors for globalisation, many people in developed countries like USA are angry against globalisation. American jobs and wage levels are severely affected by the influx of cheap imports and shifting of production to low-cost overseas locations. According to a *Business Week*/Harris Poll[21] in early 2000, more than two-thirds of Americans believe that globalisation drags down US wages. A strong majority of the Americans feel that trade policies have not adequately addressed the concerns of American workers, international labour standards, or the environment. The important pros and cons of globalisation according to the above survey are the following. Productivity grows more quickly when countries produce goods and services in which they have comparative advantage. Living standards can go up faster.

Developed countries face the threat of deindustrialisation and job losses due to flood of cheap imports from developing countries.

- Global competition and imports keep a lid on prices, so inflation is less likely to derail economic growth.
- An open economy spurs innovation with fresh ideas from abroad.
- Export jobs often pay more than other jobs.
- Unfettered capital flows give the US access to foreign investment and keep interest rates low.

The adverse effects of globalisation according to the survey are:

- Millions of Americans have lost jobs due to imports or production shifts abroad. Most find new jobs that pay less.
- Millions of others fear losing their jobs, especially at those companies operating under competitive pressure.

- Workers face pay cut demands from employers, which often threaten to export jobs.
- Service and white collar jobs are increasingly vulnerable to operations moving offshore.
- US employees can lose their comparative advantage when companies build advanced factories in low-wage countries, making them as productive as those at home.

True, globalisation can benefit the developing countries in several ways. It is, however, apprehended that unregulated globalisation will cause serious problems for developing countries.

The almost universal acceptance of the *market economy* and the globalisation driven by private enterprise tend to aggravate most of the harmful effects traditionally attributed to neocolonialism.

The global dominance of industries by MNCs is on the increase. Many countries are indiscriminate in liberalising foreign investment. Pepsi, Coke and "junk foods" are allowed even in countries like China.

A number of countries allow high foreign stake even in industries where that is not really required. This could affect domestic enterprise of developing countries.

There has been a large number of cases of takeover of national firms by foreign firms. In some of these cases, the domestic firms are driven to a situation of having to hand over the majority or complete equity to the foreign partners of joint ventures because of the inability of the Indian partners to bring in additional capital or some other incapability.

Replacement of traditional and indigenous products by modern products, resulting in the ruin of traditional crafts and industries and the livelihood of people in these sectors have also been happening in several countries.

One common criticism has been that the technology that the MNCs bring in may not be the one suited to the host country but that suits the objectives of the MNC. While this could be more true in the liberalised environment of today, another problem, *viz.,* the dumping of outmoded technology to the developing world is not as valid today as in the past and in future it is likely to be even less valid. In the past, because of the entry restrictions and resultant absence or lack of competition, developing countries could be used as a dumping ground for obsolete products, including technology. The business environment today, however, is vastly different. Because of the competition between MNCs (and national firms) made possible by the dismantling of entry barriers (and freeing of technology imports by national firms and added thrust on R&D by them), technological edge is an important determinant of success. The evolution of the motor car market in India, *for example*, gives some indication of this.

Developing countries could be very vulnerable to the harmful effects of globalisation.

In a competitive environment, a firm can survive only if it is efficient. Companies all around world, including many large multinationals, have been cutting down the size of their human resources as one of the means of achieving cost efficiency. The problem of overmanning is very severe in the developing countries. Unless these firms get rid of the surplus labour, they can hardly be competitive and successful. That means, the liberalisation can succeed only if the economy grows very fast to absorb the displaced labour and the new addition to the labour force.

The developing countries, in general, have been disadvantaged by the international trading system. The adverse terms of trade led to economic loss for the developing countries, in general. The least developed countries have been the most deprived. It may, however, be noted that one of the reasons for the adverse terms of trade of the developing countries is the demand-supply factor. It is also estimated that the least developed countries stand to lose up to $600 million a year and sub-Saharan Africa $1.2 billion as a result of the Uruguay Round Agreement, while the developed countries are expected to gain very substantially.[22] Multilateral trade liberalisations

were mostly in respect of goods traded between industrial economies and those exported from developing to the developed nations did not benefit so much. While developing countries as a group now face tariffs 10 per cent higher than the global average, the least developed countries face tariffs 30 per cent higher, because tariffs remain high on the goods with greatest potential for the poorest countries, such as textiles, leather and agricultural commodities.[23]

It should, however, be noted that a number of developing countries have improved their export performance substantially and several of them figure in the list of the top 20 exporters.

Despite the different problems and discriminations, there are chances of developing countries benefiting from trade. "Basic trade theory argues that poor people gain from trade liberalisation. Developing countries have a comparative advantage in abundant, low-cost and unskilled labour. If they concentrate on goods whose production is simple and labour-intensive, greater integration into global markets should increase their exports and output, raising the demand for unskilled labour and raising the incomes of the poor relative to those of the non-poor.

Moreover, countries move up the trade ladder, exporting more sophisticated products, leaving space on the ladder below for later-industrialising countries. All this helps reduce poverty. The countries on the higher rungs benefit most, but even those on the lower rugs should see poverty fall. And free trade should also help poor consumers—without trade protection, local prices should fall to world prices.

There should also be benefits for employment from a liberal financial regime. Removing restrictions on capital flows should attract more FDI, creating more jobs for the poor by integrating them into international systems of production."[24]

It is criticised that developed nations receive most of the FDI. A very small number of the developing countries, which are the relatively developed or large or fast growing in the developing world account for the lion's share of the FDI flows to this category. What the critics do not appreciate is that, as foreign investment flows are based on economic rational, it is unrealistic to expect the pattern of flow to be different.

Globalisation is a mixed bag containing both good and harmful fruits.

Another criticism is that the liberalisation increases the economic inequality. Even in China, the liberalisation has created many island of affluence. If inequality increases because of the worsening of the living conditions of the poor, it certainly is unjustifiable. But, if the increase in inequality is the result of improving the economic conditions of a section, while there is no economic deterioration of any section, or because of the disproportionate benefits, the question is whether the economic progress of some sections should be curbed so that there will not be a widening of the inequality.

The liberalisation may increase inequality. Further, several sectors and sections may not directly and immediately benefit from mere liberalisation. There may also be shocks and other adverse effects on the weaker sections. It is, therefore, necessary that there should be real socio-economic reforms rather than mere liberalisation. Targeted poverty eradication programmes and social safety net are very important.

The fast growth and overall development resulting from liberalisation could have a major impact on poverty. Naisbitt points out that there were an estimated 200 to 270 million Chinese living in absolute poverty in 1978 (the year in which the liberalisation began) and their number came down to 100 million by 1985.[25] Foreign capital has significantly boosted investment and economic growth in China. China has leaped forward on the export front too. Foreign funded enterprises contribute a substantial chunk of the exports from China. Other countries which carry out proper reforms in real earnest should also be expected to reap such gains in varying degrees. But, half-hearted and confused measures and implementational problems may create more problems than they solve.

Although the MNCs, by the virtue of their size and resources, have certain advantages they may also have limitations or disadvantages in certain spheres or aspects of business. Small and medium firms often have some edge over the very large ones in respect of standardised products or technologies like greater flexibility and adaptability, lower overheads, intimacy with the customers, etc. Lower costs is a great advantage which firms from developing countries enjoy. It may be noted that the major component of growth of several India pharmaceutical firms is the foreign market. They are relying mostly on bulk drugs and generics.

What is often ignored while discussing the impact of the product patent is that patented drugs account for only about 15 per cent of the Indian drug market. There are several more products which would go off patent in the coming years the production of which can also be taken up by the Indian firms. The new patent regime should be expected help the Indian industry by prompting it to give added thrust to R&D and thereby enabling Indian firms also to develop patented products. Positive signs are already there on the horizon.

There are also many evidences of the better technology brought in by the MNCs inducing or provoking Indian firms to absorb similar technology leading to their enhanced competitiveness and market expansion.

POLICY OPTIONS

With a view to minimising the damages and maximising the opportunities of globalisation from the macroeconomic point of view, the *Human Development Report 1997* of the UNDP has made to following policy suggestions.

1. Manage trade and capital flows more carefully.
2. Invest in poor people.
3. Foster small enterprises.
4. Properly manage new technology.
5. Reduce poverty and introduce safety nets.
6. Influence governance.

A number of national and international policy measures are needed to safeguard the interests of developing nations.

The Report also points out that to seize the opportunities of globalisation, the poorest developing countries need the following.

1. *A more supportive macroeconomic policy environment for poverty eradication*. The world clearly needs much more effective macroeconomic policy management at the global level—with more stable sources of international liquidity, better surveillance, faster crisis response mechanisms and a larger multinational lender of last resort. Existing organisations serve these purposes inadequately.
2. *A fairer institutional environment for global trade*. There is an urgent need to treat the products of developing countries on a par with those of industrial countries—and to accelerate the liberalisation of markets of interest to poor countries, such as textiles, and institute a comprehensive ban on dumping agricultural exports.
3. *A partnership with multinational corporations to promote growth for poverty reduction.* An incentive system that, while avoiding excessive regulation, encourages multinational corporations to contribute to poverty reduction and be publicly accountable and socially responsible. Both industrial and developing countries have interests here. Those of the industrial include preventing tax evasion.

4. *Action to stop the race to the bottom.* In a world of cut-throat competition, countries underbid each other in labour costs, labour standards and environmental protection—to produce as cheaply as possible for the international market. Many countries unilaterally try to restrain these races to the bottom. And some may come under external pressure if they tolerate dangerous working conditions and child labour, with human rights issues a basis for unilateral trade sanctions. A more efficient and equitable approach would be to strengthen institutions such as the International Labour Organisation—to support respect for labour right—and to develop similar institutions for international environmental protection. International coordination is also needed to avoid races to attract international investors by offering overly generous tax incentives that erode the tax base.
5. *Selective support for global technology priorities.*
6. *Action on global debt.* The highly indebted poor countries need debt relief now — not at some indeterminate point in the future. Providing effective relief to the 20 worst-affected countries would cost between $5.5 billion and $7.7 billion — less than the cost of one Stealth bomber and roughly equivalent to the cost of building the Euro-Disney theme park in France.

GLOBALISATION OF INDIAN BUSINESS

India's economic integration with the rest of the world was very limited because of the restrictive economic policies followed until 1991. Indian firms confined themselves, by and large, to the home market. Foreign investment by Indian firms was very insignificant.

With the new economic policy ushered in 1991, there has, however, been a change. Globalisation has, in fact, become a buzzword with Indian firms now, and many are expanding their overseas business by different strategies.

This section takes a look at the hurdles to and prospects for globalisation of Indian business and the different globalisation strategies.

Globalisation is both a challenge and opportunity for Indian firm.

Obstacles to Globalisation

The Indian business suffers from a number of disadvantages in respect of globalisation of business. The important problems are the following.

Government Policy and Procedures: Government policy and procedures in India are among the most complex, confusing and cumbersome in the world. Even after the much publicised liberalisation, they do not present a very conducive situation. One prerequisite for success in globalisation is swift and efficient action. Government policy and the bureaucratic culture in India in this respect are not that encouraging.

High Cost: High cost of many vital inputs and other factors like raw materials and intermediates, power, finance infrastructural facilities like port etc., tend to reduce the international competitiveness of the Indian business.

Poor Infrastructure: Infrastructure in India is generally inadequate and inefficient and therefore very costly. This is a serious problem affecting the growth as well as competitiveness.

Obsolescence: The technology employed, mode and style of operations etc., are, in general, obsolete and these seriously affect the competitiveness.

Resistance to Change: There are several socio-political factors which resist change and this comes in the way of modernisation, rationalisation and efficiency improvement. Technological modernisation is resisted due to fear of unemployment. The extent of excess labour employed by the Indian industry is alarming. Because of this, labour productivity is very low and this in some cases more than offsets the advantages of cheap labour.

Poor Quality Image: Due to various reasons, the quality of many Indian products is poor. Even when the quality is good, the poor quality image of India has become a handicap.

Supply Problems: Due to various reasons like low production capacity, shortages of raw materials and infrastructures like power and port facilities, Indian companies in many instances are not able to accept large orders or to keep up delivery schedules.

Small Size: Because of the small size and the low level of resources, in many cases, Indian firms are not able to compete with the giants of other countries. Even the largest of the Indian companies are small compared to the multinational giants.

Lack of Experience: The general lack of experience in managing international business is another important problem.

Limited R&D and Marketing Research: Marketing Research and R&D in other areas are vital inputs for development of international business. However, these are poor in Indian business.

Expenditure on R&D in India is less than one per cent of the GNP while it is two to three per cent in most of the developed countries. In 1994-95, India's per capita R&D expenditure was less than $3 when it was between $100 and $825 for most of the developed nations.

Growing Competition: The competition is growing not only from the firms in the developed countries but also from the developing country firms. Indeed, the growing competition from the developing country firms is a serious challenge to India's international business.

Trade Barriers: Although the tariff barriers to trade have been progressively reduced thanks to the GATT/WTO, the non-tariff barriers have been increasing, particularly in the developed countries. Further, the trading blocs like the NAFTA, EC etc. could also adversely affect India's business.

Factors Favouring Globalisation

Although India has several handicaps, there are also a number of favourable factors for globalisation of Indian business.

Human Resources: Apart from the low cost of labour, there are several other aspects of human resources to India's favour. India has one of the largest pool of scientific and technical manpower. The number of management graduates is also surging. It is widely recognised that given the right environment, Indian scientists and technical personnel can do excellently. Similarly, although the labour productivity in India is generally low, given the right environment it will be good. While several countries are facing labour shortage and may face diminishing labour supply, India presents the opposite picture. Cheap labour has particular attraction for several industries.

India has several strengths for globalisation.

Wide Base: India has a very broad resource and industrial base which can support a variety of businesses.

Growing Entrepreneurship: Many of the established industries are planning to go international in a big way. Added to this is the considerable growth of new and dynamic entrepreneurs who could make a significant contribution to the globalisation of Indian business.

Growing Domestic Market: The growing domestic market enables the Indian companies to consolidate their position and to gain more strength to make foray into the foreign market or to expand their foreign business.

Niche Markets: There are many marketing opportunities abroad present in the form of market niches. (A niche is a small segment of a market ignored or not properly served by large players). Such niches are particularly attractive for small companies. Several Indian companies have become very successful by niche marking.

Expanding Markets: The growing population and disposable income and the resultant expanding internal market provides enormous business opportunities.

Transnationalisation of World Economy: Transnationalisation of the world economy, *i.e.*, the integration of the national economies into a single world economy as evinced by the growing interdependence and globalisation of markets is an external factor encouraging globalisation of India business.

NRIs: The large number of non-resident Indians who are resourceful – in terms of capital, skill, experience, exposure, ideas etc. – is an asset which can contribute to the globalisation of Indian business. The contribution of the overseas Chinese to the recent impressive industrial development of China may be noted here.

Economic Liberalisation: The economic liberalisation in India is an encouraging factor of globalisation. The delicensing of industries, removal of restrictions on growth, opening up of industries earlier reserved for the public sector, import liberalisations, liberalisation of policy towards foreign capital and technology etc. could encourage globalisation of Indian business. Further, liberalisation in other countries increases the foreign business opportunities for Indian business.

Competition: The growing competition, both from within the country and abroad, provokes many Indian companies to look to foreign markets seriously to improve their competitive position and to increase the business. Sometimes companies enter foreign market as a *counter-competitive strategy, i.e.,* to fight the foreign company in its own home market to weaken its competitive strength.

CONCLUSION

The intent of globalisation is efficiency improvement and market optimisation taking advantage of the opportunities of the global environment. Therefore, in many cases, Indian companies have to globalise to survive and grow in the emerging competitive environment.

Many Indian companies have very admirably responded to the globalisation challenge.

The limitations of national markets, the diversity and unevenness of resource endowments of different nations, complexity of technological developments, differences in the levels of development and demand patterns, differences in production efficiencies and costs, technological revolution in communication and other fields etc., mandate globalisation.

The restrictive economic policies of the past severely affected the competitiveness and growth of the Indian Industry in general. The new economic policy, *albeit* suffers from certain defects, is a welcome change.

If the Indian firms have the facility to obtain the latest technology in the world, to raise finance from the cheapest source and procure the materials from the best source in the world, they are on equal footing with the foreign firms in many respects. And if the Indian firms can muster some edge over the foreign firms in respect of labour cost, productivity, product quality/ features etc., that could be a competitive advantage.

In many cases, size is an important factor which influences the competitive power. The economic liberalisation by pruning down the list of industries reserved for the public sector, delicensing and amending the MRTP Act has provided an environment which enables companies to grow fast, both internally and externally. The growth plans of many Indian companies indicate

a great leap forward. The increase in the size could keep the companies on a strong footing to make further dent into both the domestic and foreign markets. In short, the Indian industry is where they can make jumps compared to the past situation of limping forward.

Several Indian companies are already leading players. The Ispat Group of the Mittals which has units in countries like the US, Canada, Indonesia, Trinidad and Tobago is the largest sponge iron producer in the world. The Aditya Birla Group is the world's largest player in viscose fibre and carbon black and also the largest refiner of palm oil. The Essel Packaging which is already the world's second largest integrated producer of laminated tubes is aiming to climb up to the number one poison. Arvind Mills, one of the world's largest producer of denim cloth, is making further thrusts. When its ongoing projects are fully implemented, Reliance Industries would be the second largest texturiser in the world to be fully integrated from naphtha to fabrics. India is also a major player in two-wheelers and bicycles. India is the largest producer of several agricultural commodities.

The liberalisation in India and in other countries posed a real challenge to the Indian business to prove its mettle. And they are doing it remarkably well.

SUMMARY

Globalisation may be defined as "the growing economic interdependence of countries worldwide through increasing volume and variety of cross-border transactions in goods and services and of international capital flows, and also through the more rapid and widespread diffusion of technology." Globalisation is advancing and is unstoppable so that the challenge is how to live with it and take advantage of the opportunities.

Globalisation may be considered at two levels, *viz.,* at the macro level (*i.e.,* globalisation of the world economy) and at the micro level (*i.e.,* globalisation of the business and the firm). Globalisation of the world economy is achieved, quite obviously, by globalising the national economies. Globalisation of the economies and globalisation of business are very much interdependent.

Globalisation is not a new phenomenon. The period 1870 to 1913 experienced a growing trend toward globalisation. The new phase of globalisation which started around the mid-20th century became very widespread, more pronounced and overcharging since the late 1980s by gathering more momentum from the political and economic changes that swept across the communist countries, the economic reforms in other countries, the latest multilateral trade agreement which seeks to substantially liberalise international trade and investment and the technological and communication revolutions.

There are several similarities and differences between the two phases of globalisation. The current phase of globalisation is characterised by several new features: new markets; new technologies, new actors and new rules and norms.

At the corporate level, globalisation in its true sense is a way of corporate life necessitated, facilitated and nourished by the transnationalisation of the world economy and developed by corporate strategies. Globalisation is an attitude of mind – it is a mind-set which views the entire world as a single market so that the corporate strategy is based on the dynamics of the global business environment. International marketing or international investment does not amount to globalisation unless it is the result of such a global orientation. Normally, a firm passes through different stages of development before it becomes a truly global corporation. Typically, a domestic firm starts its international business by exporting. Later, it may establish joint ventures or subsidiaries abroad. From an international firm, it may then develop into a multinational firm and finally into a global one.

There are some essential conditions to be satisfied on the part of the domestic economy as well as the firm for successful globalisation of the business. They include the following: business freedom; required facilities; government support; resources; competitiveness and proper strategic orientation.

There are a number of foreign market entry strategies for going global. The choice of the most suitable alternative is based on the relevant factors related to the company and the environments of the domestic and foreign markets. The important market entry strategies are depicted in Figure 41.1.

Globalisation has both beneficial and harmful effects. It affects differently different countries, sectors industries and sections of people.

It is interesting to note that while developing countries which, in the past, were against globalisation, have wide opened their doors for globalisation, many people in developed countries like USA are angry against globalisation because of the deindustrialisation, job cuts etc., and the associated problems.

Although globalisation can benefit the developing countries in several ways, unregulated globalisation will cause serious problems for developing countries. The almost universal acceptance of the *market economy* and the globalisation driven by private enterprise tend to aggravate, in the absence of proper regulation, most of the harmful effects traditionally attributed to neocolonialism. Several measures at the national and international levels are required to mitigate the harmful effects and to reap the benefits of globalisation.

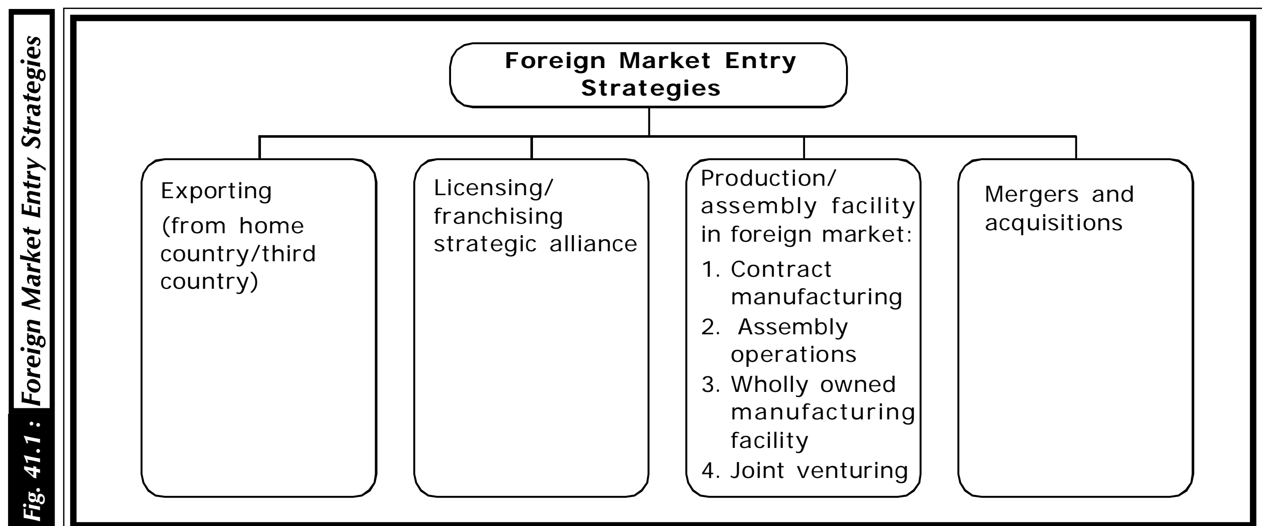

Fig. 41.1 : Foreign Market Entry Strategies

India's economic integration with the rest of the world was very limited because of the restrictive economic policies followed until 1991. Indian firms confined themselves, by and large, to the home market. Foreign investment by Indian firms was very insignificant. With the new economic policy ushered in 1991, there has, however, been a change. Globalisation has, in fact, become a buzzword with Indian firms now and many are expanding their overseas business by different strategies.

The Indian business, however, suffers from a number of disadvantages in respect of globalisation of business. Not only that the government policy lacks a positive orientation in some respects but also the government policy and procedures in India are among the most complex, confusing and cumbersome in the world. Another problem is that the high cost/inadequacy of many vital inputs and other factors like raw materials and intermediates, power, finance infrastructural facilities like port etc., tend to reduce the international competitiveness of the

Indian business. There are also problems related to technology, small size and lack experience of firms, poor quality, lack of R&D efforts etc.

Although India has several handicaps, there are also a number of favourable factors for globalisation of Indian business. These include the human resources, growing entrepreneurship; growing domestic market; the growing foreign market, the opening up more and more, niche markets; large number of non-resident Indians who are resourceful; etc. If the Indian firms have the facility to obtain the latest technology in the world, to raise finance from the cheapest source and procure the materials from the best source in the world, they are on equal footing with the foreign firms in many respects. And if the Indian firms can muster some edge over the foreign firms in respect of labour cost, productivity, product quality/features etc., that could be a competitive advantage.

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Chapter 42

DEVELOPMENT AND REGULATION OF FOREIGN TRADE

Structure

Regulation of Foreign Trade

Foreign Trade Policy

Strategy for Doubling Exports

Export Promotion

An Evaluation

Summary

References

The foreign trade policy and regulation is a very important determinant of the business environment. The export-import policy, *for example*, can have significant impact on the competitive environment and the export sector. This chapter gives a brief account of three important government measures which impact the business environment, *viz.,* regulation of foreign trade, Exim policy and export measures.

REGULATION OF FOREIGN TRADE

Control of foreign trade in India dates back to the early years of the Second World War. Import Control was introduced in 1940 as a war-time measure under the Defence of India Rules with the primary objective of conserving the foreign exchange resources and restricting physical imports so as to reduce the pressure on the limited available shipping space. Initially, the import of only 68 commodities, mainly consumer goods, were brought under control. Subsequently, with the increasing pressure on the foreign exchange resources, import control was extended to other commodities as well.

After the end of the war, the Defence of India Rules lapsed and hence in September 1946, the Emergency Provisions (Continuance) Ordinance, 1946, was promulgated to continue the import trade control. This was ultimately replaced by the Imports and Exports (Control) Act, 1947, which came into force with effect from 25th March, 1947. This Act gave the Government enormous powers of control over the foreign trade of India. The imports and exports were controlled by the Government under the Imports (Control) Order and Exports (Control) Order issued under this Act. The Imports and Exports (Control) Act, 1947 was replaced by the Foreign Trade (Development and Regulation Act), 1992 (FTDRA).

The emphasis of India's trade law shifted from prohibition and control to development, in tandem with economic reforms.

Besides the FTDR Act, there are some laws which control the trade in certain items. For instance, the export of antiquities is regulated under the Antiquities and Art Treasures Act, 1972; export of coffee is regulated by the Coffee Board under the Indian Coffee Act, 1942; export of tea is regulated under Tea Act, 1953, etc.

The major concern of Government in the past was restriction of imports with a view to controlling the trade deficit and protection of domestic industries against foreign competition. Imports were, therefore, very much restricted by prohibition of imports of many items, import licensing, very high import duties and foreign exchange restrictions. The foreign trade policy was characterised by the overtone of negativism.

THE FOREIGN TRADE (DEVELOPMENT AND REGULATION) ACT, 1992

This Act which replaced the Imports and Exports (Control) Act, 1947, came into force on 19th June, 1992.

No export or import shall be made by any person except in accordance with the provisions of this Act, the orders and rules made under this Act and the export and import policy.

Objective

The objective of the FTDR Act is to *provide for the development and regulation of foreign trade by facilitating imports into, and augmenting exports from India and for matters connected therewith or incidental thereto.*

Main Provisions

The main provisions of the FTDR Act are the following.

1. *Development and Regulation:* The FTDRA empowers the Central Government to make provision for the development and regulation of foreign trade by facilitating imports and increasing exports.

2. *Prohibition and Restriction:* The Act also empowers the Central Government to make provision for prohibiting, restricting or otherwise regulating the import or export of goods as and

The FTDRA empowers the Central Govt. to take measures for the development and regulation of foreign trade by facilitating imports and promoting exports.

when required. All goods which are so regulated under this sub-section shall be deemed to be goods the import or export of which has been prohibited under section 11 of the Customs Act, 1962, and all the provisions of that Act shall have effect accordingly.

It may be noted that it is according to this sub-clause that the Government has provided for negative lists of exports and imports in the Exim policy.

3. *Exim Policy:* The Act lays down that the Central Government may, from time to time, formulate and announce the export and import policy and may also amend that policy.

4. *Director General of Foreign Trade:* The Act provides for the appointment by the Central Government, of a Director General of Foreign Trade for the purpose of this Act. The DGFT shall advise the Central Government in the formulation of the export and import policy and shall be responsible for carrying out that policy. [The corresponding authority under the Imports and Exports (Control Act), 1947, was called the Chief Controller of Imports and Exports (CCIE).]

5. *Importer-Exporter Code Number:* The Act lays down that no person shall make any import or export except under an Importer-Exporter Code (IEC) Numbers granted by the DGFT or the Officer authorised by him in his behalf.

The Director General is empowered to suspend or cancel the Importer-Exporter Code Number granted to any person if there is valid reason to do so, like contravention of law relating to Central excise or customs or foreign exchange or having conducted import/export in a manner gravely prejudicial to the trade relations of India with any foreign country or in a way detrimental to the interests of the country.

6. *Issue and Suspension/Cancellation of Licence:* The Director General or any other Officer authorised under this Act is empowered to suspend or cancel a licence issued for export or import of good in accordance with this Act for good and sufficient reasons, after giving the licence holder a reasonable opportunity of being heard.

7. *Search, Inspection and Seizure:* Where any contravention of any condition of the licence of authority under which any goods are imported is suspected or made, any person authorised by the Central Government may search, inspect and seize such goods, documents, things and conveyances subject to such requirements and conditions as may be prescribed.

8. *Penalty for Contravention:* Where any person makes or abets or attempts to make any export or import in contravention of any provisions of this Act or any rules or orders made under this Act or the Exim policy, he shall be liable to a penalty not exceeding one thousand rupees or five times the value of the goods involved, whichever is more.

FOREIGN TRADE POLICY

Government of India had been announcing Five Year **Export-Import Policy (Exim Policy)**. Since 2004, it is known as **Foreign Trade Policy (FTP)**. A new Foreign Trade Policy should have come into effect on April 1, 2014 on the expiry of the FTP 2009-14. However, a new Policy was announced only on April 1, 2015, nearly a year after the Narendra Modi Government assumed office, as the new Government needed time to recast the Policy.

While unveiling the Policy for 2015-20, Commerce Minister Nirmala Sitharaman stated that it is in line with the initiatives ‘Make in India’, ‘Digital India’ and ‘Skill India’ announced by the government earlier. There will be a mid-term review of the Policy, compared to the past practice of annual reviews.

SALIENT FEATURES

Some of the salient features of the Foreign Trade Policy 2015-20 are outlined below.

Objective

According to the Commerce Minister, the FTP 2015-20 aims at making the country a bigger player in global trade by improving the business environment and simplifying trade transactions in the wake of trade facilitation agreement of the World Trade Organisation. It seeks to provide a stable and sustainable policy environment for foreign trade in merchandise and services and to promote diversification of India's export basket.

Export Growth Targets

The FTP 2015-20 aims at almost doubling the merchandise exports of India from $466 billion in 2013-14 to $900 billion by 2019-20, by raising India's share in world exports from 2 per cent to 3.5 per cent during this period.

Simplification and Restructuring of Reward Schemes

The FTP for 2015-20 has restructured existing incentive schemes and introduced certain new schemes.

Earlier, there were 5 different schemes (Focus Product Scheme, Market Linked Focus Product Scheme, Focus Market Scheme, Agri. Infrastructure Incentive Scrip, VKGUY) for rewarding merchandise exports with different kinds of duty scrips with varying conditions (sector specific or actual user only) attached to their use. Now, all these schemes have been merged into a single scheme, namely Merchandise Export from India Scheme (MEIS) and there would be no conditionality attached to the scrips issued under the scheme.

Rewards for eligible export of goods to notified markets under MEIS shall be payable as percentage of realised FOB value (in free foreign exchange). The debits towards basic customs duty in the transferable reward duty credit scrips would also be allowed adjustment as duty drawback. Earlier, only the additional duty of customs/excise duty/service tax was allowed adjustment as CENVAT Credit or drawback, as per Department of Revenue rules.

The current Policy has replaced the earlier scheme known as Served from India Scheme (SFIS) with Service Exports from India Scheme (SEIS). SEIS shall apply to 'Service Providers located in India' instead of 'Indian Service Providers'. Thus, SEIS provides for rewards to all service providers of notified services, who are providing services from India, regardless of the constitution or profile of the service provider.

Incentives under MEIS and SEIS have been extend to units located in SEZs also.

For the first time, exports by e-commerce firms will be provided incentives while under the MEIS.

New Trade Promotion Agency

Apart from the existing Board of Trade, a Council for Trade Development and Promotion will be set up comprising representatives from States and Union Territories.

Status Holders

For a long time, the Government has been recognising large exporters as Status Holders and given special treatment and privileges to facilitate their trade transactions, in order to reduce their transaction costs and time. (Also see *Export Houses and Trading Houses* in Chapter 42.)

The current Policy has changed the nomenclature of Export House, Star Export House, Trading House, Star Trading House, Premier Trading House certificate to One, Two, Three, Four, Five Star Export House. The criteria for export performance for recognition of status holder have been changed from Rupees to US dollar earnings. The new criteria is as under:

TABLE 42.1 : CATEGORIES OF EXPORT HOUSE

Status Category	*Export Performance FOB/FOR (as converted) Value (in US $ million) during current and previous two years*
One Star Export House	3
Two Star Export House	25
Three Star Export House	100
Four Star Export House	500
Five Star Export House	2000

NEW INITIATIVES FOR EOUs, EHTPs AND STPs

According to the Foreign Trade policies of the past, units undertaking to export their entire production of goods (except permissible domestic tariff area [DTA]) were permitted under Export Oriented Unit (EOU) Scheme, Electronic Hardware Technology Park (EHTP), Software Technology Park (STP) Scheme, Bio-Technology Park (BTP) Scheme for manufacture of goods including repair, remaking, reconditioning, reengineering and rendering of services. The *FTP 2015-20* has modified these schemes. Important modifications include the following, among others:

(a) EOUs, EHTPs and STPs are allowed to share infrastructural facilities among themselves. This will enable units to utilise their infrastructural facilities in an optimum way and avoid duplication of efforts and cost to create separate infrastructural facilities in different units.

(b) Inter-unit transfer of goods and services are allowed among EOUs, EHEPs, STPs, and BTPs. This will facilitate group of those units which source inputs centrally in order to obtain bulk discount. This will reduce cost of transportation, other logistic costs and result in maintaining effective supply chain.

(c) EOUs are allowed facility to set up Warehouses near the port of export. This will help in reducing lead time for delivery of goods and will also address the issue of unpredictability of supply orders.

(d) STP units, EHTP units and software EOUs are allowed the facility to use all duty free equipment/goods for training purposes. This will help these units in developing skills of their employees.

BOOST TO 'MAKE IN INDIA'

To encourage domestic production, Export Obligation (EO) for domestic procurement under EPCG Scheme has been reduced to 90 per cent of the normal export obligation (6 times at the duty saved amount) to 75 per cent, in order to promote domestic capital goods manufacturing industry.

Further, it is proposed to give higher level of rewards to products with high domestic content and value addition, as compared to products with high import content and less value addition.

The government also extended tax breaks to exporters of defence, pharma and environment-friendly products. The government will focus on branding India's products for which campaigns would be started soon in sectors including pharma and engineering. Traditional exports like handloom alongside yoga in services would also be promoted.

EVALUATION

The BJP Government took one year to do required homework for a new five year Foreign Trade Policy instead of coming out with a new Policy (which was due in April 2014) in a hurry soon after coming to power. Considerable thought has gone into the making of the new Policy.

However, it may be said that the new Policy reflects the general trend of the past of rationalising existing export promotion schemes and introducing new ones zeroing in the emerging business environment.

Although catchy terms of the favour of the present government such as 'Make in India', 'Digital India' and 'Skill India' are used in the Policy, they are more or less extensions of initiatives of the past. Indeed, every successive Policy has been a step forward from the previous Policy. It is true of the Foreign Trade Policy 2015-20 too. The endeavours towards procedural simplification and digitalisation have been carried further forward by the current Policy.

The Policy document evinces a serious homework. The success of the policy in achieving the objectives will depend on the efficiency of the implementation. The foreign trade environment in particular and the business environment in general being characterised by frequent changes and, some times, even turbulence, the Policy should be amenable to needed flexibility. In this context, the replacement of the Annual Review by Mid-term Review may not be appreciated by everybody.

EXPORT PROMOTION

Government of India, like almost all other nations, has been endeavouring to develop exports.

Export development is important to the firm and to the economy as a whole. Government measures aim, normally, at the general improvement of the export performance of the nation for the general benefit of the economy. Such measures help exporting firms in several ways.

Export development can help achieve domestic economic stability and growth.

The benefits of exports to the economy are many.

When the domestic market is small, foreign market provides opportunities to achieve economies of scale and growth. *Secondly,* the supply of many commodities, as in the case of a number of agricultural products in India, is more than the domestic demand. *Thirdly,* exports enable certain countries to achieve export-led growth. *Fourthly,* export markets may help mitigate the effects of domestic recession. *Fifthly,* a country may need to boost its exports to earn enough foreign exchange to finance its imports and service its foreign debt. It may be noted that many countries are suffering from trade deficit and foreign debt. *Lastly,* even in the case of countries with trade surplus, export promotion may be required to maintain its position against the international competition and the level of domestic economic activity.

The principal objectives of export promotion measures in India have been to:

- Compensate the exporters for the high domestic cost of production.
- Provide necessary assistance to the new and infant exporters to develop the export business.
- Increase the relative profitability of the export business *vis-à-vis* the domestic business.

ORGANISATIONAL SET-UP

Government has established or sponsored a number of organisations to provide different types of assistance to the exporters. Apart from the organisations established exclusively for export promotion, there are also a number of other institutions which assist the export sector. An outline of the important organisations which help to promote exports is given below.

Ministry of Commerce

The Ministry of Commerce, Government of India, is the most important organ concerned with the promotion and regulation of the foreign trade of the country. The Ministry has elaborate organisational arrangement to look after various aspects of trade regulation and promotion. The Department of Commerce in the Ministry of Commerce is assigned a very important role in different matters concerned with foreign trade of the country including commercial relation with other countries, promotion and regulation of foreign trade, state trading etc. Matters related to

foreign trade are dealt with by eight divisions in the Department of Commerce, namely, *(i)* Administrative and General Division, *(ii)* Finance Division, *(iii)* Economic Division, *(iv)* Trade Policy Division, *(v)* Foreign Trade Territorial Division, *(vi)* Exports Products Division, *(vii)* Services Division, and *(viii)* Industries Division.

Autonomous Bodies

1. ***Export Inspection Council:*** The Export Inspection Council, a statutory body, is responsible for the enforcement of quality control and compulsory pre-shipment inspection of various exportable commodities.
2. ***Indian Institute of Foreign Trade*:** The Indian Institute of Foreign Trade, registered under the Societies Registration Act, is engaged in activities like training of personnel in modern techniques of international trade; organisation of research in problems of foreign trade; organisation of marketing research, area surveys, commodity surveys and market surveys; and dissemination of information arising from its activities relating to research and market studies.
3. ***Indian Institute of Packaging:*** The Indian Institute of Packaging is registered under the Societies Registration Act. The main aims of the Institute are to undertake research on raw materials for the packaging industry, to organise training programmes on packaging technology, to stimulate consciousness of the need for goods packaging technology, to stimulate consciousness of the need for good packaging, etc.
4. ***Export Promotion Councils, Commodity Boards and Authorities*:** There are a number of Export Promotion Councils under the administrative control of Ministry of Commerce. These Councils are registered as non-profit organisations under the Companies Act. The Councils perform both advisory and executive functions. These Councils are also the registering authorities under the Import Policy for Registered Exporters. For some products, instead of the EPCs, there are Commodity Boards responsible for production, development and export (like Spices Board, Coir Board, Tea Board). For some other products, the concerned export promotion organisation is Export Development Authority. The Marine Products Export Development Authority (MPEDA) is responsible for development of the marine products industry with special reference to exports. The Agricultural and Processed Food Products Export Development Authority, set up in 1986, serves as the focal point for agricultural exports, particularly the marketing of processed foods in value-added forms.

Export promotion includes measures to increase export production, organisations to assist export development, export marketing assistance and measures to reduce business risks and increase profitability.

5. ***Federation of Indian Export Organisations:*** The Federation of Indian Export Organisations is an apex body of various export promotion organisations and institutions. It also functions as a primary servicing agency to provide integrated assistance to Government recognised Export Houses and as a central coordinating agency in respect of export promotion efforts in the field of consultancy services in the country.
6. ***Indian Council of Arbitration:*** The Indian Council of Arbitration, set up under the Societies Registration Act, promotes arbitration as a means of settling commercial disputes and popularises arbitration among the traders, particularly those engaged in international trade.
7. ***India Trade Promotion Organisation*:** The ITPO was bought into being in 1992 by merging together the erstwhile Trade Fair Authority of India (TFAI) and the erstwhile Trade Development Authority of India (TDA). The functions of the ITPO are to:
   (a) Develop and promote exports and imports and upgrade technology through fairs in India and abroad
   (b) Compile and disseminate trade related information
   (c) Undertake publicity through the print and electronic media

(*d*) Organise visit of foreign buyers and trade delegations to industry and trade establishments in India with a view to promoting trade contracts

(*e*) Assist Indian companies in trade development

(*f*) Organise export development programmes, buyer-seller meets; and conduct promotion programmes and integrated marketing promotion programmes for the trade and industry in India.

Public Sector Undertakings

The following trading/service corporations are functioning under the administrative control of the Ministry of Commerce.

(*i*) The State Trading Corporation of India and its subsidiaries

(*ii*) The Minerals and Metals Trading Corporation of India and its subsidiary, *viz.*, Mica Trading Corporation

(*iii*) The Spices Trading Corporation

(*iv*) The Export Credit Guarantee Corporation

Advisory Body

Central Advisory Council on Trade: The Central Advisory Council on Trade, consisting of representatives from different organisations and individuals with business standing and expertise in the field of trade and commerce, advise Government on matters relating to:

(*i*) Export and import policy programme

(*ii*) Operation of import and export trade controls

(*iii*) Organisation and development of commercial services

(*iv*) Export Credit Guarantee Corporation

The Commerce Minister is the Chairman of this Council.

Attached and Subordinate Offices

1. ***Office of the Director General of Foreign Trade (DGFT):*** The DGFT is responsible for the execution of the export and import policies of the Government. Import and Export Licensing of iron and steel and ferro alloys is also looked after by this organisation. The DGFT with the head office at New Delhi has subordinate offices located at different parts of the country. Earlier, the office of the DGFT was known as the Chief Controller of Imports and Exports (CCIE).
2. ***Director General of Commercial Intelligence and Statistics:*** This Director is the primary Government agency for the collection, compilation and publication of the foreign, inland and ancillary trade statistics and dissemination of various types of commercial information. The Director brings out a number of publications, particularly on trade statistics which are utilised in framing economic policies, formulating trade agreements with foreign countries and monitoring these agreements. These publications are also used by the trading public and research scholars. The Director conducts studies on various topics relating to promotion of trade. It also helps in the settlement of commercial disputes and provides Indian businessmen going abroad with letters of introduction to Indian Commercial representatives concerned. It maintains Commercial Library which is widely used by the exporters, importers, research scholars and others.
3. ***Offices of Development Commissioners:*** For each of the export processing zone/exclusive economic zone in the country, there is an office of the Development Commissioner responsible for the administration of the zone.

INCENTIVES

Export incentives are a widely employed strategy of export promotion. The main aim of these incentives is to increase the profitability of export business. Important export incentives in India include rebate of duties, cash compensatory support, income tax concession, interest subsidies, freight subsidy etc. It has been common to describe these as incentives. However, as the Abid Hussain Committee has observed, they are more a compensation for the comparative disadvantages faced by the Indian exporter than incentives. We give below a very brief account of these 'incentives' which serve the first rationale of export promotion mentioned earlier in this section, *viz.,* to compensate the exporters for the high domestic costs.

Duty Exemption/Drawback

The scheme of duty exemption is designed to avoid the incidence of commodity taxes like excise duty and customs duties on the exports so as to make the exports more price competitive. "This is a worldwide practice and the rationale is straightforward. Customs duties and excise duties on inputs raise the cost of production in export industries and thereby affect the competitiveness of exports. Therefore, exporters need to be compensated for the escalation in their costs attributable to such customs and excise duties.

Duty exemption as an export promotion measure had its origin in India during the Second Plan. Over the years, the scheme has been enlarged and modified.

The exporters are either exempted from the payment of duty while procuring inputs like raw materials and intermediates or, in cases where the duty is paid on the inputs, the duty is refunded. Thus, under the duty drawback system, the exporters are reimbursed for tariff paid on the imported raw materials and intermediates and central excise duties on domestically produced inputs which enter into export production.

Because of a series of modifications to the import policy for registered exporters, particularly the introduction of the advance licensing system, exporters can now make most of the import of inputs without payment of customs duty.

Eligible exporters are entitled to interest-free bank credit against the duty drawback applicable to them up to a period of 90 days or up to the time they realise the drawback, whichever is earlier. Similarly, with the application of MODVAT, a large number of products, covered by the MODVAT, can be exported in bond and in that event, the duty relief in the form of drawback would be restricted only to basic customs and auxiliary duties suffered, if any, by the inputs.

There are two types of drawback rates, *viz.,* all industry rate applicable to a group of products and brand rate applicable to individual products not covered by the industry rate.

The all industry drawback rates are derived from estimates of average quantity of value of materials used in the manufacture of exports, the average amount of duties paid on imported materials or excisable materials used in the manufacture of these goods, and the average amount of duties paid on the materials wasted in the manufacturing process. Such average industry rates are fixed by the Drawback Directorate in the Ministry of Finance.

Awards

A number of awards have been instituted to encourage exports and to recognise excellence in exports. There are separate awards for different categories of exporters. Awards are given on the basis of certain specified criteria such as development of market for products which have not been exported previously, substantial increase in exports, successful introduction of new products, product development, successful breakthrough in foreign markets where conditions have been especially difficult etc. References to some other incentives are made in the sub-section on *Marketing Assistance*.

Other Incentives

Some important incentives were terminated consequent to certain measures taken as part of the economic liberalisation.

The *Cash Compensatory Support* (CCS) was a cash subsidy scheme designed to compensate the exporters for unrebated indirect taxes and to provide resources for product/market development. The CCS enabled the exporters to increase the profit or to reduce the price to the extent of the subsidy without incurring a loss. With the devaluation of the Rupee in July 1991, the CCS was abolished.

Another important incentive was the system of *Import Replenishment* (REP) licenses, which were related to the f.o.b. value of exports. The REP was, for the most part, a facility insofar as it enabled exporters to import inputs where the domestic substitutes were not adequate in terms of price, quality or delivery rates; it was also an incentive insofar as there was a premium on REP licences which were transferable. The new trade policy announced in July 1991 which renamed the REP as *Exim Scrip* significantly modified the scheme. The Exim Scrip Scheme was, however, abolished with the introduction of the partial convertibility of Rupee since April 1992.

The *International Price Reimbursement Scheme* (IPRS) was designed to make available specified inputs to exporters at international prices. The scheme which was initially available to steel was later extended to aluminium also and there was a proposal to extend to other items. The IPRS has been replaced by *Engineering Products Exports (Replenishment of Iron and Steel Intermediates) Scheme*.

PRODUCTION ASSISTANCE/FACILITIES

Exports depend, *inter alia,* on exportable surplus and the quality and price of the goods. Government have, therefore, taken a number of measures to enlarge and strengthen the production base, to improve the productive efficiency and quality of products and to make the products more cost-effective. Measures in these directions include making available raw materials and other inputs of required quality of reasonable prices; facilities to establish and expand productive capacity, including import of capital goods and technology; facilities to modernise production facilities, provision of infrastructure for the growth of export oriented industries etc.

MARKETING ASSISTANCE

A number of steps have been taken to assist the exporters in their marketing effort. These include conducting, sponsoring or otherwise assisting market surveys and research; collection, storage and dissemination of marketing information, organising and facilitating participation in international trade fairs and exhibitions; credit and insurance facilities; release of foreign exchange for export marketing activities; assistance in export procedures; quality control and pre-shipment inspection; identifying markets and products with export potential; helping buyer-seller interaction, etc. Some of the schemes and facilities which assist export marketing are mentioned below.

Market Development Assistance

An important export promotion measure taken by the Government is institution of the Market Development Assistance (MDA). Assistance under the MDA is available for market and commodity researches; trade delegations and study teams; participation in trade fairs and exhibitions; establishment of offices and branches in foreign countries; and grants-in-aid to EPCs and other approved organisations for export promotion.

Market Access Initiative

In 2001, Government had also announced the launching of the Market Access Initiative Scheme for undertaking marketing promotion efforts abroad on country-product focus approach

basis. This Scheme is in line with market promotion and development schemes being implemented by many other countries. The Exim Policy, 2002-07, has proposed to further broaden the scope of this scheme to include activities considered necessary for focussed market promotion efforts.

Trade Fairs and Exhibitions

As trade fairs and exhibitions are effective media of promoting products, facilities are provided for enabling and encouraging participating of Indian exporters/manufacturers in such events. As mentioned earlier, foreign exchange is released for such purpose, the cost of participation is subsidised and the ITPO plays an important role in organising and facilitating participation in trade fairs/exhibitions.

Besides the ITPO, some other promotional agencies also organise trade fairs. *For example,* the MPEDA organises seafood trade fair, in India, in every 2nd year, which attracts a number of foreign buyers and others connected with the seafood industry.

Export Risk Insurance

As international business in fraught with different types of risks, measures have been taken to provide insurance covers against such risks. The Export Credit Guarantee Corporation (ECGC) has policies covering different political and commercial risks associated with export marketing, certain types of risks associated with overseas investments and risks arising out of exchange rate fluctuations. Further, ECGC extends the export credit risks cover to the commercial banks. Marine insurance is provided by the General Insurance Corporation and its subsidiaries.

Finance

The Export-Import Bank and commercial banks and certain other financial institutions like specified cooperative banks provide pre-shipment and post-shipment finance to exports. Some of these institutions also provide suppliers' credit, including line of credit, to promote Indian exports. Export credits generally carry concessional interest rates.

Quality Control and Preshipment Inspection

A number of steps have been taken by the Government to improve the quality of exports and to ensure that only goods of appropriate quality are exported from the country. The Export (Quality Control and Inspection) Act empowers the Government to make necessary regulations in this respect.

Institutional Assistance

As mentioned earlier, export marketing is assisted in different ways by a number of organisations like the ITPO, EPCS, Commodity Boards, Export Development Authorities like the MPEDA and APEDA, IIFT, Indian Missions abroad etc.

India Brand Equity Fund

Government of India initiated steps to establish an *India Brand Equity Fund* with the objective of promoting the made in India image abroad. It was also proposed to set up a *Brand Acquisition Fund* to help Indian corporate to acquire big international brands put up for sale and build them up as Indian brands in the international markets.

EPZs, EOUs, TPs and SEZs

As a part of the export promotion drive, Government have, from time to time, introduced several schemes to promote units primarily devoted to exports. These include Export processing Zones (EPZs), Hundred Per cent Export Oriented Industrial Units (EOUs), and different categories of Technology Parks (TPs). In 2000, a scheme of Special Economic Zones (SEZs) was also introduced.

Export Processing Zones/EOUs

Export Processing Zones (EPZs) are industrial estates which form enclaves from the national customs territory of a country and are usually situated near seaports or airports. The entire production of such a zone is normally intended for exports. Such zones are provided with well developed infrastructural facilities. Industrial plots/sheds are normally made available at concessional rates. Units in these Zones are allowed foreign equity even up to 100 per cent. EPZ units can import capital goods, raw materials etc., for export production without payment of duty. Domestically procured items are also eligible for duty exemption.

A Free Trade Zone (FTZ) is different from an EPZ. Goods imported to a free trade zone may be re-exported without any processing in the same form. But, goods exported by units in an EPZ are expected to have undergone some value addition by manufacturing or other processing. A Free Port is one in to which imports and from which exports are free from trade barriers. A FTZ may be a part of or adjacent to a port; the rest of the port being subject to the national customs regulation.

The main objectives of an EPZ are:

1. To earn foreign exchange
2. To generate employment opportunities
3. To facilitate transfer of technology by foreign investment and other means
4. To contribute to the overall development of the economy

The Kandla Free Trade Zone (KAFTZ), set up in 1965, is India's first EPZ (it was a misnomer to call it a free trade zone). This multi-product zone is located 10 kms away from the Kandla Port, Gujarat State. The second one is the Santacruz Electronics Export Processing Zone (SEEPZ) set up in 1974. This exclusive zone (for electronic goods) is situated near the Santacruz Airport, Mumbai. Four more free trade zones were set up later in the country at Chennai, Cochin, Noida (UP) and Falta (West Bengal) and they commenced exports during the Seventh Plan (1985-86). Later, another EPZ was developed in Vizag (AP).

Government also introduced schemes for Electronic Hardware Technology Park (EHTP) units and Software Technology Park (STP) units.

Hundred per cent export oriented unit (EOU) refers to an industrial unit which offers for exports its entire production, excluding permitted levels of rejects. EOUs were allowed in industries in respect of which the export potential and export targets were considered by the relevant Export Promotion Council. EOUs were not normally encouraged in respect of products subject to export control quota ceilings which can be reached by existing units in the industry. Thus, the scheme of 100 per cent export oriented units had been designed to create additional export capacity; units which result in mere substitution for the existing units' production were not to be permitted.

Being outside the EPZs, the EOUs did not get the benefits of the built-in facilities of the Zones. EOUs enjoyed most other facilities and incentives as were available to the EPZ units.

An EPZ/EOU unit had to be a net foreign exchange earner. The level of foreign exchange earning as a percentage of exports (NFEP) was calculated annually and cumulatively for a period of 5 years since the commencement of commercial production. The NFEP requirement for different products varied from 10 per cent for plain gold jewellery to 60 per cent for computer software and tissue culture plants. However, electronic hardware units were allowed to be set up without stipulation of a positive NFEP.

The following supplies were also allowed to be counted towards fulfilment of the export obligation:

1. Supplies effected in domestic tariff area (DTA — all parts of the country where the national tariff laws are applicable) which are eligible to be regarded as *deemed exports*.
2. Supplies effected in DTA against payment in foreign exchange.

3. Supplies, with the permission of the Development Commissioner, to other EOUs/EPZ/EHTP/STP units, as per the Policy.
   (a) The entire production of EOU/EPZ/EHTP/STP units was required to be exported, except:
   (b) Rejects up to 5 per cent or such percentage approved by the Development Commissioner in consultation with the local customs authority. Rejects could be sold in the DTA, subject to payment of appropriate duties.
   (c) 25 per cent of the production in value terms was allowed to be sold in the DTA subject to the fulfilment of NFEP and payment of applicable duties. No DTA sale was permissible in respect of certain items like motor cars and alcoholic liquor.
   (d) However, units in agriculture and related fields were permitted to sell upto 50 per cent of the production in value terms in the DTA subject to positive NFE earnings.
   (e) Electronics hardware products could be sold in the DTA subject to the conditions laid down in the Policy.

An EOU/EPZ/EHTP/STP unit could export goods manufactured by it through an Export House/Trading House/Star Trading House/Superstar Trading House recognised under the Exim Policy or any other EOU/EPZ/EHTP/STP unit. This permission is extended only to the marketing of the goods by the above category of exporters. The manufacture of the goods shall be done in the EOU/EPZ units.

SEZs

While announcing the Exim Policy for 2000-01, the Commerce Minister stated that India would develop Special Economic Zones to boost the country's exports. Any State Government or corporate body may set up a SEZ. The only laws which will operate in these Zones will be the labour and banking laws. The SEZs are different from the EPZs: in the SEZs there will not be any inspector raj and once commodities go in, nobody will ask any questions until they come out, clarified the Minister. Units in the SEZs may also do domestic sales by paying all relevant duties. However, they have to be net foreign exchange earners.

"While EPZs are industrial estates, SEZs are virtually industrial townships that provide appropriate infrastructure such as housing, roads, ports and telecommunication. The scope of activities that can be undertaken in the SEZs is much wider, their linkages with the domestic economy are stronger. Resultantly, they have a diversified industrial base. Their role is not transient like the EPZs, as they intended to be instruments of regional development as well as export promotion. As such, SEZs can have tremendous impact on exports, inflow of foreign investment and employment generation."[1]

Proposals have already come up for establishment of many SEZs in different States also.

It was also announced that all the existing EPZs will be converted into SEZs.

The move to develop SEZs was inspired by the success of the SEZs in China which contribute about 40 per cent of her exports. The Indian EPZs have contributed little to the country's exports. The SEZs are expected to bring about a major breakthrough. It is pointed out that one important reason for the success of the Chinese SEZs is the absence of trade union rights there. A democratic country like India cannot think of denying the labour rights. Yet, the big push of development envisaged by the SEZs should be expected to have a very significant impact.

EXPORT HOUSES

From the beginning of the Second Five Year Plan, the foreign exchange problem began to assume serious proportions, and the Government began to realise the need for vigorous export promotion. It was very clear the concentrated efforts should be made for the promotion of the export of non-traditional items. It was also realised that unless positive steps were taken to build

up a number of merchant houses, concentrating almost exclusively on exports and capable of undertaking trade on a sustained basis, it would be impossible to compete successfully against the highly experienced and resourceful trading houses of other countries. The importance of promoting merchant houses was further underlined by the need for providing channels for the export of the products of the small-scale sector.

An export house is defined as a registered exporter holding a valid Export House Certificate issued by the Director General of Foreign Trade.

An export house is a registered exporter who satisfies certain specific criteria. An export house is entitled to certain facilities and incentives.

The scheme of export houses has been modified a number of times.

The objective of the scheme was to recognise established exporters as Export House, Trading House, Star Trading House and Superstar Trading House with a view to build marketing infrastructure and expertise required for promotion. Such Houses had to operate as highly professional and dynamic institutions and act as important instruments of export growth.

In the past, different categories of export house like Export House, Trading House, Star Trading House or Superstar Trading House were recognised on the basis of foreign exchange earnings.

The Foreign Trade Policy 2009-14 classifies Export and Trading House into five categories as shown in Table 42.1.

Merchant as well as Manufacturer Exporters, Service Providers, Export Oriented Units (EOUs) and Units located in Special Economic Zones (SEZs), Agri Export Zones (AEZs), Electronic Hardware Technology Parks (EHTPs), Software Technology Parks (STPs) and Biotechnology Parks (BTPs) shall be eligible for Export and Trading House status.

See the subsection *Status Holders* and Table 42.1 in Chapter 42 for the current policy.

AN EVALUATION

The success of export promotion measures should be judged by the growth of exports and the dynamism of the export sector.

No doubt, India's total exports have been growing and the export sector has achieved some diversification and sophistication. However, the achievements have been far below the requirements and potentials and have been very poor in comparison with those of several developing countries. Thus, export development measures in India have not been successful in producing the needed results. The infrastructure for international marketing is not efficient enough.

An effective export promotion should compensate for the disadvantages of the national exporters and should make the export business profitable enough to lure entrepreneurs to this sector and achieve the ultimate objective of boosting the exports.

The general feeling is that the export promotion regime in India has not succeeded in achieving these objective.

It has also been pointed out that one of the drawbacks of the exports incentives regime in India is that it is largely transparent in character.

"While foreign buyers have sharp eyes for them, these constitute an eyesore for the governments particularly of the industrialised importing countries. The importer try to grab these incentives almost in their entirely on the pretext of growing competition, thus depriving the Indian exporters of the benefits of the promotional measures. In fact, these tend to create an insatiable urge for more and more incentives in extent and magnitude. On the other hand, the governments of the developed countries viewing these as subsidies invoke the provisions of the anti-dumping and countervailing duty laws. The effectiveness and purposiveness of incentives thus lie in their non-transparent character. This could be possible only by devising a policy framework with inherent and inbuilt, albeit latent, promotional incentives".[2]

A major factor necessitating large incentives is the structural weakness and high cost of the Indian economy. It, is, therefore, necessary to remove these handicaps to reduce the needs for the exogenous incentives. Further, the institutional inadequacies and procedural complexities and delays need to be urgently attended to. Absence/lack of dynamism and innovativeness in policies, procedures, product development and marketing continue to hamper India's export development.

SUMMARY

The export-import (Exim) policy and regulation can have significant impact on the business environment on the economy in general and the import competing, import dependent and export oriented industries in particular.

The foreign trade of India is regulated mostly by the Foreign Trade (Development and Regulation Act), 1992 (FTDRA), which replaced the erstwhile Imports and Exports (Control) Act, 1947. Besides the FTDR Act, there are some laws which control the trade in certain items. For instance, the export of antiquities is regulated under the Antiquities and Art Treasures Act, 1972; export of coffee is regulated by the Coffee Board under the Indian Coffee Act, 1942; export of tea is regulated under Tea Act, 1953, etc.

The objective of the FTDR Act is to *provide for the development and regulation of foreign trade by facilitating imports into, and augmenting exports from India and for matters connected therewith or incidental thereto.*

No export or import shall be made by any person except in accordance with the provisions of this Act, the orders and rules made under this Act and the export and import policy.

The FTDRA empowers the Central Government to make provision for the development and regulation of foreign trade by facilitating imports and increasing exports. Accordingly, the Central Government may make provision for prohibiting, restricting or otherwise regulating the import or export of goods as and when required.

The Act provides for the appointment by the Central Government, of a Director General of Foreign Trade for the purpose of this Act. The DGFT shall advise the Central Government in the formulation of the export and import policy and shall be responsible for carrying out that policy. [The corresponding authority under the Imports and Exports (Control Act), 1947, was called the Chief Controller of Imports and Exports (CCIE).]

The Act lays down that the Central Government may, from time to time, formulate and announce the export and import policy and may also amend that policy.

The principal objectives of the present Exim Policy are: to accelerate the country's transition to an internationally oriented vibrant economy with a view to derive maximum benefit from the expanding global market opportunities; to stimulate sustained economic growth by providing access to essential raw materials, intermediates, components, consumable and capital goods required for augmenting production; to enhance the technological strength and efficiency of Indian agriculture, industry and services, thereby improving their competitive strength while generating new employment opportunities, and encourage the attainment of internationally accepted standards of quality, and to provide consumers with good quality products at reasonable prices.

A very important feature of the Exim Policy since 1992 is freedom. Licensing, quantitative restrictions and other regulatory and discretionary controls have been substantially eliminated. All goods, except those coming under the negative list, may be freely imported and exported.

The policy of the government is to keep the negative lists as small as possible under given circumstances. In accordance with the WTO commitment, the quantitative restrictions (QRs) have almost been completely removed with effect from April 2001. This does not mean imports are free now; most items are subject to a relatively high level of import duty.

The Exim Policy and the associated measures of economic reforms or liberalisation have far-reaching implications. The regime of high protection is gradually vanishing and the Indian economy is increasingly exposed to more foreign competition. This means that the Indian firms should become competitive if they should survive. They have to pay due attention to cost and price, quality, delivery schedules, after-sales service etc. In fact, a buyer's marketing is emerging in several industries which in the past were sellers' markets.

Another important implication of the liberalisation is that now Indian firms can obtain their raw materials and the like more competitively, including from abroad. This would help them to control costs and improve quality.

Government of India has been giving high importance to export promotion. The principal objectives of export promotion measures in India have been to: compensate the exporters for the high domestic cost of production; provide necessary assistance to the new and infant exporters to develop the export business and increase the relative profitability of the export business *vis-à-vis* the domestic business.

Government has established or sponsored a number of organisations to provide different types of assistance to the exporters. Apart from the organisations established exclusively for export promotion, there are also a number of other institutions which assist the export sector.

Export incentives are a widely employed strategy of export promotion. The main aim of these incentives is to increase the profitability of export business. Important export incentives in India include rebate of duties, cash compensatory support, income tax concession, interest subsidies, freight subsidy etc. Although it has been common to describe these as incentives, they are really more a compensation for the comparative disadvantages faced by the Indian exporter than incentives.

As a part of the export promotion drive, Government have, from time to time, introduced several schemes to promote units primarily devoted to exports. These include Export Processing Zones (EPZs), Hundred Per Cent Export Oriented Industrial Units (EOUs), and different categories of Technology Parks (TPs). In 2000, a scheme of Special Economic Zones (SEZs) was also introduced.

Government of India has a scheme to recognise established exporters as One Star Export House, Two Star Export House, Three Star Export House, Four Star Export House and Five Star Export House.

Although a number of measures have been taken by the Government from time to time to promote exports, they have not been successful in producing the needed results.

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2. **M.L. Verma,** ***Foreign Trade Management in India*****, Vikas Publishing House, New Delhi, 1988, pp. 72-73.**

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FOREIGN EXCHANGE MANAGEMENT ACT

Chapter 43

Structure

Regulation of Foreign Exchange Transactions
Foreign Exchange Management Act
FERA and FEMA — A Comparison
Summary
Reference
Annexure 43.1: Definitions

REGULATION OF FOREIGN EXCHANGE TRANSACTIONS

Foreign exchange transactions were regulated in India by the Foreign Exchange Regulations Act (FERA), 1973. This Act also sought to regulate certain aspects of the conduct of business outside the country by Indian companies and in India by foreign companies.

The FERA was widely described as a draconian and obnoxious law. Following the economic liberalisation ushered in 1991, some amendments to the FERA were effected in 1993.

The main objective of FERA, framed against the background of severe foreign exchange problem and the controlled economic regime, was conservation and proper utilisation of the foreign exchange resources of the country.

There was a lot demand for a substantial modification of FERA in the light of the ongoing economic liberalisation and improving foreign exchange reserves position. Accordingly, a new Act, the Foreign Exchange Management Act (FEMA), 1999, replaced the FERA.

FOREIGN EXCHANGE MANAGEMENT ACT

The FEMA, which came into effect from January 1, 2000, extends to the whole of India and also applies to all branches, offices, and agencies outside India, owned or controlled by a person resident in India.

Objectives

The objectives of FEMA are:

- To facilitate external trade and payments
- To promote the orderly development and maintenance of foreign exchange market.

Dealing in Foreign Exchange etc.

Section 3 of FEMA imposes restrictions on dealings in foreign exchange and foreign security and payments to and receipts from any person outside India. Accordingly, except as provided in terms of the Act, or with the general or special permission of the Reserve Bank, no person shall—

(a) deal in any foreign exchange or foreign security with any person other than an authorised person;

(b) make any payment to or for the credit of any person resident outside India in any manner;

(c) receive otherwise through an authorised person, any payment by order or on behalf of any person resident outside India in any manner;

(d) enter in to any financial transaction in India as a consideration for or in association with acquisition or creation or transfer of a right to acquire, any asset outside India by any person.

Further, same as otherwise provided in this Act, no person resident in India shall acquire, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India.

Holding of Foreign Exchange etc.

Same as otherwise provided in this Act, no person resident in India shall acquire, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India.

Current Account Transactions

FEMA permits dealings in foreign exchange through authorised persons for current account transactions. However, the Central Government can impose reasonable restrictions in public interest.

Capital Account Transactions

Any person may sell or draw foreign exchange to or from an authorised person for a capital account transaction permitted by the Reserve Bank in consultation with the Central Government.

The Reserve Bank may, however, without prejudice to the generality of this, prohibit, restrict or regulate the following.

(a) transfer or issue of any foreign security by a person resident in India;

(b) transfer or issue of any security by a person resident outside India;

(c) transfer or issue of any security or foreign security by any branch, office or agency in India of a person resident outside India;

(d) any borrowing or lending in foreign exchange in whatever form or by whatever name called;

(e) any borrowing or lending in rupees in whatever form or by whatever name called between a person resident in India and a person resident outside India;

(f) deposits between persons resident in India and persons resident outside India;

(g) export, import or holding of currency or currency notes;

(h) transfer of immovable property outside India, other than a lease not exceeding five years, by a person resident in India;

(i) acquisition or transfer of immovable property in India, other than a lease not exceeding five years, by a person resident outside India;

(j) giving of a guarantee or surety in respect of any debt, obligation or other liability incurred—

1. by a person resident in India and owed to a person resident outside India; or
2. by a person resident outside India.

A person resident in India may hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India if such currency, security or property was acquired, held or owned by such person when he was resident outside India or inherited from a person who was resident outside India.

A person resident outside India may hold, own, transfer or invest in Indian currency, security or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was resident in India.

The Reserve Bank may prohibit, restrict, or regulate establishment in India of a branch, office or other place of business by a person resident outside India, for carrying on any activity relating to such branch, office or other place of business.

The Reserve Bank shall not impose any restriction on the drawal of foreign exchange for payments due on account of amortisation of loans or for depreciation of direct investments in the ordinary course of business.

Export of Goods and Services

1. Every exporter of goods shall—

   (a) furnish to the Reserve Bank or to such other authority a declaration as specified, containing true and correct material particulars, including the amount representing the full export value or, if the full export value of the goods is not ascertained at the time of export, the value which the exporter, having regard to the prevailing market conditions, expects to receive on the sale of the goods in a market outside India;

   (b) furnish to the Reserve Bank such other information as may be required by the Reserve Bank for the purpose of ensuring the realisation of the export proceeds by such exporter.

For the purpose of ensuring that export value of the goods is received without any delay, the Reserve Bank may direct any exporter to comply with such requirements as it deems fit.

Every exporter of services shall furnish to the Reserve Bank or to such other authorities a declaration as specified, containing the true and correct material particulars in relation to payment for such services.

Realisation and Repatriation of Foreign Exchange

Where any amount of foreign exchange is due or has accrued to any person, he shall take all reasonable steps to realise and repatriate it to India with in the time and in the manner prescribed by the RBI. Several exemptions are, however, granted to this clause.

Contravention and Penalties

Under this chapter, penalty for any kind of contravention under this Act is liable to a penalty up to thrice the amount involved where it is quantifiable or up to ₹ 2 lakhs where it is not quantifiable and where such contravention is continuing one, further penalty which may extend to five thousand rupees for every day after the first day during which the contravention continues. This provision is in total contrast to the respective provision in the erstwhile FERA which provided for imprisonment and no limit on fine. Under FEMA, a person will be liable to civil imprisonment only if he does not pay the fine within 90 days from the date of notice and that too after formalities of showcause notice and personal hearing. If he does not respond to the notice, there can be a warrant of arrest.

Administration of the Act

The FEMA has assigned an important role to the Reserve Bank of India in the administration of this Act. The rules, regulations and norms pertaining to several sections of the Act are to be laid down by the RBI, in consultation with the Central Government.

The Act requires the Central Government to appoint as many officers of the Central Government as Adjudicating Authorities for holding inquiries pertaining to contravention of the Act. There is also a provision for appointing one or more Special Directors (Appeals) to hear appeals against the order of the Adjudicating Authorities. The Central Government shall also establish an Appellate Tribunal for Foreign Exchange to hear appeals against the orders of the Adjudicating Authorities and the Special Director (Appeals).

The FEMA provides for the establishment, by the Central Government, of a Director of Enforcement with a Director and such other officers or class of officers as it thinks fit for taking up for investigation the contraventions under this Act.

FERA AND FEMA – A COMPARISON

Important differences between FERA and FEMA have been summed up as follows.[1]

1. In FEMA, only the specified acts relating to foreign exchange are regulated, while in FERA, anything and everything that has to do with foreign exchange was controlled. Also, the aim of FEMA is facilitating trade as against that of FERA, which was to prevent misuse. In other words, the theme of FERA was: 'everything that is specified is under control'. While the theme of FEMA is: 'everything other than what is expressly covered is not controlled'. Thus there is a lot of deregulation.
2. FEMA is a much smaller enactment — only 49 sections as against 81 of FERA.
3. In the process of simplification, many of the "laid downs" of the erstwhile FERA have been withdrawn.
4. Many provisions of FERA like the ones relating to blocked accounts, Indians taking up employment abroad, employment of foreign technicians in India, contracts in evasion of the act, vexatious search, culpable mental state etc., have no appearance in FEMA.

SUMMARY

The Foreign Exchange Management Act (FEMA), 1999, replaced the Foreign Exchange Regulations Act (FERA), 1973, which regulated the foreign exchange transactions in India and which sought to control certain aspects of the conduct of business outside the country by Indian companies and in India by foreign companies.

The FEMA, which came into effect from January 1, 2000, extends to the whole of India and also applies to all branches, offices, and agencies outside India, owned or controlled by a person resident in India.

The objectives of FEMA are to facilitate external trade and payments; and to promote the orderly development and maintenance of foreign exchange market.

The Reserve Bank of India is assigned an important role in the administration of this Act.

The FEMA empowers the Central Government to impose restrictions on dealings in foreign exchange and foreign security and payments to and receipts from any person outside India.

The Act imposes restrictions on persons resident in India on acquiring, holding or owning foreign exchange, foreign security and immovable property abroad and on transfer of foreign exchange or security abroad.

The FEMA lays down that all dealings in foreign exchange or foreign security and all payments from outside the country to India shall be made only through authorised persons, except with the general or special permission of the Reserve Bank. The Act also prohibits any payment outside India except with the general or special permission of the Reserve Bank.

The FEMA permits dealings in foreign exchange through authorised persons for current account transactions. However, the Central Government can impose reasonable restrictions in public interest.

Any person may sell or draw foreign exchange to or from an authorised person for a capital account transaction permitted by the Reserve Bank. However, the Act empowers the RBI to impose a number of restrictions on capital account transactions.

The FEMA permits a person resident in India to hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India if such currency, security or property was acquired, held or owned by such person when he was resident outside India or inherited from a person who was resident outside India. Also, a person resident outside India may hold, own, transfer or invest in Indian currency, security or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was resident in India.

The Reserve Bank is empowered by this Act to prohibit, restrict, or regulate establishment in India of a branch, office or other place of business by a person resident outside India, for carrying on any activity relating to such branch, office or other place of business. However, the RBI shall not impose any restriction on the drawal of foreign exchange for payments due on account of amortisation of loans or for depreciation of direct investments in the ordinary course of business.

The Act requires the exporters to furnish to the Reserve Bank or to such other authority certain details regarding the exports.

For the purpose of ensuring that export value of the goods is received without any delay, the Reserve Bank may direct any exporter to comply with such requirements as it deems fit.

Where any amount of foreign exchange is due or has accrued to any person, he shall take all reasonable steps to realise and repatriate it to India with in the time and in the manner prescribed by the RBI. Several exemptions are, however, granted to this clause.

Under this chapter, penalty for any kind of contravention under this Act is liable to a penalty up to thrice the amount involved where it is quantifiable or up to ₹ 2 lakh where it is not quantifiable and where such contravention is continuing one, further penalty which may extend to five thousand rupees for every day after the first day during which the contravention continues. This provision is in total contrast to the respective provision in the erstwhile FERA which provided for imprisonment and no limit on fine. Under FEMA, a person will be liable to civil imprisonment only if he does not pay the fine within 90 days from the date of notice and that too after formalities of showcause notice and personal hearing. If he does not respond to the notice, there can be a warrant of arrest.

An important difference between FERA and FEMA is that while in FEMA, only the specified acts relating to foreign exchange are regulated, in FERA, anything and everything that has to do with foreign exchange was controlled. Also, the aim of FEMA is facilitating trade as against that of FERA, which was to prevent misuse. In other words, the theme of FERA was: 'everything that is specified is under control'. While the theme of FEMA is: 'everything other than what is expressly covered is not controlled'. Thus, there is a lot of deregulation.

REFERENCE

1. **Chinubhai R. Shah and Komal Parikh, *"FERA to FEMA: A Journey from Forbidden Lands to Semi-open Pastures", Chartered Secretary*, May 2000, pp. A175:590-2.**

ANNEXURE 43.1

Definitions

The meaning of some of the important terms used in FEMA are given below.

Foreign Exchange

Foreign exchange means foreign currency and includes —

(i) Deposits, credits and balances payable in any foreign currency,

(ii) Drafts, travellers' cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency,

(iii) Drafts, travellers' cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency.

Foreign Currency

Foreign currency means any currency other than Indian currency.

Foreign Security

Foreign security means any security, in the form of shares, stocks, bonds, debentures or any other instrument denominated or expressed in foreign currency and includes securities expressed in foreign currency, but where redemption or any form of return such as interest or dividends is payable in Indian currency.

Person

Person includes—

(i) An individual.

(ii) A Hindu undivided family,

(iii) A company,

(iv) A firm,

(v) An association of persons or a body of individuals, whether incorporated or not,

(vi) Every artificial juridical person, not falling within any of the preceding sub-clauses, and

(vii) Any agency, office or branch owned or controlled by such person.

Person Resident in India

Person resident in India means—

(i) A person residing in India for more than one hundred and eighty-two days during the course of the preceding financial year but does not include—

(A) a person who has gone out of India or who stays outside India, in either case—

(a) for or on taking up employment outside India, or

(b) for carrying on outside India a business or vocation outside India, or

(c) for any other purpose, in such circumstances as would indicate his intention to stay outside India for an uncertain period;

(B) a person who has come to or stays in India, in either case, otherwise than—

(a) for or on taking up employment in India, or

(b) for carrying on in India a business or vocation in India, or

(c) for any other purpose, in such circumstances as would indicate his intention to stay in India for an uncertain period;

(ii) Any person or body corporate registered or incorporated in India,

(iii) An office, branch or agency in India owned or controlled by a person resident outside India;

(iv) An office, branch or agency outside India owned or controlled by a person resident in India;

Person Resident Outside India

Person resident outside India means a person who is not resident in India.

Service

Service means service of any description which is made available to potential users and includes the provision of facilities in connection with banking, financing, insurance, medical assistance, legal assistance, chit fund, real estate, transport, processing, supply of electrical or other energy, boarding or lodging or both, entertainment, amusement or the purveying of news or other information, but does not include the rendering of any service free of charge or under a contract of personal service.

Authorised Person

Authorised person means an authorised dealer, money changer, offshore banking unit or any other person for the time being authorised under the Act to deal in foreign exchange or foreign securities.

Currency

Currency includes all currency notes, postal notes, postal orders, money orders, cheques, drafts, travellers' cheques, letters of credit, bills of exchange and promissory notes, credit cards or such other similar instruments, as may be notified by the Reserve Bank.

Current Account Transaction

Current account transaction means a transaction other than a capital account transaction and without prejudice to the generality of the foregoing such transaction includes—

(i) Payments due in connection with foreign trade, other current business, services, and short-term banking and credit facilities in the ordinary course of business;

(ii) Payments due as interest on loans and as net income from investments;

(iii) Remittances for living expenses of parents, spouse and children residing abroad; and

(iv) Expenses in connection with foreign travel, education and medical care of parent, spouse and children.

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Part 8

CASES

Title of the Case	Area/Dimensions
McKinsey's Agenda for India's Economic Reforms	Economic and political and government environments
South-East Asian Economic Crisis	Global economic environment
Remains of a Dream	Political and government environment
The Costs of Delay	Political and government environment
Natural Thrust	Social and global environments
The Swap	Domestic and global environments
A Question of Ethics	Business ethics
Different for Gamble	Social and global environments
Ill-treatment	Social and global environments
Human Rights Protection	Social responsibility, business ethics
Whose Basmati is it?	Global and political and government environments
The Sensex	Economic, political and government, social and global environments
Globalisation of Pop Culture	Social and global environments
The Environmental Services Business	Technological and natural environments

Case

1

An era of economic reforms ushered in India in 1991. However, even after a decade, the progress of the reforms and the performance of the economy presented a picture that was far from satisfactory. The state of and the Government's approach towards reforms even appeared to be confusing. The Union Budget Speech for 2001-02 had several proposals for further reforms so much so that it was hailed as the initiation of the second generation of the reforms. However, some of these proposals came in for opposition even from the ruling parties.

It is against this background that the McKinsey Global Institute (MGI) — an arm of the international consultancy, McKinsey and Company — presented to the Prime Minister of India, on 6th September 2001, a report titled *India: The Growth Imperative*, containing a 13-item prioritised reform agenda that would make India "a very different country in ten years time" — with a GDP growth of 10 per cent per annum, doubling of real per capita income and 75 million new jobs outside agriculture by 2010. Unless GDP grows at closer to 10 per cent a year, India could face unemployment as high as 16 per cent by 2010. The MGI has studied India's economy to see what is holding back growth and what policy changes might accelerate it and according to this study, with the right new policies, GDP growth of 10 per cent a year is within India's reach.

The Report is based on a detailed examination of 13 sectors—two in agriculture, five in manufacturing and six in services. Together, they accounted for 26 per cent of India's GDP and 24 per cent of its employment. The researchers these findings identified the barriers to productivity and output growth in each of these sectors in a bottom-up, rigorous manner and quantified their impact. These findings were then extrapolated to the overall economy.

According to the MGI Report, there are three main barriers to faster growth.

- The multiplicity of regulations governing product markets (*i.e.,* regulations that affect either the price or output in a sector).
- Distortions in the land markets.
- Widespread government ownership of businesses.

TABLE C.1.1 : THE REFORM ROUTE TO FASTER GDP GROWTH

India (status quo)	5.5%
Product market barriers	2.3%
Land market barriers	1.3%
Government ownership	0.7%
Others (include poor transport infrastructure and labour market reforms)	0.35%
India (with complete reforms)	10.0%

The MGI has estimated that together these inhibit GDP growth by around 4 per cent in a year. In contrast, it was found that the factors more generally believed to retard growth — inflexible labour laws and poor transport infrastructure — while important, constrain India's economic performance by less than 0.5 per cent of GDP a year. Therefore, it would be a mistake to focus growth policies exclusively on these familiar problems. To raise India's growth trajectory, a broader reform agenda is required.

The Report argues that removing the main barriers to growth would enable India's economy to grow as fast as China's, at 10 per cent a year. Annual growth in labour productivity would double to 8 per cent. Some 75 million new jobs would be created, sufficient not only to ward off the looming crisis in employment, but also to reabsorb any workers that might be displaced by productivity improvements.

In order to overcome the main hurdles to growth and to ensure that India's economy grows as fast as it must, the government will have to adopt a deeper, faster process of reform immediately. The MGI has identified 13 policy changes the government should enact. See Table C.1.2. It may

be noted that the McKinsey proposals have many thing in common with the recommendations made by some official bodies as well as by others in India. See Box C.1.1.

TABLE C.1.2 : REFORM MEASURES REQUIRED

Category		*Action*	*Key sectors directly affected*
Product market	1	Eliminate reservation of all products for small-scale industry; start with 68 sectors accounting for 80 per cent of output of reserved sectors	• 836 manufactured goods
	2	Equalise sales tax and excise duties for all categories of players in each sector and strengthen enforcement	• Hotels and restaurants • Manufacturing (e.g., steel, textiles, apparel) • Retail trade
	3	Establish effective regulatory framework and strong regulatory bodies	• Power • Telecom • Water supply
	4	Remove all licensing and quasi-licensing restrictions that limit number of players in affected industries	• Banking • Dairy processing • Petroleum marketing • Provident fund management • Sugar
	5	Reduce import duties on all goods to levels of South-East Asian Nations (10 per cent) over 5 years	• Manufacturing
	6	Remove ban on foreign direct investment in retail sector and allow unrestricted foreign direct investment in all sectors	• Insurance • Retail trade
Land market	7	Resolve unclear real estate titles by' setting up fast-track courts to settle disputes, computerising land records, freeing all property from constraints on sale, and removing limits on property' ownership	• Telecom • Construction • Hotels and restaurants
	8	Raise property taxes and user charges for municipal services and cut stamp duties (tax levied on property transactions to promote development of residential and commercial land and to increase liquidity of land market)	• Retail trade
	9	Reform tenancy laws to allow rents to move to market levels	
Government ownership	10	Privatise electricity sector and all central and state government-owned companies; in electricity sector, start by privatising distribution; in all other sectors, first privatise largest companies	• Airlines • Banking and insurance • Manufacturing and mining • Power • Telecom
Others	11	Reform labour laws by repealing Section 5-B of the Industrial Disputes Act; introducing standard retrenchment-compensation norms; allowing full flexibility in use of contract labour	• Labour-intensive manufacturing and service sectors
	12	Transfer management of existing transport infrastructure to private players, and contract out construction and management of new infrastructure to private sector	• Airports • Ports • Roads
	13	Strengthen extension services to help farmers improve yields	• Agriculture

The Effects of Reform

According to the MGI report, if India immediately removes all the existing barriers to higher productivity, the resulting increases in labour and capital productivity will boost growth in overall GDP to 10 per cent a year; they will release capital for investment worth 5.7 per cent of GDP; and they will generate 75 million new jobs outside agriculture, in modern as well as transitional sectors. (The report observes that India's economy has three types of sector: modern sectors with production processes resembling those in modern economies — provide 24 per cent of employment and 47 per cent of output; transitional sectors provide 16 per cent of employment and 27 per cent of output; and agricultural sectors provide 60 per cent of employment and 26 per cent of output. Transitional sectors comprise those informal goods and services consumed by a growing urban population: street vending domestic service, small-scale food processing and cheap, mud housing, to name a few. The transitional businesses typically require elementary skills and very little capital, so they tend to absorb workers moving out of agriculture.)

Removing all the productivity barriers would almost double growth in labour productivity to 8 per cent a year over the next ten years. The modern sectors would account for around 90 per cent of the growth, while it would remain low in the other two sectors. In fact, productive in the modern sectors of the economy would increase almost three times over the next 10 years. Though there may be small improvements in agricultural productivity, mainly from yield increases, the massive rise in agricultural productivity which mechanised farming has supported in developed countries is unlikely to occur in India for another ten years, at least, while there is still a surplus of low-cost rural labour to deter farmers from investing in advanced machines. Enterprises in the transitional sectors have inherently low labour productivity because they use labour-intensive "low-tech" materials, technologies or business formats. So although these sectors will grow to meet the rising urban demand, their labour productivity will remain about the same.

If all the barriers were removed, capital productivity in the modern sectors would grow by at least 50 per cent. Increased competition would force managers to eliminate the tremendous time and cost overruns on capital projects and low utilisation of installed capacity which they can get away with now, especially in state-run enterprises. Regulation to ensure healthy competition, equitably enforced, would prevent unwise investments common today.

Although many policymakers and commentators believe it would take investment equivalent to more than 35 per cent of GDP, an almost unattainable amount, to achieve a 10 per cent GDP growth rate in India, McKinsey's analyses suggest that, at the higher levels of labour and capital productivity, India can achieve this rate of GDP growth with investment equivalent to only 30 per cent of GDP a year for a decade.

According to the Report, although still a challenge, this rate is certainly achievable, since removing the barriers that hinder productivity will unleash extra funds for investment, equivalent to the consequent drop in the public deficit and the increase in FDI. These sources, by themselves, would be sufficient to increase investment from its current level of 24.5 per cent of GDP to 30.2 per cent. The funds would be released in the following manner: Removing the barriers to labour productivity would generate extra revenue for the government through more efficient taxation — particularly on property — and from privatisation, and the government would save what it now spends on subsidies to unprofitable state-owned enterprises. As a result, its budget deficit would decrease by around 4 per cent of GDP, an amount which would then become available for private investment elsewhere.

According to the Report, productivity growth and increased investment will create more than 75 million new jobs outside agriculture in the next 10 years compared to the 21 million projected as a result of current policies. But while most of the productivity gains and 32 million of the new jobs will, indeed, appear in the modern sectors, 43 million new jobs will be created in the transitional sectors, making the move to town worthwhile for low paid and underemployed

agricultural workers. Agricultural wages will therefore rise. Although there will be job losses in government dominated sectors like steel, retail banking and power, these will be more than offset by new jobs in transitional and modern sectors such as food processing, retail trade, construction, apparel and software. More workers with more disposable income will stimulate more demand for goods and services. Greater demand will create opportunities for further investment, in turn creating more jobs.

The migration of labour between sectors is a feature of all strongly growing economies and should be welcomed by policymakers. For even though increasing productivity may displace labour, it stimulates more overall employment.

The Report counsels that while the Central Government must take die lead, State Governments will have a crucial supporting role to play: one-third of the reforms required—those concerning the land market and power sectors—lie in their hands. However, State Governments will need careful guidance from the centre. Central Government should identify for each state the critical areas for reform; design model laws and procedures for the states to adapt and enact; and encourage them to inclement the reforms with financial incentives.

BOX C. 1.1 : REFORM PROPOSALS

Prime Minister `s Economic Advisory Council Report

- *End controls on movement and stocking of agricultural commodities*
- *Revise the procurement policy; limit role of FCI*
- *Abolish Milk and Milk Products Control Order and retention price scheme for fertilisers*
- *Involve private sector in agricultural R&D*
- *Reduce import tariffs to 12 per cent by 2005*
- *End small-scale sector reservation*
- *Amend labour laws to facilitate companies to restructure*
- *Speed up the privatisation process*

The Ahluwalia Task Force on Employment Opportunities

- *End all controls on agriculture and ease regulations on food processing*
- *Liberalise leasing of land to enable commercialisation of agriculture*
- *End small-scale reservation*
- *Repeal the Rent Control Act; reduce stamp duties; liberalise land use rules*
- *Allow FDI in retail; encourage modern supermarkets and department stores*
- *Reform labour laws*

QUESTIONS

1. Evaluate the recommendations of the McKinsey Report.
2. Discuss the implications of each of the recommendations for business.
3. Assuming that McKinsey's recommendations are worth accepting, what are the essential conditions/requirements for implementing them?

— F — F — F —

Case

SOUTH-EAST ASIAN ECONOMIC CRISIS

2

An economic crisis, which erupted in Thailand in mid-1997 and which soon spread to neighbouring countries—Malaysia, Indonesia, Philippines and South Korea – came to be popularly referred to as South-East Asian economic crisis (although South Korea is in East Asia and only the other countries are in South-East Asia).

Although experts do not fully agree on the reasons behind the crisis, it is generally held that the crisis was caused mainly by the following factors.

1. Persistence of large current account deficit.
2. Large foreign debt and particularly, a high proportion of short-term debt.
3. Large inflow of foreign capital, particularly the sensitive short-term capital.
4. Indiscriminate lending by banks and other financial institutions, arising from lack of adherence of financial intermediaries to prudent norms concerning capital adequacy, asset classification, provisioning, and absence of disclosure requirements.
5. Lack of transparency in the economic system that made proper judgement by investors and others, for decision making difficult.
6. Over-investment in several sectors.
7. Imprudent lending by international lenders.
8. Large *real effective exchange rate* appreciation.

As the crisis first occurred in Thailand, a look at the factors which led to the Thai crisis would help understand reasons for the emergence of the crisis. These factors are depicted in Fig. C.2.1.

Because of the appreciation of the Yen against the US dollar after the *Plaza Accord* of 1985, Japanese exports were becoming costlier and hence Japanese firms were on the lockout for cheap manufacturing locations. The cheap Thai labour attracted lot of FDI from Japan. (and also from other countries). The high returns on short-term investments attracted large portfolio investments and short-term funds to Thailand. The pegged exchange rate system followed by the SE Asian countries encouraged such investments because of the absence of exchange rate risk under that system. The high interest rate differential between the developed markets and Thailand (also other SE Asian countries) tempted banks to channel funds from developed economies to Thailand. The indiscriminate lending by banks (and other financial institutions) resulted in the over-expansion of several industries. The speculative investments in real estate created such a situation that the occupancy rates in new buildings were only about 20 per cent. The inability of the borrowers to repay resulted in 58 of the 91 finance companies downing the shutters.

The investment spurt and increase in the demand for labour made Thai labour very costly—reported to be 3 to 5 times than the labour in neighbouring countries including China. The Thai exports suffered a setback due to increasing cost and increasing competition from cheap Chinese goods. The increased spending and high cost in Thailand encouraged imports, causing alarming current account deficit.

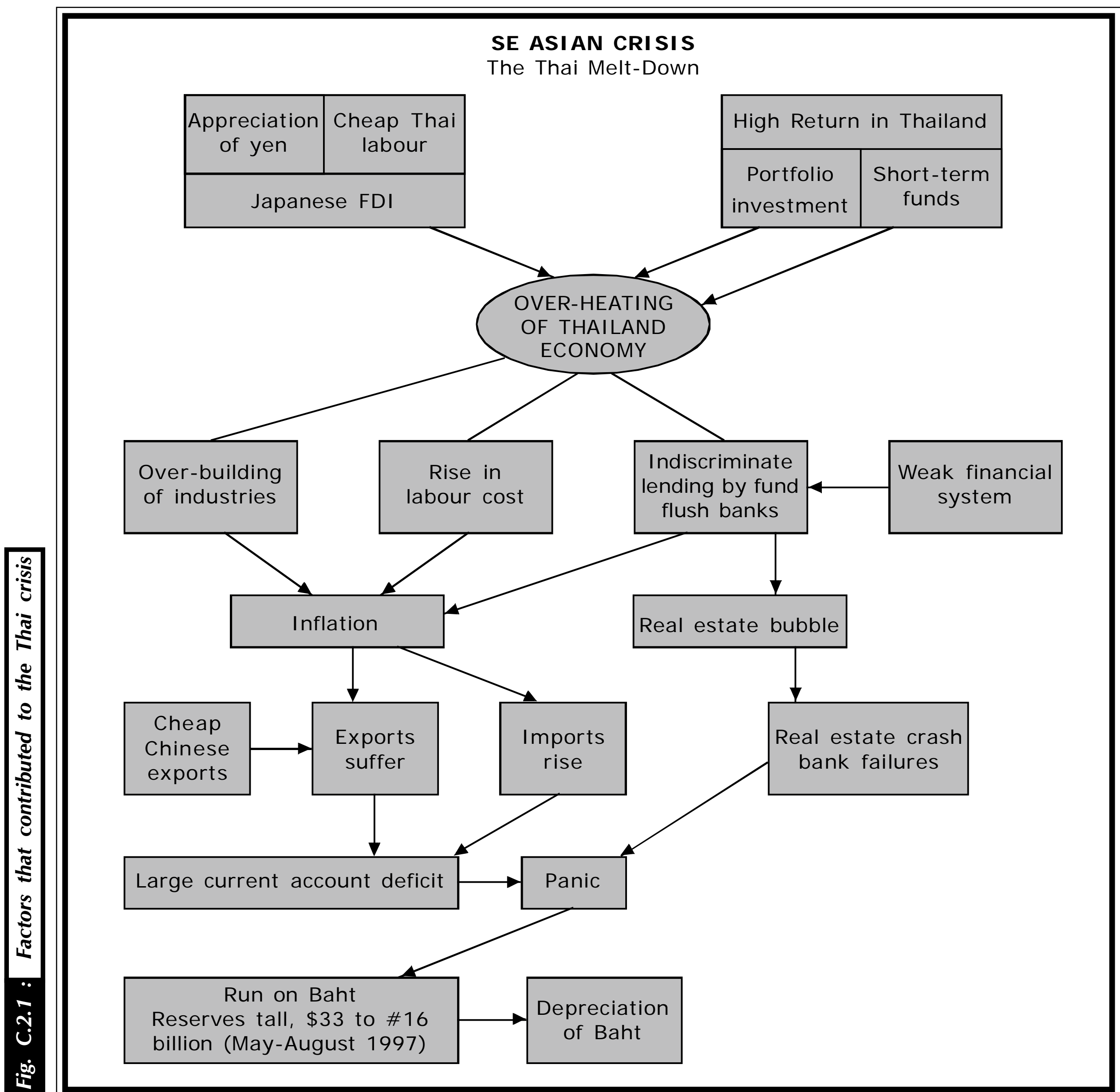

Fig. C.2.1 : *Factors that contributed to the Thai crisis*

All the above developments created an all around panic and the feeling that the Thai currency, *Baht,* would have to be devalued became stronger. There was a run on the *Baht*—people wanted to convert *Baht* into dollar so that they could re-exchange dollar for more units of *Baht* when it would be devalued. The Thai Central bank sold more than $23 billions forward in a desperate attempt to defend *Baht*. This only encouraged speculation. Finally, from July 2, the *Baht* was allowed to float. It immediately depreciated by 20 per cent and further later.

As the crisis, emerged, short-term foreign investors began to withdraw their money. The crisis soon spread to other SE Asian countries where the conditions, in several respects, were similar to those in Thailand. Between end of June 1997 and end of March 1998, depreciation of these currencies against the US$ ranged between 11 per cent and 74 per cent. Between end of June 1997 and end of January 1998, stock prices declined in the range of 32 to 53 per cent. As these SE Asian economies were highly integrated with the rest of the world, the crisis have had its impact on the world economy as a whole. The high foreign trade to GDP ratio of these nations (varying between 50 and 120 per cent) is one indication of their global integration. Equally important are the inward and outward capital flows.

TABLE C.2.1 : CURRENT ACCOUNT DEFICIT (PER CENT OF GDP)

	1995	*1996*	*1997*
Indonesia	–3.3	–3.3	–2.9
S. Korea	–2.0	–4.9	–2.8
Malaysia	–10.0	–4.9	–5.8
Philippines	–4.4	–4.7	–4.5
Thailand	–8.0	–7.9	–3.9
India	–1.1	–1.8	–1.0

TABLE C.2.2 : EXTERNAL DEBT RATIOS (1996)

	Total debt as % of GNP	*Short-term debt as % of total debt*	*Debt service ratio*
Indonesia	67	25	37
Malaysia	49	28	8
Philippines	54	19	14
Thailand	56	41	12
India	28	7	24

QUESTIONS

1. Discuss the possible impact of the South-East Asian economic crisis on:
   (i) Exports of India to South-East Asia
   (ii) Exports of India to the rest of the world
   (iii) Imports of South-East Asia to India
   (iv) Global trade of South-East Asia
   (v) FDI and portfolio investments in South-East Asia
   (vi) FDI and portfolio investments in India
   (vii) South-East Asian Investment in India
   (viii) South-East Asian companies
2. Discuss whether there is possibility of South-East Asian type crisis occurring in India.

— F — F — F —

Case

3

REMAINS OF A DREAM

This is a tragic story, narrated in first person, of an entrepreneur who became bankrupt for no fault of him, without producing anything, mostly because of the irresponsible political and government environment. This case study, documented by Bibek Debroy and P.D. Kaushik and published in *Business Today* is reproduced here with permission.

In the 1980s, I worked as a chemical analyst for a transnational in Germany, but kept thinking about shifting to India.

Opportunity knocked when I saw an advertisement by the Uttar Pradesh government inviting NRI professionals to start a chemical unit in the newly identified Basti Chemical Industrial Complex. I hail from Lucknow. Hence, this was attractive. I inquired from the Indian High Commission and was told that there is single window clearance for NRI investors. The brochure said several things about the benefits—excise and sales tax holiday for five years, uninterrupted power supply, low rate of interest on loans, and clearance of application within 30 days.

I started the application formalities for a chemical unit. Once the application was accepted, I requested for long leave from my employers. I also inquired from my relatives in Lucknow and was told that the Uttar Pradesh government's intentions are clear, and developmental work is progressing at fast speed.

Every now and then, I received a letter from the ministry of industry in Uttar Pradesh to furnish some paper or the other, as part of procedural formalities. After three months, I received my provisional sanction letter for allotment of land, and term loan. The letter also stated that within six months, I must take possession of the land, and initiate construction. Otherwise, the deposited amount (₹ 1 lakh as part of my contribution) will be forfeited. I resigned from the company, and shifted permanently to India, since my employer turned down my request for long leave.

On reaching the complex, I was surprised to see that the Uttar Pradesh State Industrial Development Corporation (UPSIDC) had actually developed the land in terms of markers, and signboards, compared to what I had seen on my last visit.

Though roads were not fully laid, it was evident that work was in progress. I took possession of my land and started construction.

Meanwhile, I approached the UPFC for granting me the term loan for ordering the plant and machinery. The first obstacle came from the Uttar Pradesh State Electricity Board (now Uttar Pradesh Power Corporation). The electricity supply to the complex was not yet available. On inquiring, I was told that the plan had been sanctioned, but required clearance from the power ministry, before undertaking further work. The approximate time to get grid supply ranged between four and six months.

The next obstacle came from the Uttar Pradesh Financial Corporation (UPFC). It could release the first instalment after I completed construction till the plinth level. I continued work with the help of a diesel generating set. It took another month to reach the plinth level.

But before I could request UPFC to release my first instalment, I received a letter from UPFC that I had to deposit interest against the amount paid to the UPSIDC for land possession. This was a shock, because interest had to be paid even before anything was produced.

But I had no alternative, because the first instalment was due. The UPFC promptly released the first instalment after inspecting the construction. It helped me continue construction work, and also book for plant and machinery.

Six months went by. Construction was almost complete. I had received three instalments from the Uttar Pradesh Financial Corporation (UPFC). Each time the payment of interest was due, the required sum was adjusted from the instalment released. If there was any shortfall in money required for construction, I paid from my own pocket.

But after nine months, my coffers went empty. Machinery suppliers were after me, for payment. UPFC insisted on interest payments, because this was the last instalment of my term loan and interest due couldn't be deducted from future instalments. I borrowed from family and friends and paid up. Then I received the final instalment from UPFC for plant and machinery, with another notice that the yearly instalment for the principal was due.

Within two months, machinery was commissioned at the site. But electricity was yet to reach the complex. In the previous year, I had visited the Uttar Pradesh State Electricity Board (UPSEB) office innumerable times. I also approached the industry association to assist me. But all my efforts were in vain. This did not help me, or others like me, to get the grid supply.

There were 14 others who were in the same boat. The biggest company of them all—obviously with contacts at higher levels—arranged for grid supply from the rural feeder. But that plan also did no take off, because the rural feeder supplied poor quality power for a mere six hours. A process industry requires 24 hours of uninterrupted electricity supply without load fluctuations. It is precisely because of this that all 15 of us, who were waiting for electricity, had insisted on industrial power from UPSEB.

All plans failed. Captive generation was not a viable alternative now. And we continued to wait for the grid supply. We met the former minister for industry and pleaded our case. He assured us that he would take up the case with the power ministry.

Meanwhile, I defaulted on interest payments. So did the others. The final blow came in the Assembly elections, when both the sitting : Member of Legislative Assembly, from Basti, and the state industrial minister lost their seats. Suddenly, everything—from road construction work, to the laying of sewer and phone lines—came to a standstill.

Only the police post and the UPSKB rural feeder office remained. The new incumbent in the industrial ministry hailed from Saharanpur, so the thrust of the ministry changed. Basti was not on their priority list anymore. After waiting for two years, UPSEB was not able to connect the complex with grid supply.

In the end, UPFC initiated recovery action and sealed my unit. Besides, they claimed that I could not get NRI treatment, with preferential interest rates, because I had permanently moved to India. Thus, there were also plans to file a case against me on account of misinforming the corporation. Experts suggested I should file for insolvency if I wanted to avoid going to prison. This I did in 1994. I spent ₹ 15 lakh from my own pocket.

Now, all that remains of an entrepreneurial dream is a sealed chemical unit in Basti and a complex legal tangle.

I was better off working for the transnational in Germany. Power does not come out of the barrel of a gun. A gun's barrel comes out of power, especially when the latter does not exist.

QUESTIONS

1. Identify and analyse the environmental factors in this case.
2. Who were all responsible for this tragic end?
3. Is it right on the part of the government and promotional agencies to woo entrepreneurs by promising facilities and incentives which they are not sure of being able to provide?
4. Should there be legislation to compensate entrepreneurs for the loss suffered due to the irresponsibility of public agencies? What problems are likely to be solved and created by such a legislation?
5. What are the lessons of this case for an entrepreneur and government and promotional agencies?

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Case

4

THE COSTS OF DELAY

The public sector Indian Oil Corporation (IOC), the major oil refining and marketing company which was also the canalising agency for oil imports and the only Indian company in the Fortune 500, in terms of sales, planned to make a foray in to the foreign market by acquiring a substantial stake in the Balal Oil field in Iran of the Premier Oil. The project was estimated to have recoverable oil reserves of about 11 million tonnes and IOC was supposed to get nearly four million tonnes.

When IOC started talking to the Iranian company for the acquisition in October 1998, oil prices were at rock bottom ($11 per barrel) and most refining companies were closing shop due to falling margins. Indeed, a number of good oil properties in the Middle East were up for sale. Using this opportunity, several developing countries "made a killing by acquiring oil equities abroad."

IOC needed Government's permission to invest abroad. Application by Indian company for investing abroad is to be scrutinised by a special committee represented by the Reserve Bank of India and the finance and commerce ministries. By the time the government gave the clearance for the acquisition in December 1999 (*i.e.,* more than a year after the application was made), the prices had bounced back to $24 per barrel. And the Elf of France had virtually took away the deal from under IOC's nose by acquiring the Premier Oil.

The RBI, which gave IOC the approval for $15 million investment, took more than a year for clearing the deal because the structure for such investments were not in place, it was reported.

QUESTIONS

1. Discuss internal, domestic and global environments of business revealed by this case.
2. Discuss whether it is the domestic or global environment that hinders the globalisation of Indian business.
3. Even if Elf had not acquired Premier Oil, what would have been the impact of the delay in the clearance on IOC?
4. What would have been the significance of the foreign acquisition to IOC?
5. What are the lessons of this case?

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Case

Balsara Hygiene Products Ltd., which had some fairly successful household hygiene products introduced in 1978 a toothpaste, *Promise*, with clove oil (which has been traditionally regarded in India as an effective deterrent to tooth decay and tooth ache) as a unique selling proposition. By 1986 Promise captured a market share of 16 per cent and became the second largest selling toothpaste brand in India. There was, however, an erosion of its market share later because of the fighting back of the multinationals. Hindustan Lever's *Close-Up* gel appealed to the consumers, particularly to the teens and young, very well and toppled Promise from the second position.

Supported by the Export Import Bank of India's Export Marketing Finance (EMF) programme and development assistance, Balsara entered the Malaysian market with Promise and another brand of tooth paste, *Miswak*.

The emphasis on the clove oil ingredient of the Promise evoked good response in Malaysia too. There was good response to Miswak also in the Muslim dominated Malaysia. Its promotion highlighted the fact that miswak (Latin name: Salvadora Persica) was a plant that had been used for centuries by as a tooth cleaning twig. It had references in Koran. Quoting from *Faizal-E- Miswak*, it was pointed out that prophet Mohammed used "miswak before sleeping at night and after awakening." The religious appeal in the promotion was reinforced by the findings of scientists all over the world, including Arabic ones, of the antibacterial property of clove and its ability to prevent tooth decay and gums.

Market intelligence revealed that there was a growing preference in the advanced counties for nature based products. Balsara tied up with Auromere Imports Inc. (AAII), Los Angeles. An agency established by American followers of Aurobindo, an Indian philosopher saint. Eight months of intensive R&D enabled Balsara to develop a tooth paste containing 24 herbal ingredients that would satisfy the required parameters. *Auromere* was voted as the No.1 toothpaste in North Eastern USA in a US Health magazine survey in 1991.

The product line was extended by introducing several variants of Auromere. A saccharine free toothpaste was introduced. It was found that mint and menthol were taboo for users of homoeopathic medicines. So, a product free of such mints was developed. Auromere Fresh Mint for the young and Auromere Cina Mint containing a combination of cinnamon and peppermint were also introduced. When the company realised that Auromere was not doing well in Germany because of the forming agent used in the product, it introduced a chemical free variant of the product.

QUESTIONS

1. Explain the environmental factors which Balsara used to its advantage.
2. What is the strength of AAII to market ayurvedic toothpaste in USA?

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Case

THE SWAP

6

The Economic Times, 22 October 2000, reported that Reliance Industries entered into a swap deal for the export and import of 36 cargoes of naphtha over the next six months. Accordingly, three cargoes of 50,000 tonnes each were to be exported every month from Reliance Petroleum's Jamnagar refinery and three cargoes of the same amount were to be imported to the Reliance Industries' Hazira facility. The deal was done through Japanese traders Mitsubishi, Marubeni, ltochu, IdCmitsu and Shell. The export was done at around Arabian Gulf prices plus $22.

Reliance needs petrochemical grade naphtha for its Hazira facility which is not being produced at Jamnagar. Therefore, its cracker at Hazira gets petrochemical grade naphtha from the international markets in return for Reliance Petroleum selling another grade of naphtha from its Jamnagar refinery to the international oil trade.

If RIL imports naphtha for Hazira petrochemical plant, the company does not have to pay the 24 per cent sales tax, which it will have to pay on a local purchase, even if it is from Reliance Petro. Besides, Reliance Petro will also get a 10 per cent duty drawback on its crude imports if it exports naphtha from the refinery at Jamnagar.

The export of naphtha with Japanese traders is being looked as a coup for Reliance as it gives the company an entry into the large Japanese market.

Indian refineries have a freight advantage over the Singapore market and can quote better prices.

QUESTIONS

1. Examine the internal and external factors behind Reliance's decision for the swap deal.
2. What environmental changes could make swap deal unattractive in future?
3. Could there be any strategic reason behind the decision to import and export naphtha?
4. Should Reliance import and export naphtha even if it does not provide any profit advantage?

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Case

7

A QUESTION OF ETHICS

TELCO opened bookings for different models of its proud small car *Indica* in late 1998. The consumer response was overwhelming. Most of the bookings were for the AC models, DLE and DLX. The DLE model accounted for more than 70 per cent of the bookings.

Telco has planned to commence delivery of the vehicles by early 1999. However, delivery schedules for the AC models were upset because of some problems on the roll-out front. According to a report in *The Economic Times* dated 13 March, 1999, Telco officials attributed the delay to non-availability of air-conditioning kits.

Subros Ltd. supplies AC kits for the DLE version and Voltas is the vendor for the DLX version. Incidentally, Subros is also the AC supplier to Maruti Udyog Ltd.

Telco officials alleged that Subros was being pressured by the competitor to delay the supply of kits. "If this continues, we will be forced to ask Voltas to supply kits for the DLE version too," a company official said.

QUESTIONS

1. Why did Telco land itself in the problem (supply problem in respect of AC kits)?
2. If the allegation about the supplier is right, discuss its implications for the supplier.
3. Evaluate the ethical issues involved in the case. (Also consider the fact Maruti was 50 per cent Government-owned).

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DIFFERENT FOR GAMBLE

8

Procter and Gamble (P&G), a global consumer products giant, "stormed the Japanese market with American products, American managers, American sales methods and strategies. The result was disastrous until the company learnt how to adapt products and marketing style to Japanese culture. P&G which entered the Japanese market in 1973 lost money until 1987, but by 1991 it became its second largest foreign market."

P&G, acclaimed as "the world's most admired marketing machine", entered India, which has been considered as one of the largest emerging markets, in 1985. It entered the Indian detergent marketing the early nineties with the *Ariel* brand through P&G India (in which it had a 51 per cent holding which was raised 65 per cent in January 1993, the remaining 35 per cent being hold by the public). P&G established P&G Home products, a 100 per cent subsidiary later (1993) and the Ariel was transferred to it. Besides soaps and detergents, P&G had or introduced later product portfolios like shampoos (Pantene) medical products (Vicks range, Clearasil and Mediker) and personal products (Whisper feminine hygiene products, Pampers diapers and Old Spice range of men's toiletries).

The Indian detergents and personal care products market was dominated by Hindustan Lever Ltd. (HLL). In some segments of the personal care products market, the multinational Johnson & Johnson has had a strong presence. Tata Group's Tomco, which had been in the red for some time, was sold to Hindustan Lever Ltd. (HLL). HLL, a subsidiary of P&G's global competitor, has been in India for about a century. The takeover of Tomco by HLL further increased its market dominance. In the low priced detergents segment, Nirma has established a very strong presence.

Over the period of about one-and-a-half decades since its entry in India, P&G invested several thousand crores. However, dissatisfied with its performance in India, it decided to restructure its operations, which in several respects meant a shrinking of activities – the manpower was drastically cut, and thousands of stockists were terminated. P&G, however holds that, it will continue to invest in India. According to Gary Cofer, the country manager, "it takes time to build a business category or brand in India. It is possibly an even more demanding geography than others."[1]

China, on the other hand, with business worth several times than in India is less than 12 years, has emerged as a highly promising market for P&G. When the Chinese market was opened up, P&G was one of the first MNCS to enter. Prior to the liberalisation, Chinese consumers had to content with shoddy products manufactured by government companies. Per capita income of China is substantially higher than India's and the Chinese economy was growing faster than the Indian. Further, the success of the single child concept in China means higher disposable income.

Further, it is also pointed out that for a global company like P&G, understanding Chinese culture was far easier since the expat Chinese in the US was not very different from those back home whereas most Indian expats tended to adapt far more to the cultural nuances of the immigrant country.[2]

One of P&G's big bets in India was the compact technology premium detergent brand *Ariel*. After an initial show, Ariel, however, failed to generate enough sales – consumers seem to have gone by the per kilo cost than the cost per wash propagated by the promotion. To start with, P&G had to import the expensive state-of-the-art ingredients, which attracted heavy customs duties. The company estimated that it would cost ₹ 60 per kilo for Ariel compared to ₹ 27 for Surf and ₹ 8 for Nirma. Because of the Rupee devaluation of the early 1990s, the test market price of ₹ 35 for 500 gms was soon ₹ 41 by the time the product was launched. HLL fought Ariel back with premium variants of Surf like Surf Excel.

It is pointed out that, "in hindsight, even P&G managers privately admit that bringing in the latest compact technology was a big blunder. In the eighties, P&G had taken a huge beating in

one of its most profitable markets, Japan, at the hands of local company Kao. Knowing the Japanese consumer's fondness for small things, Kao weaved magic with its new-found compact technology. For a company that prided itself on technology, the drubbing in Japan was particularly painful. It was, therefore, decided that compacts would now be the lead brand for the entire Asia-Pacific region. When P&G launched Ariel in India, it hoped that the Indian consumer would devise the appropriate benchmarks to evaluate Ariel. As compacts promised economy of use, P&G hoped that consumers would buy into the low-cost-per-wash story. But selling that story through advertising was particularly difficult, especially since Indian consumers believed that the washing wasn't over unless the bar had been used for scrubbing. Even though Ariel was targeted at consumers with high disposable income, who represented half the urban population, consumers simply baulked at the outlay.

Thereafter, one thing led to another. Ariel's strategy of introducing variants was a smart move to flank Lever at every price point by cleverly using the brand's halo effect. And by supporting the brand in mass media and retaining the share of voice. By 1996, it had become clear that Ariel's equity as a high-performance detergent had begun to take a beating. Its equity as a top-of-the-line detergent was getting eroded...Nowhere in P&G's history had a concept like Super Soaker been used to gain volumes...It was decided that Super Soaker would no longer be supported, nor would Ariel bar be supported in media."[3]

QUESTIONS

1. Discuss the reasons for the initial failure of P&G in Japan.
2. Where did P&G go wrong (if it did) in the evaluation of the Indian market and its strategy?
3. Discuss the reasons for the differences in the performance of P&G in India and China.

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3. ***Ibid.***

— F — F — F —

Case

9

ILL-TREATMENT

Indian leather exports, an important foreign exchange earner for the country has been reportedly hit hard by the decision of some major US retail chains like Eddie Bauer, L.L. Bean, Timberland and Casual Corner, and a German company Bader to boycott leather goods from India in protest against the ill-treatment of animals here. This move came shortly after a decision by global retail chains Gap, Marks & L. Spencer, Liz Claiborne and J. Crew not to buy Indian leather goods. This development has a lot to do with the lobbying by the US-based animal rights group People for Ethical Treatment of Animals (PETA) for a ban on leather goods from India by documenting evidence of "cruelty to animals" killed for making leather. It has been reported that the overseas firms have officially communicated to the Indian outfit of PETA that they will not be sourcing leather products from India until there is strict enforcement of animal protection laws. Following this, the Mumbai-based Teja Industries, the official supplier of leather goods for Marks & Spencer in India, started outsourcing leather from other countries to manufacture products for the global chain.

QUESTIONS

1. In the light of the above, discuss the implications of social activist groups for business.
2. With reference to this case, discuss the failure of the governments, Council for Leather Exports and the leather industry and the lessons of this case.
3. What should the governments, Council for Leather Exports and the leather industry do to overcome the problem?

— F — F — F —

Case

Reebok, the well-known athletic shoe multinational, gets its product contract manufactured by independent firms in the developing countries. The MNC which gives importance to low cost and high quality is also concerned with human rights protection and requires its suppliers to follow the following human rights standards.

Non-discrimination: Reebok will seek business partners that do not discriminate in hiring and employment practices on grounds of race, colour, national origin, gender, religion, or political or other opinion.

Working hours/overtime: Reebok will seek business partners who do not require more than 60-hour work weeks on a regularly scheduled basis, except for appropriately compensated overtime in compliance with local laws, and we will favour business partners who use 48-hour work weeks as their maximum normal requirement.

Forced or compulsory labour: Reebok will not work with business partners that use forced or other compulsory labour, including labour that is required as a means for political coercion or as punishment for holding or for peacefully expressing political views, in the manufacture of its products. Reebok will not purchase materials that were produced by forced prison or other compulsory labour and will terminate business relationships with any sources found to utilise such labour.

Fair wages: Reebok will seek business partners who share our commitment to the betterment of wage and benefit levels that address the basic needs of workers and their families as far as possible and appropriate in light of national practices and conditions. Reebok will not select business partners that pay less than the minimum wage required by local law or that pay less than prevailing local industry practices (whichever is higher).

Child labour: Reebok will not work with business partners that use child labour. The term "child" generally refers to a person who is less than 14 years of age, or younger than the age for completing compulsory education if that age is higher than 14. In countries where the law defines "child" to include individuals who are older than 14, Reebok will apply that definition.

Freedom of association: Reebok will seek business partners that share its commitment to the right of employees to establish and join organisations of their own choosing. Reebok will seek to assure that no employee is penalised because of his or her non-violent exercise of this right. Reebok recognises and respects the right of all employees to organise and bargain collectively.

Safe and healthy work environment: Reebok will seek business partners that strive to assure employees a safe and healthy workplace and that do not expose workers to hazardous conditions.

QUESTIONS

1. Discuss the human rights protection endeavours of Reebok.
2. What are its implications for the developing country suppliers? Will these standards pose a problem for the suppliers? In what ways will these standards benefit the suppliers in particular and developing country industrial sector in general?

— F — F — F —

Case

WHOSE BASMATI IS IT?

11

Basmati is an aromatic rice grown in Northern India and Pakistan.

In September 1997, Rice Tec, a small food technology company based in Texas, United States, was granted a patent by the US patent office to call an aromatic rice variety developed in USA Basmati. India challenged the case, arguing that basmati is a unique aromatic rice grown in Northern India, and not a name Rice Tec could claim. In fact, only inventions can be patented. Consequently, the US patent office accepted India's basic position, and Rice Tec had to drop 15 of the 20 claims that it had made. Of the remaining claims, Rice Tec managed to evolve three new varieties of rice for which it got a patent from United States Patent and Trademarks Office (USPTO), as India had not objected to these. The ruling has not handed over Rice Tec the basmati brand. Rather, it provides it a patent for superior three strains of basmati developed by cross-breeding a Pakistani basmati with a semi-dwarf American variety.

According to the WTO Agreement, geographical indications like basmati can be legally protected and their misuse can be thus prevented. The unfortunate thing is that Government of India has not taken timely steps for protecting our geographical indications and biodiversity. Although a Geographical Indication of Goods Bill was introduced in Indian Parliament in 1999, even at the end of 2001 it had not become an Act.

QUESTIONS

1. Can any of the following, *viz*., turmeric, neem and the name *basmati* be patented? Substantiate your answer.
2. Evaluate the role played by Government of India in preventing the misuse of the name basmati.

— F — F — F —

Case 12

That the BSE *Sensex* crashed by 140 points, causing a fall in the investor wealth by ₹ 25,000 crore (due to the fall in the market capitalisation) the day the *Economic Survey 2000-01*, which indicated the possibility of an economic slowdown, was presented in the Parliament is an indication of the importance of economic factors to business. It is interesting to note that four days later when the Finance Minister presented the Union Budget for 2001-02, which was widely regarded business-friendly and which claimed to initiate the second generation economic reforms, the Sensex soared by 177 points. However, on the second day, the sensex nose-dived by 176 points reacting to the news of sustained weaknesses in technology stocks across the globe and certain vicious rumours.

The stock markets all over the world took a severe beating following the terrorist attack on the World Trade Centre and the consequent military actions. Although the Sensex made some recovery for about a week around mid-October 2001 largely because of positive government measures and sustained purchases by FIIs. However, the mounting fears triggered by the spread of the deadly anthrax disease and concerns about bio-terrorism triggered panic selling in most European and Asian markets, leading to chain reactions on Indian bourses. The bellwether Sensex tumbled 62 points or 2 per cent to close below the psychologically important 3,000 mark at 2,981 on 18th October, putting an end to the seven-day 279 point rally which had led to a 10 per cent rise of the Sensex. However, on the next day, equities staged a smart recovery, once again lifting the Sensex above the psychological mark of 3000 to about 3017 encouraged by Government's liberalisation share buyback conditions.

While the anthrax scare caused a setback to the stock market in general, shares of pharmaceutical companies which produce anthrax antidote ciprofloxacin like Ranbaxy, Dr. Reddy's and Cipla gained significantly. The rice of Bayer India scrip increased by 52 per cent in 10 days ended 17th October following the news that the Chennai-based Indian Syntans group was increasing its stake in Bayer through open market purchases.

The Sensex and Nifty began to move up since the results of the exit polls of the 2014 Lok Sabha election came out and they surged for months since the electron results have shown a clear majority for the BJP and the Narendra Modi Government assumed power.

QUESTION

1. Discuss the factors affecting Sensex.

— F — F — F —

Case

GLOBALISATION OF POP CULTURE

13

Cultural barriers is one of the most talked about in international business problems. It is, however, very interesting to note that cross-border transmission of culture is very rampant. Many politicians, sociologists and others are highly critical of the invasion of the Western culture in the developing countries. The export of American culture is interpreted as means to spread American imperialism. The Coca Cola culture or the corn flakes culture or the pop culture are terms which have come to be very broadly used to include, besides the pop music and associated things, the Western products and styles such as foreign jeans, cola drinks, fast foods, Hollywood movies and the like the youth, particularly, are crazy about. They have fast spread to the developed and developing countries.

The emergence of culture as economic goods that can be traded – crafts, music, films, TV programmes, software, books, tourism etc. — has contributed very substantially to the globalisation of culture.

A UNESCO study shows that world trade in goods with cultural content—printed matter, literature, music, visual arts, cinema and photographic, radio and television equipment—has grown tremendously. For the United States the largest single export industry is not aircraft, computers or automobiles—it is entertainment, in films and television programmes. Hollywood films grossed more than $30 billion worldwide in 1997, and in 1998 a single movie, *Titanic,* grossed more than $1.8 billion.

As the *Human Development Report 1999* points out, the vehicles for this trade in cultural goods are the new technologies. Satellite communications technology from the mid-1980s gave rise to a powerful new medium with a global reach and to such global media networks as CNN. The development of the Internet is also spreading culture around the world, over an expanded telecommunications infrastructure of fiber optics and parabolic antennas.

The Report referred to above points out that the global market for cultural products is becoming concentrated, driving out small and local industries. At the core of the entertainment industry—film, music and television—there is a growing dominance of US products, and many countries are seeing their local industries wither. Although India makes the most films each year, Hollywood reaches every market, getting more than 50 per cent of its revenues from overseas, up from just 30 per cent in 1980. It claimed 70 per cent of the film market in Europe in 1996, up from 56 per cent in 1987—and 83 per cent in Latin America and 50 per cent in Japan. By contrast, foreign films rarely make it big in the United States, taking less than three per cent of the market there.

QUESTIONS

1. In the light of the above account, evaluate the view that culture is a highly difficult barrier to international business.
2. What are the implications of the spread of pop culture for business?
3. What could be the reasons for the adoption, particularly by the youth, of the pop culture?
4. Can pop culture encourage achievement motivation?
5. Discuss the impact of pop culture on the domestic business? What strategies they should adopt to fight the adverse impact of the pop culture on their business?
6. Discuss the social implications of the pop culture.

— F — F — F —

Case 14

THE ENVIRONMENTAL SERVICES BUSINESS*

* Reproduced from ITC, *International Trade Forum*, Issue 2/2001

Though hardly known to the general public, environmental technologies, products and services have, in 20 years grown to match the aerospace and pharmaceutical industries in size – a US$450 billion global market in 2000. By 2010, it is expected to expand to US$640 billion. Developing and emerging markets represent over 15 per cent of this total.

According to the Organisation for Economic Cooperation and Development (OECD), "the environmental industry consists of activities which produce goods and services to measure, prevent, limit and minimise or correct environmental damage to water, air and soil, as well as problems related to waste, noise, and eco-systems". This sector deals with waste management, air pollution, water and waste, along with environmental services and equipment. But the structure of the industry is rapidly growing and changing, and it suffers from a lack of clear identity and poor representation as a sector in its own right. Canada, Japan and the United States have adopted broad definitions of the environment industry. Italy, Germany and Norway, on the other hand, have chosen narrow ones. Such differences are bound to affect any data collected on the industry.

Even more important, the unclear definition of the industry may cause confusion in the application of World Trade Organisation (WTO) agreements. There are separate WTO agreements dealing with goods and services, but this distinction is by no means clear in the environmental industry, for example, sewerage and waste-water treatment or solid waste management. This creates potential difficulties in liberalising international trade in environmental industries, although the problems are now widely recognised. Various discussion papers were prepared in advance of the General Agreement on Trades and Services (GATS) 2000 negotiations. All these papers recognise that future trade negotiations should acknowledge the integration of trade in environmental goods and services.

The current market is dominated by developed countries in North America, Western Europe and Japan. However, developing and emerging markets in Asia and Latin America are growing rapidly as protection of the environment becomes a higher priority. Developing countries with growing population and fast-paced development need environmental goods and services. In addition, aid agencies are placing a greater emphasis on sustainable development and environmental performance in their funding support programmes.

The 15 per cent estimate for the developing and emerging markets' share of the environmental industry in the 21st century compares with an estimate of less than 10 per cent in 1995, an indication of the speed with which these countries are expected to expand their environmental services. Over the decade to 2010, the United Kingdom's Joint Environmental Markets Unit predicts that developing and transition countries will expand their environmental business by 10 per cent a year, producing a market of US$178 billion, compared with a 3 per cent to 5 per cent growth in developed economies, which will still hold the lion's share of the market (perhaps US$773 billion).

Statutory requirements in North America, the impact of the North American Free Trade Agreement (NAFTA) and the demand for environmental services on the United States-Mexico border will be key driving forces for changes in environmental legislation and environmental standards required by consumers worldwide (ISO 14000) also mean opportunities for both foreign and domestic firms in the environmental services field. The European Union (EU), split between a generally mature system in the North and a developing infrastructure in the South, recently emphasised that EU candidate countries also need to take measures to harmonise existing legislation with EU environmental legislation.

In Asia, national and local governments are increasingly feeling growing public pressure to take concerted action. Improvements have been made in the past decade in the corporate sector with approaches such as the adoption of environmental management systems. This trend is expected to continue as companies perceive these environmental credentials as beneficial to their export strategies.

In China, environmental agencies face skills shortages and difficulties in enforcing compliance within a largely state-owned industrial sector. With continuing industrialisation and government environmental protection initiatives, however, it is estimated that the Chinese market will grow

by 10 per cent—faster than in other developing countries — to reach US$15 billion in 2010 from US$5 billion in 2000.

In India, new laws have been enacted in recent years, but the regulatory framework remains weak. The main market driver in India is therefore expected to be infrastructure development in the municipal and energy sectors. In all, the environmental services market is expected to, be worth US$7 billion in India by 2010.

In South America, Brazil and Chile have the most advanced regulatory frameworks, but the enforcement framework is still developing. Future growth is expected to be led by infrastructure and privatisation projects, along with stronger enforcement of environmental legislation. Current estimates put the regional market at US$15 billion by 2010.

Central and East European countries report that environmental degradation has been falling since the start of transition to market economies, even in the most polluted areas. Further development of the environmental industry is currently limited by lack of funding. By 2010, the market is expected to reach US$23 billion. The market drivers include continuing reforms in legislative and administrative frameworks, continuing privatisation, major investment in the environmental infrastructure, industrial and energy sectors, and the availability of funding through various aid programmes.

Environmental services, as distinct from the equipment or resources market, account for about 50 per cent of the total market, 22.6 per cent, water treatment services for 14.3 per cent, consulting and engineering for 5.9 per cent, and remediation and industrial services, 3.3 per cent. Given the increasing demands on industry to improve its environmental management, this whole sector is expected to grow by 7 per cent to 10 per cent a year.

Looking at the sector more closely, the United States generates about 80 per cent of worldwide hazardous waste, and is therefore the largest market for hazardous waste equipment and systems. Those most in demand include treatment chemicals, and incineration and processing equipment.

The recycling market has been growing at 7 per cent to 13 per cent a year over the last decade and this rate is expected to continue. Technologies showing increasing demand include ultra-filtration for reducing oil and paint-solvent usage, vibratory cleaning in microelectronics for reducing sludge production, and processes such as neutralisation, detoxification and evaporation. Market drivers include the enforcement of environment legislation and the obligation to meet higher recycling targets set by European countries, the United States and Japan.

BOX C.14.1 : COMPANIES AND THE ENVIRONMENT: WIMBY AND NIMBY

It is often not clear why a company moves its operations from one country to another, no matter what it says. "Real" reasons such as cheap labour, weak labour unions, unenforced health and safety regulations, low environmental regulations and standards may all be cited by critics. The idea that industries would move to other countries to escape regulations at home and find an open door elsewhere has been dubbed the "WIMBY" (Welcome in My Back Yard) phenomenon, as distinct from "NIMBY" (Not in My Back Yard).

Before the mid-1990s` several WIMBY cases were documented. More responsible businesses conversely use their investments in developing countries to transfer knowledge and technology that comply with the highest environmental standards:

- *General Motors (GM), through its Delphi subsidiary, has invested more than US$1 billion in Mexico, employing 75,000 people. Following three years of voluntary audits in all its plants to monitor environmental best practices and compliance with Mexico`s health and safety regulations, the company received a "clean enterprise" award from the Mexican Government.*
- *Most of the GM plants treat their waste waters to a standard that enables the water to be recycled and reused by manufacturing processes or for agricultural irrigation.*
- *Other materials (plastics, cardboard, solvents and other chemicals) are recycled. The company follows its own environmental guidelines, which are often tougher than those required by Mexican law.*
- *In 1997, GM launched a pilot project with local authorities in Mexico to keep track of all hazardous waste products, using a computerised system to prompt companies to arrange for the correct disposal of hazardous wastes.*

- *Following industrial investments by multinational companies around the world, end-of-pipe technologies have been exported to developing countries.*
- *Companies in various industrial sectors are adopting Corporate Environmental Reporting: they range across electricity-generating and distribution companies, government departments, water supply and sewerage companies, aviation companies, industrial conglomerates, engineering and construction firms and food retailing businesses.*

These trends create business opportunities for the environmental services sector.

In water and waste-water management — which accounts for up to 40 per cent of the total environmental market, spending on the market definition used — the strongest demand is expected to be for automatic systems, secondary and tertiary treatment facilities, and waste-water technologies, particularly computer monitoring systems, aerobic systems for removing contaminants, and air injection for groundwater clean-up systems. Air pollution control has developed rapidly over the past 20 to 30 years. However, there is little international trade and the sector is dominated by a handful of large firms. The highest growth rates in the next decade are expected for technologies such as microbial cleaning processes, electro-membrane technologies, catalytic converters, flue gas desulphurisation, and wet and flue gas scrubbers. The main industrial sectors driving this increase in demand will be the petrochemical, steel, car and energy industries.

In 1998, OECD produced a report on *"The Global Environmental Goods and Services Industry"*, listing the factors likely to influence future competitiveness:

- ***Technological innovation***: It has been estimated that 50 per cent of the environmental goods that will be in use in 15 years do not currently exist.
- ***Quality and service performance:*** The ability to adapt to clients' needs and to produce effective and easily managed products.
- ***Marketing and export strategies:*** These will need to respond to increasing globalisation and new market opportunities.
- ***Flexibility in production:*** As regulatory requirements are modified, rapid and low-cost changes in products will be required, Conventional economies of scale and cost are less important as factors. Large firms with wide competence are increasingly necessary. Tailor-made solutions dependent on performance and innovation can be more important than price.

The adoption of worldwide environmental standards will expand international markets. Privatisation and deregulation of utilities such as water and electricity will expand the opportunities for foreign firms to participate. Consolidation of the industry and increasing firm size will also increase internationalisation.

Though industries from Germany, Japan and the United States have the largest shares of most international markets, small countries such as Finland and Norway have very internationally-oriented industries that export some 50 per cent of their production. Australia, Canada and the United Kingdom are now increasing their efforts to expand environmental exports.

QUESTIONS

1. What are the factors driving the growth of the environmental services business?
2. What are the factors influencing the competitiveness in the environmental services business?
3. Discuss the scope of the developing countries in the environmental industries?

— F — F — F —

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