



# **ALAGAPPA UNIVERSITY**

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(A State University Established by the Government of Tamil Nadu)

**KARAIKUDI – 630 003**



# **ONLINE PROGRAMMES**

**B.Com.**

**I - Semester**

200213

**BUSINESS ENVIRONMENT**

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**Vikas® Publishing House:** Units (2.3, 4.2.1-4.2.2, 6.5, 12.3-12.9, 14.0-14.2)

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E-28, Sector-8, Noida - 201301 (UP)

Phone: 0120-4078900 • Fax: 0120-4078999

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**Work Order No. AU/DDE/DE1-238/Preparation and Printing of Course Materials/2018 Dated 30.08.2018 Copies - 500**

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## Business Environment

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## INTRODUCTION

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### NOTES

Two words ‘business’ and ‘environment’ comprise business environment. Business refers to the state in which a person remains busy performing some or the other activity. From an economic point of view, business implies human activities like production, extraction or purchase or sales of goods that are performed for earning profits. Ideally, the external factors influencing a business comprise a business environment. They can be forces of economic, social, political and technological factors.

In this era of globalization, a business cannot perform in isolation, since it is the social and economic organ of the society. The government of a particular country has an important role to play in the functioning of a business. It enacts legislation, formulates business policies and controls business in the best interest of people. On one hand, business environment affects the political, social and economic environment of the region it is operating in and on the other, the business in turn is affected by the country’s social, legal and political environment. A competent management system is capable of adapting to the business environment. A sound knowledge of business environment helps in capitalizing emerging opportunities, forming basis of business strategies and activating further management. This book takes a detailed look at the notion of business environment at the backdrop of the Indian business scenario.

The economic environment of business in India has been changing at a fast rate mainly due to the changes in the economic policies of the government. At the time of independence, the Indian economy was basically agrarian with a weak industrial base. The Government adopted several control measures on the functioning of private sector enterprises. All these efforts resulted a mixed response. There was growth in net national product, per capita income and development of capital goods sector and infrastructure. But rate of industrial growth was slow, inflation increased and government faced a serious foreign exchange crisis during eighties. As a result, the government of India introduced a radical change in economic policies in 1991. This policy abolished industrial licensing in most of the cases, allowed private participation in most industries; disinvestment was carried out in many public sector industrial enterprises and opened up the economy considerably. Foreign Investment Promotion Board was set up to channelise foreign capital investment in India.

This book, *Business Environment*, is divided into fourteen units that follow the self-instruction mode with each unit beginning with an Introduction to the unit, followed by an outline of the Objectives. The detailed content is then presented in a simple but structured manner interspersed with Check Your Progress Questions to test the student’s understanding of the topic. A Summary along with a list of Key Words and a set of Self-Assessment Questions and Exercises is also provided at the end of each unit for recapitulation.



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**BLOCK I**  
**INTRODUCTION AND LEGAL BUSINESS**  
**ENVIRONMENT**

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**NOTES**

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**UNIT 1 BUSINESS ENVIRONMENT**

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**Structure**

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**1.0 INTRODUCTION**

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Business environment is a marketing term and refers to factors and forces that affect a firm's ability to build and maintain successful customer relationships. The three levels of the environment are micro environment, internal environment and macro environment. This unit explains this concept of business environment in detail and describes the relating factors.

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**1.1 OBJECTIVES**

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

- Discuss concept of business environment
- Describe capitalist, socialist and mixed economy
- Explain economic role of government

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**1.2 CONCEPT OF BUSINESS**

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The term business comes from 'busyness' or the state of being busy. Business is an economic activity with the object of earning an income, i.e., profit and thereby accumulate wealth. The economic activity must be regular and continuous. It involves

## NOTES

(i) production of goods and services with a view to selling them at a profit or (ii) merely purchasing of goods and services to resell at a profit. The real objective of any business, as pointed out by Peter Drucker is to create a customer and to ensure repeat sale which is possible only when the customer can get due service and satisfaction in the marketplace where exchange takes place in monetary terms.

**Old concept of business:** In the past, business was conceived merely in terms of business. 'The business of business is business.' In those days, the exclusive objective of business was maximization of profit at any cost. Business began merely as an institution for the purpose of making money. The businessman felt no particular obligation and acknowledged no responsibility to the community. As he was the owner of the business he thought he had the perfect right to do with it what he pleased.

**New concept of business:** The modern business enterprise is a social and economic institution. It does not exist in vacuum. Business by itself is not an end, but a means to achieve an end – i.e., public welfare.

Urwick has rightly pointed out that profit can no longer be the main objective of a business than eating is the main objective of living.

According to Peter Drucker, the objective of business is to create a customer.

The customer is the master and to serve him well is the only purpose of business. Business cannot survive without customers. Modern business aims at profit through service.

### **Business in the 21st Century: e-Commerce**

E-commerce refers to the sophisticated computer technology which allows commerce through the electronic media. It is a marketplace where business is using information technology and networks to securely transform their business relationship for selling and buying the goods and services. People all over the world can obtain what they desire through a few mouse clicks on their personal computers.

The system of e-commerce is very interesting because here no money transfer takes place. Companies will maintain their catalogue and order forms on the net and customers will have to fill and send them. Hence, the mere transformation of the information and order forms are exchanged. The total system can be called the Electronic Data Interchange (EDI). Nowadays, EDI is the globally accepted method of fast and efficient business transaction. EDI eliminates the need for the paperwork by providing the electronic link between companies and between companies and customers. It is the blend of a number of internets and intranets.

The technology involved in the EDI can be explained with an example. Suppose a customer wants to purchase a Maruti car. For this, he has to first fill the order form, imprint his credit card number and send it to the respective company in an encrypted format. On receipt of the form, the company will again decrypt it and depending upon the quantity on the value of the order they will confirm the account of the said customer through the respective bank. The bank will then

furnish the information to the customer, which he sends to the company. On receiving that information the company will despatch the said commodity to the customer.

The backbone of e-commerce is the sophisticated technology of computers.

Three types of infrastructure are required to support e-commerce. First is the internet access system which is the telephone. Telephone-based access will certainly improve on the net over the years, but will continue to be urban in orientation. E-commerce transactions should have a strong credit card backbone.

## NOTES

### 1.3 LEVELS OF BUSINESS ENVIRONMENT

Suppose your objective is to become a successful manager. Your success as a manager depends on a number of factors and these constitute your work environment. As a manager you do not work in vacuum, but in an environment. When you take decisions you cannot neglect the limitations of your environment. As a business manager, you have to constantly review your business environment.

Environment refers to the sum of all factors — economic, political, social and cultural — which are external to and beyond the control of the individual business enterprises and their management. Environment furnishes the macro-contexts, while the business firm is the micro-unit. The environmental factors are a ‘given’ within which the firm operates. The environmental factors are numerous and complex. Some of these factors are static while others are dynamic. Environmental factors generally vary from country to country. The environment found in India may not be found in the USA or the UK, and vice versa.

Environment may be local, national and international. Again, environment may be market environment and non-market environment. When the business environment is influenced by market forces like demand, supply or competition, it is referred to as market environment. When business environment is influenced by social customs, government laws, religious taboos, it is referred to as non-market environment.

Also, business environment is influenced by economic and non-economic factors. Economic environment is shaped by the monetary policies, tax policies, economic policies, industrial policies, etc., of the country concerned.

The non-economic environment is shaped by political, social, cultural and historical factors.

It is necessary to examine the business environment because it will enable the manager to know which factors are helping or hindering the success of his business. If he could identify the factors which hinder his success in business, he will adopt an alternative course of action.

There are various techniques of scanning business environment.

First, identify the particular environment. Then find out what are the elements of such an environment and analyse them. Since the environmental factors are macro variables, they are beyond the control of a particular firm.

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The first technique of scanning is changing the economic activity, i.e., adjusting the means to the ends or the ends to the means.

Second, change the decision-making process of the firm. When input is the constraining factor, the firm's decision variable is the output, and when output is the constraining factor, the firm's decision variable is the input.

### Components of Environment

A business cannot be said to function within vacuum; like any other organic entity, it is in constant interaction with – and is duly impacted by – its environment. Its immediate environment may be said to be composed of micro-components such as its suppliers, customers, competitors, the workforce and attendant working climate, and regulatory agencies. Extending beyond this troposphere (to use a term more allied to geography) lies a more diffused but no less influential outer zone acting on the organization—an incredibly complex medley of influences which may be described as the macro environment. This peripheral layer comprises macro components such as the economic environment, natural environment, the political environment, demographic environment, international environment, and so on. Therefore, we shall study the effect of both the micro as well as the macro environments on business organizations.

There does not seem to be any comprehensive and all-encompassing definition of the environment surrounding a business organization. While Gerald Bell says that, 'An organization's external environment consists of those things outside an organization such as customers, competitors, government units, suppliers, financial firms and labour pools that are relevant to an organization's operations.' Paire and Anderson claim that the business environment is 'the sum of those inputs to an organization which are under the control of other organizations or interest groups or are influenced by interaction of several groups, such as the economy'.

William F. Glueck and Lawrence R. Jauch imply that there are two distinct components of the environment, micro and macro, when they say that 'The environment *includes factors outside the firm* (italics ours – eds.) which can lead to opportunities for, or threats to, the firm. Although there are many factors, the most important are socio-economic, technological, suppliers, competitors and government.' Richman and Copen maintain that the environmental factors largely, if not totally impact the firm, the boundaries of which extend well beyond its formal limits. Given this cross-section of opinions culled from management tracts, we shall be on safe ground if – for purposes of academic study – we treat the micro and macro components as separate sets of factors influencing the overall business environment of a country.

#### 1.3.1 The Micro Environment

The micro environment comprises those forces in the immediate vicinity of an organization that influence its functioning. It is this proximity that makes them so potent in their impact. While all firms have a micro environment, the components

thereof affect different firms in different ways, depending on their peculiar set of circumstances. For example, while a firm manufacturing cigarettes will be directly affected by shrinking supplies of tobacco, labour unrest or ageing plant and machinery, a flour miller will be hard hit by its customers gradually drifting towards packaged flour brands like ITC's 'Aashirwad'. Philip Kotler sums it up neatly when he says that, '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 public.' Taking a cue from Kotler, let us proceed to examine these one by one.

## NOTES

- 1. Suppliers:** A company's suppliers are its umbilical cord, since they provide it with the raw materials, components and other provisions that enable it to function. An army with its supply chain cut off will be defeated. Since suppliers are so important, companies rarely depend on only one supplier, since if, for some reason, that supplier is paralysed or shuts down its operations, the company will be left stranded. In a situation where supplies are uncertain or sporadic, companies are forced to maintain huge inventories of stocks and components such as dealers of a car maker like Daewoo, which went out of business due to an overstretched financial position and serious irregularities. Sometimes, a concerted move by suppliers to organize themselves in order to wrest more concessions from the company can also be a cause of concern. Hence, it is necessary for firms to keep track of suppliers' attitudes, financial health, changes in their immediate environment, and so on.
- 2. Customers:** Customers are the single most important reason why a company is in business, apart from its own profitability. A firm could have customers spread across a variety of segments such as governmental, foreign buyers, industrial users, wholesalers, retailers, domestic buyers, and so on. Each segment will need a separate approach, in order to tap business and for data needed for improving products and services. Each segment will need to be constantly probed and analysed so as to find out what products or services these customers prefer, or want, so that efforts can be made to meet these demands before the competition does.

This is an area that presents constant challenge in as much as the demands of customers are constantly changing; they are getting increasingly more complex, and loyalties are prone to shift to a competitor who offers what they want. Customer retention is even more crucial than winning new customers, since it is as much as five times more expensive to win a new customer than to retain an existing one. As products get increasingly commoditized, i.e., similar in terms of features, appearance and price, it is the intangibles like after sale service and the overall buying experience that helps retain/pull in customers...and more customers across segments means greater market share and share of the customer's heart and wallet space—vital ingredients of the company's profitability.

## NOTES

**3. Labour:** A healthy industrial relations climate creates amicable terms between the workforce and the management that allows a company to function smoothly. In large organizations where the labour force may number in thousands, they are usually organized into unions that periodically negotiate with the management in order to increase wages, facilities and retirement benefits. A militant trade union can lead to crippling strikes and lockouts that can severely affect a firm's prospects. Hence, labour is a force to be reckoned with in large companies. Since these labour unions often have substantial political backing, it is crucial to find various avenues to placate them or lobby for support against their anti-organizational activities... all of which only goes to illustrate how the various factors in the micro environment can be interlinked.

**4. Business Partners:** An organization's business allies can be valuable sources of support, whether in coming out in support of their policies, helping out in times of financial stringency or in any type of crisis. They could be tapped for new business avenues, sources of supplies, or even for introductions to import markets.

**5. Competitors:** Directly as well as indirectly, competitors play a crucial role in any organization's performance and progress. The various ways in which this could happen are:

(i) *Share of wallet:* With the vast majority of Indian buyers having limited disposable incomes, it has become important for businesses to actively pursue customers and influence them to buy their products. For example, a typical middle-class family may nurse the dream of owning a colour television set, a 310 litre refrigerator and an automatic washing machine, but can afford to buy only one of them. In such a situation, the company that has the most persuasive advertising and the best financing tie-ups will attract customers.

(ii) *Generic competition:* A variety of alternatives within the same market is known as generic competition. For instance, an investor looking for a suitable investment opportunity will have a number of alternatives to choose from—bank deposit, mutual funds, insurance policy, share market, etc.

(iii) *Product variants:* This is where a potential buyer is confronted by a range of alternative models to choose from. To illustrate, buyer for Hyundai's Accent model has to select from the *Viva* hatchback, the CRDi diesel version or the 'straight' version, with or without automatic transmission.

(iv) *Brand competitors:* A person willing to spend about ₹ 1,000 on a pair of denim jeans has a choice between several branded products including Levi's, 'Flying Machine', 'Ruf ' n Tuf', 'Woodlands', 'Wrangler', 'Pepe' and 'Numero Uno'.

**6. Regulatory agencies:** These would include a variety of government or independent agencies such as the Bureau of Indian Standards, the ISO (International Standards Organization), the Customs and Excise department, the Income Tax department, Civil Aviation Authority, TRAI (Telecom Regulatory Authority of India) . . .so important for all the players in the hectic telecom sector), DRDO (Defence Research and Development Organization), not to forget consumer courts, which of late have become very protective of consumer rights, taking punitive action against erring companies on the slightest pretext.

In order to thrive, gain market share and expand their customer base, companies need to adhere to a variety of statutory and regulatory provisions as laid down from time to time.

### 1.3.2 The Macro Environment

Extending far beyond the boundaries of the firm's internal and immediately exterior environments, the larger macro environment includes a host of forces and influences that have a powerful impact on policies and strategies that it would need to contend with. Many of these are beyond the power of the firm to control; all it can do is to capitalize on opportunities while steering clear of obstacles and potential minefields, all the while staying on the right side of ethicality, public opinion and statutory provisions. Moreover, with the emergence of regional alliances and the unmistakable signs of the emergence of a nascent global economy, no firm can afford to ignore the critical factors in the macro environment.

If one were to define the macro environment, Hill and Jones' version is worth recalling: 'The macro environment consists of the broader economic, social, demographic, political, legal and technological setting within which the industry and the company are placed.'

PESTLE (Political, Economic, Social, Technological, Legal and Environmental) is an analytical tool which considers external factors (macro factors) and helps you to think about their impacts on the economy of a country. It a useful tool for understanding the 'big picture' of the environment (i.e., macro environment) the country is operating in. As the name suggests, there are six factors in PESTLE analysis— political, economic, social, technological, legal and environmental. Specific examples of macro environment influences on business include competitors, changes in interest rates, changes in cultural tastes, disastrous weather, or government regulations.

Negative macro factors tend to occur in a cascading chain reaction. For example, increased unemployment in India may lead to lower consumer spending, which in turn leads to reduced imports from China, which also causes the Chinese GDP to decrease. A lowered Chinese GDP then leads to lowered expectations for growth, and leads to a decreased demand for natural resources, such as crude oil, iron or silver. This causes commodities to plummet globally, which can adversely

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affect the profits of miners in multiple countries. Positive macro factors occur in the same way. For example, as crude oil costs drop across the world on lowered demand, the average Bangladeshi consumer starts spending more on retail goods due to cash saved at the pump. These increasing retail numbers will increase demand for Indian exports, causing the Indian GDP to rise.

### Check Your Progress

1. Define E-commerce.
2. How did Hill and Jones define macro environment?

## 1.4 UNDERSTANDING THE ENVIRONMENT

Environmental scanning means an analysis of the environmental variables. A business manager operates in an environment and does not operate in a vacuum. At the same time, environmental scanning points towards interaction among environmental factors. Environment scanning is a step towards corporate planning.

### Need and Technologies of Environment Scanning

We have already pointed out the need of environment scanning. Now we shall discuss the techniques of Environment Scanning.

William F. Glueck has mentioned the following techniques of environment scanning:

- (i) Verbal and written information
- (ii) Search and scanning
- (iii) Spying
- (iv) Forecasting and formal studies

Another important technique of environment analysis is SWOT analysis. Corporate managers analyse the Strengths (S), Weaknesses (W), Opportunities (O) and Threats (T) that exist for the organization in the context of its environments. SWOT analysis is a systematic identification of these factors and the strategy that reflects the best match between them. It is based on the assumption that an effective strategy maximizes a business's strengths and opportunities but at the same time, minimizes its weaknesses and threats. This simple assumption has powerful implications for successfully choosing and designing an effective strategy.

Environmental analysis provides the information to identify key opportunities and threats in the firm's environment.

**Opportunities:** An opportunity is a major favourable situation in the firm's environment. Identifying previously neglected market segments, changes in competition, technological changes and improved buyer or supplier relationships might be opportunities for the firm.



**Threats:** A threat is a major unfavourable situation in the firm's environment. It is a key hindrance to the firm's present or desired future position. The entry of a new competitor, slow market growth, increased bargaining power of main buyers or suppliers, major technological change and changing regulations could be threats to a firm's future success. For example, consumer acceptance of home computers was a major opportunity for IBM. Understanding the key opportunities and threats facing a firm helps managers identify realistic options from which to choose an appropriate strategy.

The second fundamental focus in SWOT analysis is identifying key strengths and weaknesses.

**Strength:** A strength is a resource, skill or other advantage, relative to competitors and the needs of market a firm serves. A strength is a distinctive competence that gives the firm a comparative advantage in the market place. Financial resources, market leadership and buyer/supplier relations are examples of strengths.

**Weaknesses:** A weakness is a limitation or deficiency in resources, skills and capabilities that impede effective performance. Facilities, financial resources, management capabilities, marketing skills and brand image might be sources of weaknesses.

SWOT analysis can be used in at least two ways in strategic choice decisions. The most common application provides a logical framework guiding systematic discussions of the business's situation, alternative strategies and ultimately the choice of strategy. What one manager sees as an opportunity, another may see as a potential threat. Systematic SWOT analysis ranges across all aspects of a firm's situation. As a result, it provides a dynamic and useful framework for choosing a strategy.

A second application of SWOT analysis is shown in Fig. 1.1. Key external opportunities and threats are compared to internal strengths and weaknesses in a structured approach. The objective is, identification of one of the four distinct patterns in the match between the firm's internal and external situations.

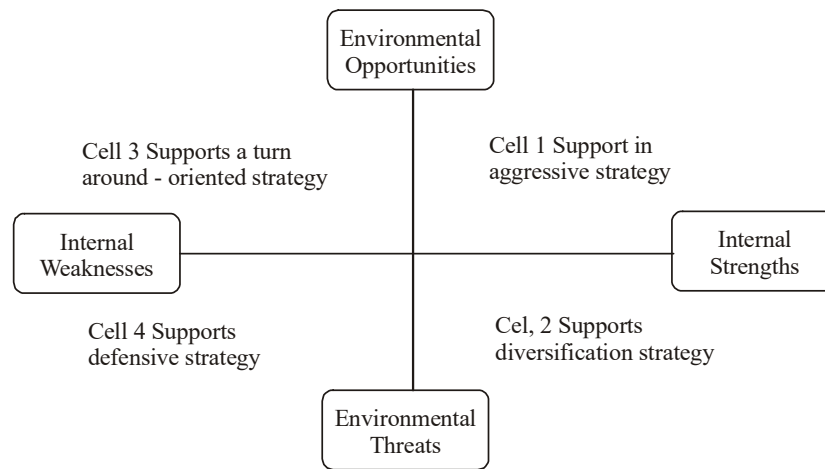
Certain patterns are represented by the four cells in our figure. Cell 1 is the most favourable situation, the firm faces several environmental opportunities and has numerous strengths that encourage pursuit of such opportunities. This condition suggests growth-oriented strategies to exploit the favourable match. Cell 4 is the least favourable situation, with the firm facing major environmental threats from a position of relative weakness. This condition calls for strategies that reduce involvement in the products/markets examined using SWOT analysis. In Cell 2, a firm with key strengths faces an unfavourable environment. In this situation, strategies would use current strengths to build long-term opportunities in other products/markets. A business in Cell 3 faces impressive market opportunity but is constrained by several weaknesses.

A host of external and uncontrollable factors influence a firm's choice of direction and action and ultimately its organizational structure and internal processes.

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The firm functions as a part of the environment and has no existence apart from the environment. By exploiting the opportunities present in the environment, the firm achieved its growth objectives. Again, it is in the environment that it finds its threats, which have to be faced successfully, if it has to achieve its objectives. The external environment has to be divided into two categories – the remote environment and the more immediate operating environment.



*Fig. 1.1*

**1.4.1 Methods and Techniques of Environmental Analysis**

The monitoring process of the appropriate environment by an organization to identify the opportunities and threats, that affect the business, is known as environmental scanning or analysis.

When the environmental scanning process is completed, planners gather all the information related to the opportunities and threats of the organization. The techniques used for environmental scanning:

- Environmental Threat and Opportunity (ETOP) Analysis
- Quick Environmental Scanning Technique (QUEST) Analysis
- Strengths Weaknesses Opportunity and Threats (SWOT) Analysis
- Political, Economic, Social and Technological (PEST) Analysis

**ETOP analysis**

ETOP is a device that considers the environmental information and determines the relative impact of threats and opportunities, for the systematic evaluation of environmental scanning. This analysis divides the environment into different sectors and then analyses their effect on the organization.

**QUEST Analysis**

QUEST was proposed by B. Nanus. It is a four-step process that uses scenario writing for environmental scanning. The four steps involved in this technique are:

1. Strategy planners first observe the events and trends of the organization.
2. From the above observation they broadly consider important issues that may affect the organization, using environment appraisal.
3. A report is created by summarizing these issues, their effects and different scenarios to show the implementation of these strategies.
4. In the last step, reports and scenarios are reviewed by the planners who decide the feasibility of the suggested strategies that are beneficial for the organization.

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### SWOT Analysis

SWOT is the heart of strategic analysis. SWOT analysis is the process of carefully inspecting the business and its environment through the various dimensions of strengths, weaknesses, opportunities, and threats. SWOT is also known as TOWS analysis. SWOT is a tool used for auditing the organization, which helps in finding the key issues and problems in the business. SWOT analyses the problems through internal and external analysis. In internal analysis, strengths and weaknesses of the organization are considered, whereas in external analysis, opportunities and threats for the organization are considered. The factors that are considered during internal analysis are:

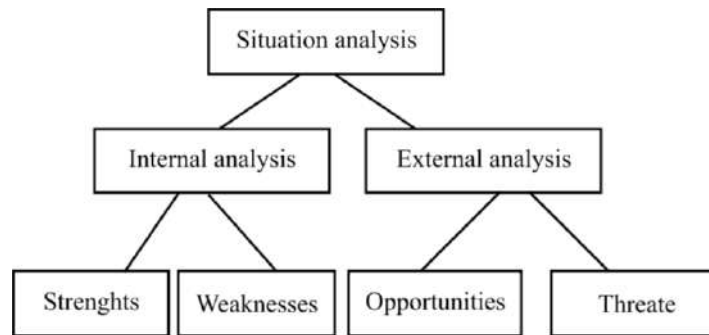
- Organizational structure
- Business location
- Organization's operational efficiency and capacity
- Market share
- Brand awareness
- Financial resources
- Patents and trade laws
- Expertise of marketing personnel
- Business reputation in the market

Similarly, various factors that an organization needs to consider in external analysis are:

- Customers and clients
- Competitors
- Market trends
- Suppliers
- Business partners
- Social change
- Latest technology
- Economic situation
- Political and legal restrictions

Figure 1.2 shows the SWOT analysis process.

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*Fig. 1.2 SWOT Analysis*

Strengths are a company's core competencies, and include proprietary technology, skills, resources, market position, patents, and others. Weaknesses are the conditions within the company that can lead to poor performance and can include obsolete equipment, heavy debt burden, poor product or market image, weak management, and others.

Opportunities are outside conditions or circumstances that the company, that suddenly realizes a growth in broad market interest, could turn to its advantage. The following opportunities must be considered in SWOT analysis:

- Advertising a product on the Internet
- Mergers, joint ventures or strategic alliances
- Business proposal from a new client with good a reputation in the market
- Moving into new market segments with improved profits
- Getting a chance to enter the international market

Threats are the current or future conditions in the outside environment that may harm the company and might include an increase in competition. The following threats must be considered in SWOT analysis:

- A new competitor in the same location
- Price wars with competitors
- Innovative products and services of competitors
- Competitors with superior access to channels of distribution
- Tax to be paid for a product or service
- Purchasing preferences
- Population shifts
- New technologies
- Increase in competition

## PEST Analysis

PEST analysis helps in analysing the environmental factors that highly affect the organizational strategies.

There are a few questions that need to be considered during PEST analysis to ascertain the key forces at work in the wider environment. These questions are:

- What environmental factors are affecting the organization?
- Which of these factors are the most important at the present time?

PEST analysis helps in analysing the organizational strategies in the following ways:

- It helps in identifying the environmental factors that affect the strategies of the organization. However, it is not necessary that the environmental analysis provides valuable information to the organizations. Hence, it becomes important for the organization to go in for a more quantitative approach to get the real data for organizational goals.
- PEST analysis may be used to identify the long-term factors that lead to globalization. For example, given the increasing globalization of some markets, it is important to identify the forces that lead to globalization. The worldwide convergence of production systems and consumer tastes in the market leads to the possibility of major economies benefiting from global manufacturing and marketing. The growth of the multinational customer and competitor has also led to the shift towards global markets, as has the overall pressure on the business for cost reduction and therefore, the search for scale economies. A further force for global development is the worldwide search for raw materials, energy and often, skills to provide service to the global business networks.
- PEST analysis helps in identifying the key factors of business and their differential impact on the organization. It also helps in determining the extent to which these factors affect the competitors of the organization. The three key external factors that affect the organizations include short life-span of technology, convergence of customer requirements and access to the resources available globally.

Consider an example of the three competitors, A, B and C who have the differential ability to cope with factors such as short life-span of technology, convergence of customer requirements and access to the resources available globally. The PEST analysis shows that firm A can easily handle the technological changes by examining its track record, its investment in Research and Development and its high market. Similarly, for firm C, centralized product planning helps in coping with more convergent customer requirements. However, A and C are not well placed when compared to B, in accessing the technical changes. But when B is compared to A and C, in terms of purchasing organizational resources, it is not centralized and does not help to cope with the convergent customer requirement.

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**Check Your Progress**

3. What is ETOP?
4. What is QUEST and who proposed it?

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**1.5 ANSWERS TO CHECK YOUR PROGRESS QUESTION**

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1. E-commerce refers to the sophisticated computer technology which allows commerce through the electronic media.
2. Hill and Jones defined macro environment as: ‘The macro environment consists of the broader economic, social, demographic, political, legal and technological setting within which the industry and the company are placed.’
3. ETOP is a device that considers the environmental information and determines the relative impact of threats and opportunities, for the systematic evaluation of environmental scanning.
4. QUEST was proposed by B. Nanus. It is a four-step process that uses scenario writing for environmental scanning.

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**1.6 SUMMARY**

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- The term business comes from ‘busyness’ or the state of being busy. Business is an economic activity with the object of earning an income, i.e., profit and thereby accumulate wealth.
- E-commerce refers to the sophisticated computer technology which allows commerce through the electronic media.
- A business cannot be said to function within vacuum; like any other organic entity, it is in constant interaction with – and is duly impacted by – its environment.
- The micro environment comprises those forces in the immediate vicinity of an organization that influence its functioning.
- Environmental scanning means an analysis of the environmental variables. A business manager operates in an environment and does not operate in a vacuum.
- SWOT is the heart of strategic analysis. SWOT analysis is the process of carefully inspecting the business and its environment through the various dimensions of strengths, weaknesses, opportunities, and threats.

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## 1.7 KEY WORDS

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- **Environment:** It refers to the natural world, as a whole or in a particular geographical area, especially as affected by human activity.
- **Customer:** It refers to a person who buys goods or services from a shop or business.
- **Organization:** It refers to an organized group of people with a particular purpose, such as a business or government department.

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## 1.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

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### Short-Answer Questions

1. Write a short note explaining the old and new concept of business.
2. Discuss the two categories of application letters.
3. Define environmental scanning.
4. List the techniques of environment scanning as mentioned by William F. Glueck.
5. Briefly discuss SWOT analysis.

### Long-Answer Questions

1. Describe the various levels and components of business environment.
2. What does a micro environment comprise of? How is it different from a macro environment?
3. Write a detailed explanation of methods and techniques of environmental analysis. Elucidate with figures wherever applicable.

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## 1.9 FURTHER READINGS

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## UNIT 2 ECONOMIC ENVIRONMENT

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### NOTES

#### Structure

- 2.0 Introduction
- 2.1 Objectives
- 2.2 Economic Environment of Business
- 2.3 The Global Economic Environment
  - 2.3.1 Economic and Policy Environment in Global Economics
- 2.4 Economic Policies
  - 2.4.1 Business and Economic Policies
- 2.5 Answers to Check Your Progress Questions
- 2.6 Summary
- 2.7 Key Words
- 2.8 Self Assessment Questions and Exercises
- 2.9 Further Readings

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### 2.0 INTRODUCTION

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An economic environment is a set of external economic conditions that impact all businesses and consumers in a market. In this unit, you will study the economic business of environment in detail. The global economic environment and economic policies are also discussed in this unit.

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### 2.1 OBJECTIVES

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

- Discuss economic environment of business
- Assess global economic environment
- Explain business and economic policies

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### 2.2 ECONOMIC ENVIRONMENT OF BUSINESS

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The economic framework within which the firm functions plays a crucial role in its efforts to thrive, grow and beat its competitors. Since business is fundamentally an economic activity, the economic environment, both within the country as well as beyond its national frontiers will have a definite influence on its fortunes. It is inconceivable that there could be any institutions, bodies or persons who are insulated from the effects of the economic environs. Business has to deal with a vast number of governmental bodies, rules, regulations, and guidelines relating to



its statutory responsibilities, the capital market, sources of finance including stock market options, venture capital, offshore funds, disinvestment options, bank funding, and so on.

All these factors compel careful analysis before decision or action, since once a particular business policy is adopted, it is practically irreversible. Economic forecasts and reports of the state of the national and global economy help the firm in taking business decisions. Overall, it is only those firms that can judge the trends in the economy that survive and prosper over long periods. In India, we have seen the meteoric rise of companies like Reliance Industries, Bharti Enterprises, Satyam and Infosys—new age companies that eclipsed many older, bricks-and-mortar business groups like those of the Modis, Jaipurias, Shrirams and Mafatlals, whose fortunes were on the wane. Only the Tata and Birla groups retained their respectability, if not their exclusivity.

Since a firm's long-term survival depends upon correctly reading the economic trends, it would be useful to examine in some detail the various components of the economic scenario, as follows:

- (i) *Economic system*: A country's economic model, i.e., socialist, capitalist, mixed economy, etc., has a vital bearing on a firm's capacity to exploit its opportunities. India followed a socialistic pattern of economy for several decades, but it did not bring rapid development. Even the experiment with a mixed economy has not fared too well, with the result that from 1991, the country has seen the government making a strategic retreat from many an economic activity, to focus on its role in governance and regulation. With the noticeable cutback in bureaucratic control following liberalization, the private sector has shown remarkable initiative in taking the economy forward, encouraged by several reserved sectors like civil aviation and petro- and gas prospecting / processing being thrown open to all on an equal footing. The growth of a resurgent middle class with ample disposable incomes, and the emergence of a new wealthy class (there are 50,000 *crorepatis* in India) seems to indicate that the economy is well set to vindicate the Goldman Sachs Report that India will be an economic super-power by 2050.
- (ii) *Economic policies*: The government plays a regulatory and supervisory role in the economic system, by means of:
  - (a) Annual budgets
  - (b) Economic planning, e.g., Five Year Plans
  - (c) Industrial laws and statutory regulations
  - (d) Industrial policy, including licencing
  - (e) Export – import restrictions
  - (f) Laws to regulate commercial and business activity, including FDI (Foreign Direct Investment)
  - (g) Wage and price controls

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- (h) Trade, commerce and transport policy
  - (i) National income and BOP/ external debt monitoring
  - (j) Agricultural produce procurement (food grains, sugarcane, etc.) policies, subsidies, rural economic upliftment programmes
  - (k) Public distribution system
  - (l) Controls over various products as regards their availability and consumption, e.g., addictive substances including tobacco
  - (m) A plethora of legislation, including the Factories Act, 1948; the Industrial Disputes Act, 1947; the Companies Act, 1956; and the Foreign Exchange and Regulation Act, 1947 (as modified by the FEMA)
- (iii) *Economic growth*: The economic performance and growth of domestic industry and business is heavily dependent on the growth of the economy as a whole, since greater all-round prosperity engenders increased levels of expenditure spending as well as investment, which results in good velocity of circulation of money in the economy and encourages exports. In contrast, depressed economic conditions would lead to less production, erode savings and result in inflationary conditions—a condition known as ‘stagflation’.
- (iv) *Interest rates*: The Reserve Bank of India, the apex bank that monitors and controls the economy, uses interest rates as one of its prime means of controlling money supply, promoting savings as well as investment, and curbing inflation. How well it does its job is reflected by the fact that India has one of the lowest rates of inflation in the world, at around 4 per cent. At the other extreme is Namibia, where there is 1000 per cent inflationary growth every month. The difference between bank borrowing (deposits) rates and lending rates is called the interest ‘spread’. Banks are now allowed to fix this ‘spread’ within upper and lower limits as set by RBI from time to time; this encourages open competition between banks, leading to greater efficiency and better customer service. Interest rates on the lower side reflect a more dynamic and healthy economy; e.g., interest rates in India are still very high as compared to the U.S. and other developed countries.
- (v) *Currency exchange rates*: National currencies are valued against each other at certain rates of exchange. For example, one US Dollar sells for about Indian Rupees 45 (selling rate). The costlier the Dollar is against the rupee, the more exports gain in rupee terms. Rupee devaluation, therefore, is beneficial for exporters, but not for importers, a property of the exchange mechanism that the Indian economy has taken advantage of in the past, when foreign exchange reserves of the country were abysmally low and exports needed to be boosted, while imports had to be strictly curbed. With forex reserves now at US\$ 160 billion, the scenario has changed. The Indian rupee is weighted against other hard currencies by exchange rates decided by RBI on the basis of a ‘basket’ of currencies. Banks can now fix their own exchange (buying and selling) rates, subject to RBI guidelines.

## 2.3 THE GLOBAL ECONOMIC ENVIRONMENT

Although the foregoing description of the origin and growth of international economics provides a broad idea of what international economics is all about, this section offers a more compact picture of its subject matter. The subject matter of international economics can be classified under the following categories:

- International trade theory
- Foreign trade policy
- Balance of payment problems and policy measures
- Exchange rate and its determination
- Open economy macroeconomics
- International monetary system
- International trade organizations and their role in international trade

To this list, one may add the international trade of a specific country and its impact on its economy and on its balance of payments. Let us now look at the basic contents of these broad areas of study under international economics.

### Foreign Trade Policy

From the very beginning, most trading countries adopted protective trade policies—policies that could increase exports and reduce imports. However, with the rapid growth of foreign trade and the inequitable distribution of gains from foreign trade, the tendency to adopt a protective or restrictive trade policy increased substantially. Protective trade policies can be classified under tariffs and non-tariff measures. Tariffs are the customs duties imposed on imports and exports. Non-tariff measures include the following:

- Imposition of quotas on imports
- Subsidization of exports
- Currency devaluation
- Dumping, i.e., exporting goods at a price lower than the domestic price

These kinds of trade policies constrained the international flow of goods and services, which adversely affected growth. As a result, the analysis of the causes and consequences of different kinds of trade policies has become a major area of study under international economics.

### Balance-of-Payments Problems and Policy Measures

The balance of payments (BOP) is the annual accounting of receipts and payments arising out of autonomous transactions of a country with the rest of the world. The BOP may show a surplus, a deficit, or be balanced. Incidentally, BOP surplus or deficit appears in the form of an increase or decrease in gold and foreign exchange

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reserves. As long as the BOP shows a surplus, it does not create a big problem for the country, as it is a healthy sign for the economy. But if there is a large BOP deficit and it persists over a period of time, it creates serious problems for the economy. The BOP deficits are generally referred to as a BOP disequilibrium. A persistent BOP disequilibrium causes growing foreign indebtedness for countries facing persistent BOP deficits. Such countries adopt different kinds of trade, fiscal and monetary policies to make adjustments in the BOP. Such policy measures have their international economic repercussions. Thus, the analysis of the kinds, causes and consequences of BOP disequilibrium faced by different countries has emerged as an important subject matter of international economics.

### **Exchange Rate and its Determination**

Another important area of study under international economics is the theory of exchange rate determination. As noted earlier, after the downfall of the gold standard in 1914, a big issue that arose was how, and at what rate, to convert the currency of one country into that of another. The problem arose because the importing countries had to make payments in terms of the currency of the exporting country. In their attempt to devise a system, economists developed theories of exchange rate determination. After World War I, Swedish economist Gustav Cassel developed a theory of exchange rate determination, called the *purchasing power parity theory*. This theory remained in practice for quite some time. However, with changing international economic conditions, the applicability of the purchasing power parity theory began to be questioned. Meanwhile, a controversy arose over whether the exchange rate should be fixed or flexible. This issue remains debatable. Over time, however, modern economists have formulated other theories of exchange rate determination. The analysis of the foreign exchange market and the theories of exchange rate determination are now an important aspect of the study of international economics.

### **Open Economy Macroeconomics**

With the rapid growth of international economic transactions, the interdependence of economies has increased. The interdependence of economies can be gleaned from the fact that merchandise trade alone accounts for 54 per cent of world GDP. When other elements of international economic transactions are taken into account, around 60 per cent of the world economy is based on international economic transactions. The high levels of foreign trade and financial flows affect most of the macro aspects of the economy, such as economic growth, industrial structure, employment, financial structure, and the price level. Countries adopt various kinds of monetary and fiscal policies to protect their economy from the adverse effects of international economic changes. This creates a need for international economic cooperation and a well-coordinated international monetary system. Thus, macroeconomic problems and the monetary policies used by the different nations and their consequences also come under international economics.

## International Monetary System

The international flow of goods and services generates international monetary flows in the process of settlements of payments. During the gold standard period, i.e., from 1880 to 1914, international payments were settled in terms of gold. But after the breakdown of the gold standard in 1914, several problems arose in the settlement of payments as different countries have different currency systems and the currency of one country is not acceptable in the others. In order to resolve payment problems, the IMF was established in 1947. It created a new international monetary system, which was reformed several times to set up a globally acceptable system of determination of the exchange rate and settlement of BO deficits. The international monetary system now refers to the rules, customs, instruments, and facilities created by the IMF. The study of the workings of the international monetary system, its weaknesses and consequent problems are the subject matter of international economics.

## International Trade Organization

Another important feature of the international economic system has been the emergence of new international economic orders, new economic institutions and organizations, formation of trade groups and custom unions, and formation of international economic organizations, to solve emerging problems. The functioning of these kinds of organizations, their success, failure and effectiveness have emerged as main points of debate and discussion. The working of international economic organizations, their contribution to the global economic order, and their success and failure, also comprise the peripheral subject matter of international economics.

To sum up, the various aspects discussed above give only a broad view of the subject matter of international economics. If one takes into account international economic issues that have cropped up over time, the scope of international economics becomes even wider.

### 2.3.1 Economic and Policy Environment in Global Economics

Economic environment relates to the global economic or business situation which either becomes conducive or a deterrent to investment and international operations. If the economic situation is favourable, multinational companies are induced to make new investment, install new manufacturing facilities, expand production and sales. The opposite happens during economic recession or downturn—business activity stagnates, reduction in production takes place leading to even closure of plants. The present global economic recession—caused primarily by the US sub-prime crisis—is a good example of this. In addition to the general global economic situation, MNEs also need to consider specific macroeconomic factors like income level or disposable income, inflation and demand patterns in different countries. Multinational companies should also pay special attention to three important economic issues: cost of production or cost of business, currency exchange rate and cost of capital.

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Cost of production is a key economic factor. Since there are less barriers to international trade today and transport costs are not significant for many products, multinational companies can look for the cheapest production location almost anywhere in the world. Labour cost is the most important factor. Wage rates differ significantly among countries. In 2000, the average hourly wage rate was US\$15 in Germany, (a high cost country) less than US\$3 in Mexico and less than US\$1 in Sri Lanka. Companies in labour-intensive industries have had to relocate production or services abroad to become more internationally competitive. For example, many American and European call centres are based in India, where wages are low. Another important determinant of labour cost is labour productivity. Labour productivity is much higher in Germany than in Sri Lanka. So the MNEs have to weigh up the advantages of cheap labour against other factors such as skills and efficiency or productivity or labour.

Cost of production is partly affected by the currency exchange rate. If the value of the euro goes up relative to other currencies, Dutch or German goods become more expensive for foreigners; and Dutch and German companies may find it more difficult to export their goods. At the same time, companies outside the euro zone may find it easier to import goods into Germany. Similarly, foreign companies may find it less attractive to invest in the Netherlands or Germany, while Dutch and German companies will find it more attractive to invest outside the euro zone. Multinational companies may have to monitor currency exchange rates in the global economy in order to identify threats and opportunities for their existing operations in different countries and formulate their strategies accordingly.

Exchange rates may affect different companies or even industries differently. Industries like electrical equipment or precision machinery are more affected by changes in exchange rates because they rely heavily on globally sourced inputs and therefore, are more dependent on exports. Companies, which operate in many countries, are sometimes less affected than others because some currency fluctuations offset among themselves and also because of multilateral netting of payments. It has been observed that foreign market participation through direct investment (FDI) reduces an MNE's exposure to exchange rate movements, particularly if a company's investments are widely spread among markets with different currencies.

Cost of capital or cost of borrowing funds is also an important economic determinant of international business environment. A multinational company can raise capital from different countries, but the cost of borrowing will vary. Therefore, MNEs need to continuously monitor the global capital market to be able to secure funds at the most competitive rates. Sometimes, MNEs change corporate nationality to take advantage of lower cost of borrowing. For example, major South African companies like South African Breweries (SAB) and the mining company Anglo American Corporation switched their stock exchange listing and headquarters from Johannesburg to London. This allowed these companies to

raise significantly larger amounts of capital to finance their international operations. When Anglo American and SAB announced their decision to move to London in late 1998, interest rates in Johannesburg were around 22 per cent, whereas, those in London were close to 6 per cent.

### **International political institutions**

Different international political institutions affect business operations. The more important ones include the International Monetary Fund (IMF), the World Bank and the WTO. The importance of global institutions varies widely. Some institutions, such as the WTO and the IMF, are quite powerful, as they can pressurize countries to change economic policy. The WTO can, for example, impose economic sanctions on member states which violate its rules. Other institutions, such as the International Labour organization (ILO) or the International Organization for Standardization (ISO), have few or no sanctions to enforce.

Global institutions generally help to facilitate international business operations. Due to the evolution of these institutions, today there are fewer barriers to trade between countries, and there is less occurrence of damaging political events than 10 or 20 years ago. There are also forums in which commercial disputes between countries can be resolved. A more steady institutional environment allows multinational companies to expand business globally. For example, when a new country wants to become a member of the WTO or the EU, adherence to intellectual property rights (IPRs) becomes a condition of membership. Till some years ago, IPRs were rarely enforced in countries such as Hungary and Poland, and cheap counterfeit copies of music CDs, computer software and other goods flooded their markets. However, these countries have now joined the battle against counterfeit products particularly after they have become members of the EU and the WTO. Therefore, manufacturers or music firms such as EMI or software companies such as Microsoft find it easier to expand globally.

Regional economic blocs and regional integration affect the strategies of MNEs. In order to benefit from lower trade barriers some companies invest in a particular country to be able to sell goods and services to other countries in the same regional bloc. For example, some foreign companies have invested in countries such as Poland to benefit from its membership of the EU. Similarly, many multinationals have invested in Mexico in order to export goods to the United States. Regional integration can pose both problems and opportunities. One of the key challenges for managers in the EU is to keep track of the countless regulations which may apply to their organizations. For example, Polish agricultural firms wishing to export goods to other EU countries were forced to obtain an HACCP (Hazard Analysis and Critical Control Point) certificate since May 2004, when Poland joined the EU. The certificate is compulsory for any agricultural firm with over 50 employees and is aimed at identifying any potential threats to human health during the food production process.

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**Government regulations in host countries****NOTES**

Political environment also includes government regulations in host countries. These include regulations on unfair trade practices, financial regulations, tax laws, environmental regulations, etc. In addition to national regulations by different governments, companies are also affected by regional entities such as EU. The EU imposes its own laws. These laws are superior, for example, to English, Dutch or Swedish law. English courts, for example, must apply European law in preference to English law whenever applicable. The role of government regulations is particularly important in the ‘transition economies’ or developing countries which generally have more protective or restrictive laws.

Government regulations can have both positive and negative effects on operations of multinational companies. For example, anti-pollution laws may increase the cost of doing business, because a company may have to install a new waste treatment facility in order to comply with government legislation. However, anti-pollution regulations can also help certain companies to compete. For example, companies in countries with more rigid environmental laws are able to secure international competitive advantage over companies in countries with less stringent environmental laws. Also, as more and more countries introduce environmental laws, a company can gain first-mover advantage by introducing a new environment-friendly product or service before its rivals in other countries do.

**Check Your Progress**

1. Define balance of payments (BOP).
2. How does economic forecasts and reports help a firm?

**2.4 ECONOMIC POLICIES**

This section discusses various economic policies and their importance in business in detail.

**2.4.1 Business and Economic Policies**

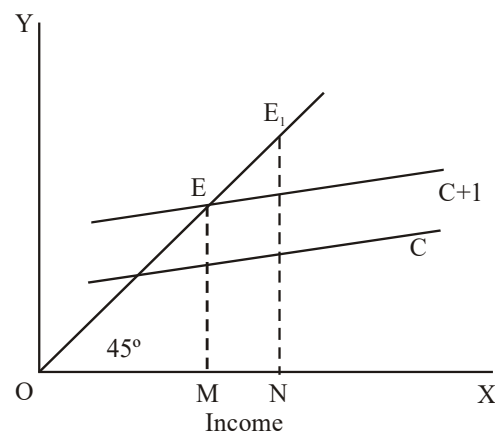
The days of laissez-faire, when there was a good deal of bias against all forms of state interference—have gone. In fact, it may be doubted whether there was ever any state that did not exercise any degree of control over the economic activities of a community. Such control was reduced to the minimum during the middle of the nineteenth century under the impact of the individualistic theory. But before the nineteenth century was over, there was a reaction against the theory of individualism followed by the decline of laissez-faire. This creeping trend towards state intervention in economic affairs was aided by the upheaval caused by World War I. The exigencies of a world war forced the state to exercise large powers of control over economic life in order to harness all resources to the task of winning the war. The colossal unemployment which prevailed in every country after the onset of the



Great Depression of the thirties, forced, the state to step in to relieve the misery of the unemployed. It slowly came to be recognised that the achievement and maintenance of full employment ought to be the fundamental aim of state policy. Mere monetary measures might not enable a country either to achieve or to maintain full employment. The factors at work in causing lapses from full employment are often non-monetary and these cannot always be controlled by monetary weapons. The volume of investment may not be sensitive to changes in the rate of interest. The long-term rate of interest declined to a considerable extent during the years 1932–41, but it was not followed by high level of investment activity. Moreover, the central bank is not always free to change the rates of interest in either direction.

A country will not suffer from acute unemployment as long as the volume of expenditure on goods and services is maintained at a high level. The existence of mass unemployment in a free enterprise economy shows that private expenditure cannot be expected to reach a level sufficient to provide employment for all workers. Hence, it becomes incumbent on the government to supplement private expenditure by the amount that will enable the country to achieve full employment.

Fiscal policy refers to the policy in connection with (a) government spending, (b) taxation and (c) borrowing. The total volume of expenditure in the community can be increased by the right type of fiscal policy. Though the fiscal techniques were discovered and first made use of during the depression of the 1930, the techniques are capable of being applied equally effectively in times of inflation. In the Figure 2.1. The line C+I line shows the aggregate expenditure of the community. It can be raised to a higher level by an appropriate fiscal policy. The result will be a shift of E towards E<sub>1</sub>, the full employment equilibrium position.



**Fig. 2.1** Aggregate Expenditure of a Community

Fiscal measures to achieve full employment or to avoid depression include (1) compensatory tax policy and (2) government expenditure policy.

1. The traditional view regards that taxation is for revenue only and the opposite view expressed by the Keynesian school is that taxation is for maintaining an adequate volume of public expenditure. All taxes bring about some

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reduction in the level of consumption or investment, and thus, affect the level of national income. Since the level of employment depends on the level of total expenditure, it is always necessary to maintain that level of total expenditure which assures full employment. Experience has shown that, private consumption expenditure and private investment expenditure, if left uncontrolled, cannot be relied upon for maintaining a level of expenditure which is appropriate to a state of full employment. During depression, the policy should be to substitute public spending for deficient private spending and to reduce taxation to encourage private spending. During boom conditions, a maximum of taxation is necessary to defend the economy against price inflation. The general purpose of counter-cyclical taxation is to encourage private consumption and investment when national income is below the full employment level, and to brake consumption and investment when full employment has been reached and further spending can result only in inflation.

2. It is held that the government should maintain a state of full employment by means of what is called compensatory spending. When prices go on falling and depression sets in, it is necessary for the government to go on injecting more and more money in order to offset the increasing disappearance of private funds from flow of spendings. When prices go on rising and inflationary conditions appear, the government should reduce public expenditure to contain inflation. At this stage, the government should have surplus budgets in order to stave off inflation. The main purpose of compensatory spending is to fill up the gap between full employment expenditure and actual expenditure. If private consumption and investment expenditures are not appropriate for full employment, the government should spend huge sums of money to make good the deficiency in total spending.

### **Short-run and Long-run Fiscal Policy**

Modern fiscal policy involves the process of shaping taxation and public expenditure in order to (1) reduce the fluctuations of trade cycle and (2) to contribute towards the maintenance of a growing, high-employment economy free from excessive inflation or deflation. When private investment and consumption spending create an inflationary (or deflationary) gap, it is the task of fiscal and monetary policy to offset the gap in the attempt to preserve price stability and full employment. The objective of fiscal policy is to achieve growth and full employment without inflation.

Fiscal weapons refer to taxation and expenditure policies. In this connection, modern economy is blessed with important 'built-in stabilizers.' Without any discretionary action, tax receipts change automatically when income changes, thereby reducing the size of the multiplier and serving to wipe out part of any disturbance. Because the automatic stabilizers never fully offset instabilities of an economy, scope is left for discretionary programmes. The principal weapons of discretionary fiscal policy are (1) varying public works and other expenditure

programmes, (2) varying transfer-expenditure programmes and (3) varying tax rates cyclically. Public works policy involves such time lags in getting under way as to make their use to combat short recession undesirable. Discretionary variations in transfer expenditures and in tax rates have greater short-run flexibility.

When people dropped the notion that government budget had to be balanced every year, they thought that the budget would be balanced over the business cycle—with boom-time surpluses just matching the depression deficits. However, it is now realized that only by coincidence would the prosperity years just balance the recession years. If we are faced by secular stagnation with private saving and investment schedules tending much of the time to produce deflationary gaps, fiscal policy may succeed in maintaining stable high employment only by having a long-term increase in the public debt. If we are in for chronic exhilaration with demand so brisk as to lead much of the time to inflationary gaps, then active fiscal policy will have a bias towards surplus financing and a secular downward trend in the public debt.

In connection with budget deficit or surplus, some new concepts are introduced. First, there is the important concept of ‘fiscal drag or dividend.’ Second, there is the concept of the ‘full employment budgetary surplus’ (or deficit) as contrasted with the actual surplus or deficit. Fiscal drag or dividend is the name for the automatic growth in tax revenues in an economy with a progressive tax structure and steady over-all growth. Unless needed to fight an inflationary gap, fiscal drag has to be offset by (1) government expenditure increase on public goods deemed vital, and (2) tax-rate cuts that increase people’s disposable incomes and expenditures in the private sector.

### **Public Debt and Modern Fiscal Policy**

To the man in the street, the size of the public debt is burdensome. But the economists do not consider it burdensome, rather they consider it a positive blessing. The main way that one generation can put a burden on a later generation is by using up currently the nation’s stock of capital goods or by failing to add the usual investment increment to the stock of capital. Looking to the future, we can say increases in public debt which are incurred in time of full employment and involve no governmental capital formation, but which do require that private investment be held down, do in fact represent a ‘burden.’ On the other hand, incurring debt when there is no other feasible way to move the C+I+G equilibrium intersection up towards full employment actually represents a negative burden on the immediate future to the degree, that it includes more current capital formation than would otherwise take place. To the degree that we borrow from abroad and pledge posterity to pay back the interest and principal on such external debt, we do place upon that posterity a net burden, which will be a subtraction from what they can later produce.

However, internally held public debt raises two problems. First, there are the transfer payments of interest that must be made to some people and the taxes

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that are levied upon all people for this purpose. To the degree that the people involved are different and that the interest receivers are richer, there will be some redistribution effects to reckon with. But even if the same people are taxed to pay the same amounts they receive in interest, there will still be the distorting effects on incentives which are present in the case of any tax. Second, because we do not live for ever, we tend as individuals to treat the public debt as something of an addition to our net worth. This feeling of greater wealth may well cause us to consume a bit more and save a bit less. Thus, the existence of a large outstanding public debt may have some long-run influence on interest-rate levels.

### Monetary Policies

Money is one of the greatest inventions of mankind and the existence of a monetary economy has done much to enhance the material welfare of the human race. Yet in actual operation it has become more and more painfully evident that money does not always perform its functions properly. Refusing to remain as a useful slave, money has often behaved as a tyrant imposing arbitrary redistribution of wealth and income among the various classes of people. It has, therefore, been felt that money should be made to behave properly. This raises the question of defining the ideal behaviour of money. Once we can define this ideal behaviour of money, the problem of defining monetary policy becomes easy.

The term monetary policy is used to denote the policy of the government regarding money matters. The government must determine the objectives of monetary management.

1. **Falling Price Level.** Marshall showed preference for a falling price-level. Periods of rising prices contain within themselves seeds of future disasters. With falling prices, though the businessmen get less, the wage-earners get more. In a progressing economy, a slowly falling price level may be the ideal monetary policy so that the benefits of economic progress might be enjoyed by all those whose money incomes are fixed by contract or customs.
2. **Stable Price Level.** One of the most popular views regarding the aim of monetary policy is that the value of money should be kept stable. If money is a measure of value, it is desirable that like all measures, it should be stable in value. A policy of stable price level is very simple and easy to grasp. In recent times, we have so experienced the evils of instability of prices that to point out the benefits of stable prices seems to be superfluous. Rising prices and falling prices are both bad and therefore, the stable prices are the best. Since money is a store of value, variations in its value cause unnecessary loss or confer unfair advantages both of which are against the principle of natural justice. Moreover, stable price would secure social justice; it would ensure justice between debtors and creditors and between wage earners and employers.

But, a policy of stable prices would not guarantee the absence of inflation and deflation. In an economy where improvements in industrial techniques

are made, prices should fall *pari passu* with the increase in productivity or decrease in cost. But if prices are kept stable, this would give rise to profit inflation leading to overinvestment and collapse. This actually happened in the USA in the period preceding 1929. The Federal Reserve Board kept the prices more or less stable during that period. But productivity was rapidly rising in the USA leading to abnormal profits, the stock exchange boom and the ultimate collapse.

3. **Generally Rising Price Level.** The case in favour of a slowly rising price level rests on the fact that it acts as a great incentive to enterprise. When prices rise, the expenses of businessmen do not rise as much as prices. Hence, during such periods businessmen can make huge profits. Prospects of profits would stimulate them to increase production. Thus, rising prices would secure full employment of workers than could otherwise be obtained. In a community characterized by varying degrees of unemployment, a slowly rising price level may be, as Keynes observed, a better monetary policy than mere price stability. According to Robertson, the industrial progress in the nineteenth century has been made possible because of the stimulus given by rising prices.

Rising prices conflict with the principle of social justice. Periods of rising prices lower the real value of money incomes of wage earners and the investing classes. It is not desirable that wage earners should be made to suffer in order to provide incentive to businessmen. Moreover, rising price might lead to overinvestment, speculative boom and ultimate collapse.

4. **Neutral Money.** In view of the defects of stable prices, Prof. Hayek has proposed that the ideal monetary policy is that which interferes as little as possible with the operation of non-monetary forces. When there is no money, and the barter system prevails, ratios of exchange would be established between different goods. The aim of monetary policy is to see that the same ratios of exchange prevail even under money economy. The introduction of money should not 'distort' the situation that should have obtained under barter. In other words, money should be neutral in its effects on prices. This could be secured not by stability of prices, but by the stability in the quantity of money in circulation. If the supply of effective money is kept constant, then there can be no distortion of the real ratios of exchange through changes in the quantity of money. The price level would then vary inversely with productive power.

But, this policy will be faced with the most serious practical difficulties. In order to keep the effective supply of money constant, the quantity of money has to be changed as its velocity of circulation is altered. But, how is the central bank to know when and in what degree the velocity of circulation has changed? Another practical difficulty arises when we consider the case of increasing productivity. Under such a policy, prices would fall as cost reductions are affected. But, if some prices are monopoly controlled and

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are thus prevented from falling, then other prices must fall by greater degree in order that average prices should correspond to the average costs. These other industries would be then subjected to a prolonged period of depression. Hansen has rightly criticized that the basic assumptions of the policy do not correspond with reality under modern development of cartels and other semi-monopolistic organizations.

5. **Avoidance of Cyclical Fluctuations.** Many economists are of opinion that business fluctuations are caused by monetary factors and can be remedied by monetary weapons. Bank credit can be regulated by the Central Bank by variation of bank rate, open market operations, etc. Through these weapons, the central bank can restrict credit to choke off a boom and expand credit to avoid recessions. But according to Keynes, business cycles are not caused by monetary factors, and hence, purely monetary weapons cannot prevent them. However, monetary policy can reduce the range of business fluctuations—make booms and slumps less severe.
6. **Stability of External Value of Currency.** The monetary policy of a country must aim at securing stability of the rate of foreign exchange. Stable exchange rates are highly important for countries like UK whose economic prosperity depends upon foreign trade. The pre-war gold standard was managed for the purpose of securing exchange stability. Stability of exchange rates secured large benefits for the world. It facilitated large-scale movements of goods from one country to another. It also fostered the growth in the volume of international investment. But, stability in the rate of foreign exchange at the cost of internal price stability is not desirable. Nowadays, exchange stability is secured through exchange control. Exchange stability is not inconsistent with internal price stability. The external and internal value of money are two aspects of the same thing. There is no reason why both cannot be kept stable by efficient management.
7. **Full Employment and High Rate of Economic Growth.** The objective of monetary policy should be full employment of all available resources and a high rate of economic growth. If private expenditure is not adequate to achieve and maintain full employment, the deficiency must be made up by public expenditure. There will be no inflation so long as there are unemployed resources which interferes as little as possible with the operation of non-monetary forces. When there is no money, and the barter system prevails, ratios of exchange would be established between different goods. The aim of monetary policy is to see that the same ratios of exchange prevail even under money economy. The introduction of money should not ‘distort’ the situation that should have obtained under barter. In other words, money should be neutral in its effects on prices. This could be secured not by stability of prices, but by the stability in the quantity of money in circulation. If the supply of effective money is kept constant, then there can be no

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7. ***Full Employment and High Rate of Economic Growth.*** The objective of monetary policy should be full employment of all available resources and a high rate of economic growth. If private expenditure is not adequate to achieve and maintain full employment, the deficiency must be made up by public expenditure. There will be no inflation so long as there are unemployed resources.

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**Check Your Progress**

3. What does a Fiscal Policy refer to?
4. What does modern Fiscal Policy involve?
5. Define fiscal weapons.

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**2.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS**

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1. The balance of payments (BOP) is the annual accounting of receipts and payments arising out of autonomous transactions of a country with the rest of the world.
2. Economic forecasts and reports of the state of the national and global economy help the firm in taking business decisions.
3. Fiscal policy refers to the policy in connection with (a) government spending, (b) taxation and (c) borrowing.
4. Modern fiscal policy involves the process of shaping taxation and public expenditure in order to (1) reduce the fluctuations of trade cycle and (2) to contribute towards the maintenance of a growing, high-employment economy free from excessive inflation or deflation.
5. Fiscal weapons refer to taxation and expenditure policies.

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**2.6 SUMMARY**

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- The economic framework within which the firm functions plays a crucial role in its efforts to thrive, grow and beat its competitors.
- Business has to deal with a vast number of governmental bodies, rules, regulations, and guidelines relating to its statutory responsibilities, the capital market, sources of finance including stock market options, venture capital, offshore funds, disinvestment options, bank funding, and so on.
- A country's economic model, i.e., socialist, capitalist, mixed economy, etc., has a vital bearing on a firm's capacity to exploit its opportunities.
- Protective trade policies can be classified under tariffs and non-tariff measures. Tariffs are the customs duties imposed on imports and exports.
- The balance of payments (BOP) is the annual accounting of receipts and payments arising out of autonomous transactions of a country with the rest of the world.
- The international flow of goods and services generates international monetary flows in the process of settlements of payments.



- Economic environment relates to the global economic or business situation which either becomes conducive or a deterrent to investment and international operations.
- Different international political institutions affect business operations. The more important ones include the International Monetary Fund (IMF), the World Bank and the WTO.
- Fiscal policy refers to the policy in connection with (a) government spending, (b) taxation and (c) borrowing. The total volume of expenditure in the community can be increased by the right type of fiscal policy.

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### 2.7 KEY WORDS

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- **Gross Domestic Product:** It is the total value of goods produced and services provided in a country during one year.
- **Laissez-Faire:** It refers to the abstention by governments from interfering in the workings of the free market.
- **Production:** It refers to the processes and methods used to transform tangible inputs (raw materials, semi-finished goods, subassemblies) and intangible inputs (ideas, information, knowledge) into goods or services.

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### 2.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

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#### Short-Answer Questions

1. What does fiscal measures, to achieve full employment or to avoid depression, include?
2. Write short notes on foreign trade policy and balance of payments.
3. Briefly discuss the international monetary system.

#### Long-Answer Questions

1. Critically comment on economic environment of business and explain in detail the various components of the economic scenario.
2. Economic environment relates to the global economic or business situation. Comment and Elucidate.
3. What are short-run and long-run fiscal policy?
4. Discuss monetary policies in detail. What are the objectives of monetary management?

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## 2.9 FURTHER READINGS

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### NOTES

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## UNIT 3 SOCIO CULTURAL ENVIRONMENT

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### NOTES

#### Structure

- 3.0 Introduction
- 3.1 Objectives
- 3.2 Business and Society
- 3.3 Business and Culture
  - 3.3.1 Indian Business Culture
  - 3.3.2 Organizational Culture
  - 3.3.3 Organizational Behaviour
- 3.4 Answers to Check Your Progress Questions
- 3.5 Summary
- 3.6 Key Words
- 3.7 Self Assessment Questions and Exercises
- 3.8 Further Readings

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### 3.0 INTRODUCTION

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The sociocultural environment is that part of the firm's environment that has to do with society and culture (as opposed to purely physical or economic factors). Each firm operates within a particular society or societies.

This unit sheds light on the socio-cultural aspects of business and discusses the concepts and relationships between business, society and culture. It further explains Indian business culture in detail.

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### 3.1 OBJECTIVES

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

- Interpret the relationships between business, society and culture
- Assess the business culture in India
- Discuss organizational behaviour

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### 3.2 BUSINESS AND SOCIETY

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According to modern academic scholarship, the word 'ethics' was first used by Aristotle based on the teachings of Socrates and the word 'morality' was first used by Saint Ambrose. Thus, tracing their origin in Greco-Roman civilizations, helps one to comprehend the evolution of ethics. It should be kept in mind that ethics and morality were present not only in Greco-Roman civilizations, but in

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other earlier civilizations also. Great thinkers have always had recourse to ethics and morality to set their intellectual or everyday projects in the world as worthy of pursuing. In the history of ethics, one finds great names such as Socrates, Plato, Aristotle, Thomas Aquinas, Thomas Hobbes, David Hume, Adam Smith, Spinoza, Immanuel Kant, Hegel, Marx, and many other great thinkers in our modern times. To do the right thing and to expect good and be led and directed by it requires critical reflection. Their ideas on ethics may not be directly extended to private corporations and corporate governance easily, but may provide insights on ethics which may be carefully employed.

Ethics is the search for what is good, what is worthy of acceptance, what is the right thing to do. Ethics is also about having the necessary knowledge and wisdom to find the good and the right. Some take ethics to be a reflection of morals which encompasses the totality of all standards required by a society for a good and proper life. Ethical inquiry is often subdivided into descriptive ethics, which provides a description of the most precise empirical measurement of actual morals; and normative ethics, which provides rationale and critique. Then there is the meta-ethical inquiry into the sources of ethics and the method of ethics. The origin of ethics in the West (in religious as well as secular cultures) was focussed on continual questioning of oneself and on the insight of who or what one is. The functional relation between oneself and one's actions are critically examined in the West. It may lead to condemnation of those actions found not worthy or not right or not good. It may lead to compensating those who suffer on account of actions by others. In the East (in religious as well as secular cultures) there is no critical reflection as found in the West, but there is reflection on who or what one is. The question may be asked, how the idea of good came about and how its impact on people's everyday lives could be described.

In everyday life, particularly in our business life which includes governance, how can we set and implement the question of good? In the context of business, where corporate governance is conceived according to the terms of the Board and its relations to corporate performance, to management, and to owners, how can we set the question of what is good for the society and the individuals involved? We take business ethics to be the source from which we aim to derive and define corporate governance. Many authors and researchers simply have reversed this with obviously many errors that follow from such reversal. Corporate governance is not the source of business ethics, it is not the task of top management to define what ethics is, but the task of top management or corporate governance is to define itself in the light of business ethics.

Why do we need to examine our everyday lives, the customs, the habits and even the values? If we do not examine, how do we know that we are doing the right thing? For building up our consciousness, and even our conscience or the discerning ability, it is best to examine our everyday lives. For example, there are people who find that their everyday life has no meaning and no purpose. When one feels that there is no purpose in life, he or she is very vulnerable to mental,

psychological, and even spiritual sickness. So it is important to question the everyday life that generates such a feeling of lack of sense of purpose. Finding a purpose, finding something worthwhile or meaningful do brings us joy and strength to live. Ethics and morality lead one in the path of achieving happiness by striving towards the best one can aim for and do. One may find this very general obviously, and each specific author may offer something different from other authors.

There is need for questioning the everyday activities in business and in directing business corporations through corporate governance to achieve greater corporate performance. Business ethics generally raises critical questions that enable one to critically examine one's everyday business practices and actions. Thus, when one does critical ethical reflection one is well prepared to correct the errors and bring about better and more appropriate ways of dealing in business and with people in society. When dealing with business ethics, here only a small subset (which can always be expanded if need arises) of those ethical ideals or principles or sources are considered, from which corporate governance definitions can be derived and implemented in the form of an institutional organization.

#### Check Your Progress

1. How is ethical inquiry divided?
2. What was the focus of origin of ethics in the west?

### 3.3 BUSINESS AND CULTURE

One of the most important component in any business is that of culture. The strategic direction of a business is directly impacted by the kind of culture it has. All major business functions such as marketing, accounting, or production as well as major management decisions are directly or indirectly influenced by culture.

It is important to have functional knowledge of rules and behaviors that are considered acceptable in social and professional relationships in the country where the business is set up. The diversity in culture and traditions of each country make people behave differently. International managers who have little or no knowledge of cultural difference may find it difficult to adapt which may lead to a feeling of rejection in the other party and even jeopardize the success of the negotiations.

#### 3.3.1 Indian Business Culture

Business environment in India can be studied under the following periods:

- **Period I:** Business in the ancient period.
- **Period II:** Business in the pre-Independence era, i.e., before AD 1850.
- **Period III:** Business between 1850 and 1947.
- **Period IV:** Business in 1947 and onwards – the post-Independence period.

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### **Business in the Ancient Period**

The first phase of entrepreneurship emerged when the Aryans ruled our country. The Aryans faced problems of developing new products and handicrafts that required labour and land as there was no proper law and order at that time regarding products. This period also saw the beginning of science in India. Studies in the fields of Astronomy, medicine, and literature gained importance during this period. Contributions of Manu in *Manusmriti* gave new ideas to the business people to carry out their activities. Agriculture and handicrafts were the major business activities of the people in the Gupta and post-Gupta period and towns and cities also developed with the beginning of entrepreneurship.

### **Business in the Pre-Independence Era, before AD 1850**

Agriculture was the source of living for the people of India during the pre-Independence era. Communities like Banias, Parsis, Chettiars and Gujaratis, established business activities like overseas trade, and also, set up manufacturing industries. The two industries prevalent at that time were the cottage industry, inventing woodcraft items and village industries, producing handloom and textile items. Business did not progress till the year 1840, on account of British colonialism.

### **Business during 1850–1947**

In this period, the business activities grew due to rapid industrialization. Establishment of railways in 1853 and development of roads raised the scope of business. Business during this period can be studied under the following heads:

- Entrepreneurship in the eastern part of the country
- Entrepreneurship in the western part of the country

In the eastern part of India, the main entrepreneurs were Europeans, who were engaged in export-oriented industries like jute, tea and coal, while in the western parts, due to political independence, it was the Indians who flourished.

### **Emergence of Parsis as entrepreneurs**

The East India Company had a great impact on the Parsi community; they worked as brokers, suppliers and craftsmen in the ship building industry. They gained power in a short time and established the steel industry in Bombay (now Mumbai) in the year 1852. Both the British and Parsis started exploiting Indian natural resources and encouraged leather and steel businesses.

### **Swadeshi movement and the birth of indigenous entrepreneurship**

Indian leaders started following Swadeshi and Boycott movements in 1905. ‘Swadeshi’ means manufacturing and consuming only Indian goods. The objectives of this movement were as follows:

- Promotion of indigenous goods
- Providing employment opportunities to Indian craftsmen
- To open a separate and wide market for selling only Indian goods

Swadeshi contribution helped Jamshedji Tata to set up his first iron and steel industry, while P.C. Roy founded the Bengal Chemical Works. There was growth in the banking and insurance sectors through the Swadeshi movement, as indigenous entrepreneurship developed in various sectors such as potteries and textiles.

### **The Managing Agency System**

During the post-War period, a system was started by Sri Dwarkanath Tagore called Managing Agency System. He invented joint stock companies and stressed that management of an enterprise must be in the hands of the firm instead of being with any individual. In this period, the number of Indian entrepreneurs went up and they also faced a number of problems like:

- Shortage of technical manpower due to lack of technical education
- Scarce managerial skills
- Lack of technical knowledge
- Lack of confidence in the staff for carrying out jobs

Due to such problems, the Tatas had to employ foreign technicians and managers for their industries.

### **Entrepreneurship in 1947 and Onwards, the Post-Independence Period**

In free India, a mixed economy - which is a rule of the private and public sector - was adopted. The government acted as a strong force to acquire entrepreneurial ventures by starting new industries and occupations. The Marwaris emerged as big investors and industrialists in comparison to small shopkeepers and moneylenders.

In 1947, the first industrial policy was announced, in which definite rules for industrial and entrepreneurial development were outlined.

### **Emergence of the Marwaris as a business class**

In the beginning of the post-Independence era, the Marwaris played an important role in creating new and small enterprises and acquired 60 per cent assets of Indian industries. Before Independence, the Marwaris managed six companies; but after Independence, they had 618 directorships, which became one-fourth of the total in 1951. The report of the Monopolies Inquiry Commission in 1964 mentioned thirty-seven large industrial houses, from which the traditional strength of various companies can be gauged.

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In the post-Independence period, the Marwaris appeared as a huge entrepreneurial class. During this period, entrepreneurship got scattered socially as well as geographically due to foreign collaboration, growth of infrastructure and introduction of technical education. Hence, the entrepreneurial class was completely modified and reached a new height. The growth of entrepreneurs can be recognized in the following aspects:

- Panchayati Raj institutions for village expansion
- Growth of money and capital market

Establishment of entrepreneur development institutions like the NSIC (National Small Industries Corporation), SISI (Small Industries Service Institute), TCOs (Technical Consultancy Organisations) and SFCs (State Financial Corporations). People belonging to the middle and low-class societies were encouraged by the government to start their own industrial ventures for the promotion of enterprise. Business groups like the Tatas, Birlas, Mafatlals, Dalmias, Ambanis and Kotharis established new ventures and extended the existing ones.

### **Industrial Development in India**

India started her quest for industrial development after Independence in 1947. The Industrial Policy Resolution of 1948 marked the beginning of the evolution of the Indian Industrial Policy. The resolution not only defined the broad contours of the policy, it also delineated the role of the state in industrial development, both as an entrepreneur and as an authority. Successive policy resolutions also emphasised this basic tilt in favour of the public sector. The Industrial Policy Resolution of 1956 gave the public sector a strategic role in the economy. It categorized industries which would be the exclusive responsibility of the state or would progressively come under state control and others. Earmarking the pre-eminent position of the public sector, it envisaged private sector coexisting with the state, and thus, attempted to give the policy framework flexibility.

The Industrial Policy initiatives undertaken by the government since July 1991, have been designed to build on the past industrial achievements and to accelerate the process of making Indian industry internationally competitive. It recognizes the strength and maturity of the industry and attempts to provide the competitive stimulus for higher growth. The thrust of these initiatives has been to increase the domestic and external competition through extensive application of market-mechanisms and forging dynamic relationships with foreign investors.

#### **3.3.2 Organizational Culture**

Organisational culture is the accumulated tradition of the organisational functioning. It is based on certain values, norms and positive attitudes of an organisation. Organisational environment becomes a culture if it is used for motivating people to avoid any friction and adopt the valuable tradition of the organisation. Organisational culture is intangible and functions like invisible hands which guide the employees



of an organisation for better performance and more satisfaction. It influences everybody and is also influenced by everybody's thinking and action.

The success of any organisation depends on its culture, as it is the invisible power governing the organisation. When the thinking and action of the employees are institutionalised, organisational culture takes birth. It continues to guide for a better achievement. The employees and other people of an organisation enjoy the culture which is immortal and invisible. Organisational culture is its strong soul which makes its functions possible and lively. With the accumulated value, it becomes extremely stronger. The organisational culture is viewed as the corporate image by the public. It enjoys market, production and financial functions. People are guided to decide what is right and what is wrong if the organisational culture is visualised, as spirited persons can easily decide what is correct and incorrect.

Organisational cultural is the invisible power which is accumulated through the constant efforts of its people. It is belief, common perception and understanding of an organisation. This unique feature of the organisation makes it distinctive from other organisations. The experiences and manner of performing are instrumental in forming the organisational culture. It is the environment under which an employee deals with its organisation and an organisation deals with its employees.

### **Characteristics of Organisational Culture**

Several authors have given different features for organisational culture. They are assumptions and values, sharing of perception, risk taking, management attitudes, employees' inclination, team building, competitiveness and stability. The structure, autonomy and conflict are used for developing the culture of organisations. A combination of these factors is the organisational culture.

#### **Assumptions and Values**

Organisational culture includes the assumptions and values of an organisation. These assumptions are believed explicitly. Workers, managers and the top management view the organisational culture in the same pattern, although they have different views individually. The behavioural pattern depends on certain invisible assumptions and their values.

#### **Sharing of Perception**

The people of an organisation mutually agree on certain perceptions although they have different attitudes and beliefs. Their common beliefs and attitudes are part of the organisational culture. They share a common perception of the organisation. The degree to which employees are encouraged to be innovative is determinant of the organisational culture.

#### **Risk Taking**

Organisational culture is influenced by the degree of risk and challenges faced by the employees. The methods of recruitment and training decide the risk-taking

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factor. Internal and external environment have a close connection with the decision of risk-taking.

### **Management Attitude**

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The management's attitude has a direct impact on the behaviour of the employees. Subordinates are supported by the management for inculcating a healthy culture. The management's active interest and support are needed for the purpose. Employees develop a feeling of having received an adequate and equitable reward under a congenial atmosphere. The management with its focus on results, provides positive attitudes. Warm feelings of the superior make the employees happy and production-oriented. Managers are expected to exhibit precision and attention to people's problems.

### **Employees' Inclination**

Organisational culture depends on the employees' inclinations which are influenced by their perception, learning and personality. If the employees take a positive view of the management's attitude, a people oriented climate is developed. The degree of confidence, tolerance and fellowman ship of the employees decides the culture of the organisation. Training and management development programmes are part of the culture. Individual's satisfaction is part of a good culture.

### **Team Building**

The management helps team building, cultural and behavioural characteristics are used for the development of a group. Behaviour of groups helps the accumulative nature of culture. More emphasis on team building helps cultural development. Functions of work group, occupational group, functional departments and organisation are a part of culture. When they are accumulated on traditional norms, they become the guiding culture for future action. Their differences create a conflicting culture. The management must be alert to prevent such a culture and inculcate an effective and positive culture.

### **Competitiveness**

A competitive atmosphere helps in developing the culture. Intragroup, intergroup and individual competitiveness demonstrate the wider scope of culture. Their positive attitudes help build good behaviour. But, negative attitudes create conflicts. Aggressive attitudes destroy culture while supportive attitudes build good culture.

### **Stability**

The stability in organisational function is referred to as a culture. Rules, regulations and officialism is maintained without favouring any person. Impersonal approach has a direct impact on the behaviours of the employees.

## **Structure**

The organisational structure is a part of culture. Bureaucratic and mechanic structures have a different culture than the democratic and organic structures. The feeling of one's responsibility and self-development are visible in the organisation's climate. The degree of autonomy has a great influence on culture.

Culture influences the performances of the employees. It is an attractive factor for remaining in the organisation. Employees exercise their creativity with goal autonomy.

## **Barriers to Culture**

The organisational culture has increased the barriers to change, diversity and merger. These barriers are detrimental to development. The barriers to change reduce the chances of development. Environment is dynamic and changes are inevitable. If culture is not changed according to the changes in the environment, the organisational effectiveness is adversely affected. It is essential to understand that if the culture is static, the effectiveness is affected. But, a dynamic culture improves the effectiveness. Culture in a real sense is adaptable to the changing situations. It is not dogmatic and adheres to the existing tradition.

The barrier to diversity refers to the organisation's core culture. The core culture inhibits acceptance of new changes. If any organisation is based on religion, caste and creed, its core value does not permit new changes. For example, if only Muslim employees only are appointed in an organisation functioning in the United Arab Emirates, Hindus or Christians are not permitted to join, irrespective of being highly qualified. A strong culture prohibits new changes. Many times, technological and social changes bring improvements. Cultural paradoxes are always hindrances to progress. Organisational culture should not be taken at par with the cultural paradox. If any organisation has cultural dogmas, it is not a real organisational culture in its true sense. Organisational culture is related to structure, functions, performances, innovations, standards and control. Dynamic culture has the scope for adaptability. New changes are incorporated in the organisation. A strong and fundamentalist approach is not the real organisational culture. Cultural compatibility is of great importance to mergers and acquisitions. Mergers are essential for financial strength. But, it is opposed by the employees because they would not like to enter a new culture after acquisitions. A dynamic culture has diverse employees having alternative strengths. Organisational culture should not be based on religion, caste and creed. An organisation is a universal phenomenon.

Culture of all types must be included in the organisation. Work culture, sympathy, humanity, love, devotion, dedication and development are related to all cultures. So, these components of culture must be inculcated in an organisation. The culture provides internal force and builds the employees' morale. People prefer to die rather than change the culture. So, cultural dynamism must be included in

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the organisation. Cultural status is not static. It is dynamic and continues to be flexible. Culture provides strength to employees, satisfaction to people and support to nation building.

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### Creating and Sustaining Culture

The traditions and way of life of the employees create culture in an organisation. The organisational culture is known by its employees' behaviour and attitudes. The early traditions are the basis of culture in an organisation. The vision and functions of an organisation are the creators of culture. Accumulated traditions and methods of functions are culture. The ideology and customs of organisational functions are organisational culture. An organisation develops progressive ideas and technological development for forming a good culture in an organisation. The mission and vision of the founder members of an organisation are the basis for creating the organisational culture. Hard work, competitive spirit and a disciplined way of life of the founders have created a disciplined organisational culture for improving the performance. The vision of Ratan Ji Tata and Ghanshyam Das Birla has created the Tata culture and Birla culture respectively in the Tata Group and the Birla Group. They are known by their organisational culture.

### Sustaining Culture

Sustaining and maintaining culture is essential for the organisation to make it a permanent source of energy. The experience gained by predecessors must be continued by the subsequent successors. An improvement for the better must be introduced into the existing culture. Reinforcement of learning, performance evaluation criteria, reward system, promotion procedures, etc. should be continued as it existed in the vision of the founders. Maintaining the culture does not mean that the organisations should adhere to a cultural paradox. The changing environment is absorbed in the dynamic culture of an organisation. The top management, selection, training-- and development programme and socialisation are the important methods of sustaining culture.

*Top management:* The attitudes of the top management should continue to guide the organisational functions. The culture is maintained by adhering to old values and developmental attitudes. They have certain norms and values which flow in the minds of sub-ordinates. The culture sponsored by the top management continues in the employees of an organisation. The latter follows the former. The top management decides and subordinates work. The dress recommended, the job designs suggested and other factors are taken into account for keeping culture alive. Tata Groups perpetuate a risk-taking, bold and innovative culture. HMT is dedicated to a culture of quality and innovative vision as the top management are practicing it themselves.

*Selection:* Culture is maintained by a proper selection policy. People who are qualified and experienced must be appointed ignoring those persons who want an entry on a pull-push basis. If needed persons are appointed, the organisation

can maintain work culture. On the contrary, if people are appointed based on political support, they are bound to destroy the existing work culture. The vision, mission and policy of a sound organisation must not be bypassed while selecting the people for work performance. In India, the public sector could not maintain the real character of the public sector because of a defective selection policy. But, those public enterprises which have been given autonomy and have no interference from politicians have worked satisfactorily. Indian Oil, Oil and Natural Gas Commission, Life Insurance Corporation of India and Steel Authority of India have been successful in maintaining some of the policies of a sound public sector. People who do not have the core values of an organisation must not be appointed because they will destroy the very structural value of the organisation.

*Training and development programme:* After selection and placement, an organisation should adopt a training and development programme based on the values of the organisation. Employees learn the values of the organisation. Training and development programmes are channelized for enhancing the culture of an organisation. Video films, practicing lectures and problem solutions are the important components of a value sustaining process. The instructor should identify the problems of learners so that they can be directed towards the cultural values of the organisation. The traits and qualities of the employees are used for instrumenting the employees on the values of the organisation.

*Socialisation:* The employees are indoctrinated in the organisation's culture through the adaptation process which is called socialisation. New employees are put in the culture of an organisation through on the job and sensitive training. An intensive training programme is instituted to make the new employees accustomed with the values of the organisation which includes performing all the activities from the early morning to sleeping time. The whole day is systematically scheduled to make the employees learn all the cultures of an organisation. The organisational culture is maintained not only in the form of work functions but also in dining, dressing and developmental activities. New graduates can easily learn all the cultural values of an organisation through the intensive training programme.

Employees prove their commitment with the cultural values of the organisation after getting the intensive training programme. The newly appointed employees remain in good standing. They learn the pivotal role or basic values of an organisation. People who fail to learn the basic values of an organisation after training are termed as 'non-conformists'. They become rebels if they have values contrary to the organisational values. These employees are further brought to a steep socialisation process, i.e. prearrival stage, encounter stage and metamorphosis stage.

*Prearrival stage:* The values, attitudes and personalities of newly appointed employees are assessed for driving them towards the organisational culture. Their weaknesses are revealed to paste them with the organisational values. Modification and smoothening of their existing values are made by the management towards the culture of an organisation. Employees might have knowledge of socialisation of

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the business functions. It is revealed how their socialisation has not moved towards the organisational values. The diagnosis reveals the possibilities of a complete socialisation of the organisational culture. Their firmness, rigidity, unfaithfulness and other anti-attitudes are smoothed to make their uses in different functions of required values. Psychologists and behaviourists are invited to smoothen their individual values towards the organisational values.

*Encounter stage:* The employees, after entering into business functions, find the activities against their attitude and expectations. The expectations of the employees may or may not be equal to the reality of the business policy, procedures and fellow workers' attitudes. If expectations are not very far from the reality in the organisation, they reinforce the values of the organisation. A smoothening process is used in this case. When expectations are far from the reality, the employees are required to replace their existing style with the organisational policy. The employees should try to adopt themselves to the values of the organisational culture. If they fail to adopt, they are put in adverse conditions. They should not be permitted to destroy the existing culture of the organisation. They are forced to resign if they do not perform according to the norms and values of the organisation after their intensive training programme.

*Metamorphosis stage:* Employees are required to change their values which are contrary to those of the organisation. The socialisation process is reintroduced for emphasising divestiture, stripping away and replacing their own values. Perception, learning and personality development programmes are used to change the values of the employees to bring them on par with those of the organisation. The group values and norms are made sacred objectives which should be achieved by individuals. Role models are used to train and encourage the employees. Monitoring and self-exercise programmes are held to make people organisation-minded. A serial socialisation is needed for changing the employees' values for organisational values.

### 3.3.3 Organizational Behaviour

Organisational behaviour has been defined as the knowledge of people's behaviour at work. It is a meaningful solution to complex human problems. "Organisational Behaviour is the study and application of knowledge about how people act within an organisation. It is a human tool for human benefit. It applies broadly to the behaviour of people in all types of organisation1." The behaviour of people at work depends on numerous factors such as technology, structure, group, social setup and so on. The organisational structure has a significant place in shaping the behaviour of people. Technology helps in the performance of the job in a successful and systematic manner. Fred Luthans has rightly emphasised on behaviour. "Organisational behaviour is directly concerned with the understanding, prediction and control of human behaviour in organisations1." It is the study of the behaviour of people to improve the efficiency of the organisation. The understanding and analysis of the behaviour of people helps in motivation for achieving the organisational goal. The study of behaviour is essential because of the different nature of people.

Besides individual differences, people are whole persons and total human beings. Behaviour is changed as a result of motivation. Human dignity and ethics are observed in their behaviour. An organisation's internal environment, social environment, individual perception and learning, group affiliations and technological development are instrumental in shaping behaviour. Behaviour is required to be modified and developed to achieve the organisational goal.

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“Organisational behaviour is concerned with the study of the behaviour, attitudes and performance of workers in an organisational setting, the organisation's and informal group's effect on the worker's perceptions, feelings and actions, the environment's effect on the organisation and its human resources and goals, and the effect of the workers on the organisation and its effectiveness<sup>2</sup>.” This definition lays emphasis on individual attributes, the group's effects, organisational structure and environment for shaping the people at work. These factors are interdependent and interrelated. Organisational behaviour is considered to be a branch of science wherein human behaviour is studied, researched, concluded and channelized for organisational effectiveness. Not only individual behaviour but the role of the group and organisational structure are also studied. The interrelated and influencing environment is appraised for deciding the typical behaviour of people at work and their impact on the organisation's effectiveness and goal accomplishment. Behavioural science studies the variables associated with the behaviour of people and their performance. Stephen P. Robbins has said, “Organisational behaviour (frequently abbreviated as OB) is a field of study that investigates the impact, that individuals, groups and structure have on behaviour within the organisations for the purpose of applying such knowledge toward improving an organisation's effectiveness<sup>3</sup>.” Organisational behaviour has become a field of study to understand the behaviour of individuals, groups and structure. The purpose of the study is to modify and mould their behaviour for increasing the effectiveness and efficiency of the organisation. It is a systematic study of behaviour to improve the performance of the people and the organisation. Many important activities of the people's development are included under organisational behaviour. Motivation, learning, personality development, conflict resolution, stress management and interpersonal communication are thoroughly discussed under this discipline. Behaviour depends on how people listen, observe, sense, ask and interact. Behaviour is a dynamic process depending on the experiences of individuals and the experiences of others related with the individuals.

Human behaviour is developed not in a vacuum but is shaped every time by the behaviour of others and environmental factors. The behaviour of a worker depends on the behaviour of his boss. If the supervisor is more friendly, trusting, informal, approachable and competent, the productivity of workers will increase and they will undertake more challenging jobs. The systematic evaluation of the factors influencing the behaviour of employees provides the basis for the effective performance of their jobs. Behaviour is caused and directed towards some specific goals. Behaviour is predictable by understanding people and situations. Different

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behaviour is perceived in different situations. This is the reason that different behaviour is exercised by different people. Beneath these differences, there are some common behaviour traits which may ordinarily be exercised by people. Therefore, it is possible to predict behaviour. The systematic study of behaviour may help to predict behaviour accurately. The cause and effect analysis, quantification of two variables of behaviour and experimental research provides important information about behaviour and its influencing factors. The common-sense observation of behaviour may or may not be correct as revealed by rigorous analysis and scientific research.

Organisational behaviour is generally confused with organisational theory, organisational psychology and human resources management. Organisational theory is the study of structure, the system, sequences and the process of organisation. Organisation behaviour, while studying all these subjects, delves into the behaviour of individuals and groups. Organisational theory is based on macro study, whereas organisational behaviour is a micro study of people's behaviour. Organisational psychology restricts its activities to psychological factors. Organisational behaviour considers and combines all the branches of study, e.g. science, technology, psychology, terminology, anthropology and other behavioural subjects. Organisational behaviour has become the basis of human resources management and development. The former is concept-oriented, whereas the latter is concerned with the technology of human development. The variables influencing human development are scientifically studied under organisational behaviour. Human resources development is successful with the use of the knowledge of organisational behaviour. There is a need for study of performance-oriented dependent variables, the search for cause and effect for human resources development which is possible through the use of concepts of organisational behaviour which helps personal growth, self-actualisation, modification and organisational development. Human relations, human activities and human resources management are activated, directed and channelized by the application of the knowledge of organisational behaviour which has become a field of study, research and application for the development of human resources and the organisation as a whole.

### **The Role of Organisational Behaviour**

Organisational behaviour has four important roles in any organisation—the human resources approach, the contingency approach, the system approach and the productivity approach.

### **Human Resources Approach**

Organisational behaviour is mainly interested in the development of its human resources. The employees' growth and development in an organisation are basic requirements for its continuous growth and survival. The success of any organisation depends on the competency and creativity of its employees because they are the central points of every function of management. Traditionally, managers were



important for deciding on task performances and carrying them out successfully under their directions. Employees cannot be treated merely as order followers; they are supportive and should be made more responsible. An organisation has to develop a suitable climate wherein employees can improve their behaviour with job satisfaction for achieving organisational goals with efficiency and economy. Developed employees improve their performance effectiveness. Satisfied employees utilise their fullest capacities for task performance. Developed employees contribute to the development of the organisation with much zeal and spirit and without creating conflicts and facing stress. If monetary incentives are given, it encourages working only as long as monetary benefits are given. However, if employees are developed, their capacities become increased for better work performances throughout life. The role of the manager has changed from that of a controlled approach to a supportive approach to employees.

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### **Contingency Approach**

Behavioural science is being used for solving problems which may arise at any time. Behavioural knowledge is being applied to solve these problems. One or few accepted principles cannot solve all the problems. Employees are therefore trained to face any sort of problems. They should have the capacity to meet the challenges of the environment. Employee-oriented leadership is better suited for solving problems than task-oriented leadership. When situations are much more complex, employees are to be developed to handle situations with the use of their capacities and capabilities rather than with the use of abstract principles. Different situations require different functions and behavioural approaches. It is known as the contingency approach because it believes that there is no such thing as the best way to handle the problem. Solutions as per situations are more effective and useful. This approach encourages analysis of each situation before and after incurring the problem. The contingency approach is an interdisciplinary and system-oriented approach of management. There is no perfect style of management. On some occasions, the participative approach may be useful, while in some situations, autocratic decisions will be more useful. The effectiveness of task performance is contingent upon the situation, and organisational behaviour deals with these contingents to arrive at an appropriate decision in a particular situation.

### **System Approach**

The system approach includes several subsystems which exist in an organisation, and therefore affect each other. Managers have to look beyond immediate situations to foresee future situations. There is a need for a systematic and fruitful framework involving general relationships. The purpose is to improve organisational behaviour for effective management. A system is developed where people work in a congenial atmosphere. The theories of organisational behaviour are applied to the system for achieving organisational goals. Better organisational behaviour provides greater success of the system approach. Developed employees perform all the subsystems in an effective manner. The organisation and society are benefitted

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by organisational behaviour. Better people have better organisational relationships wherein the objectives of individuals, organisation and society are served. The General System Theory (GST) has been developed for the success of the system approach.

### Productivity Approach

The ultimate objective of organisational behaviour is to increase productivity. With the given inputs, if production is improved, it is a symbol of productivity improvement. In other words, productivity is the production volume per unit of input. It is measured in terms of economic inputs and outputs. Better organisational behaviour increases the output in relation to inputs. The human behaviour is developed for performing jobs in an effective manner. If people's knowledge and skills are developed, their abilities to perform tasks also increase. If proper motivation is provided, people work to the best of their abilities. Motivation depends on the situations and attitude of the employees. Ability and motivation determine the people's potential performance. If the human performance is supported with adequate resources, organisational productivity is increased. Organisational behaviour influences people's knowledge, skill, attitude, ability and performance potential.

#### Check Your Progress

3. What does 'Swadeshi' mean?
4. Who started the Managing Agency System?
5. What is organisational culture?

### 3.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Ethical inquiry is often subdivided into descriptive ethics, which provides a description of the most precise empirical measurement of actual morals; and normative ethics, which provides rationale and critique.
2. The origin of ethics in the West (in religious as well as secular cultures) was focussed on continual questioning of oneself and on the insight of who or what one is.
3. 'Swadeshi' means manufacturing and consuming only Indian goods.
4. During the post-War period, a system was started by Sri Dwarkanath Tagore called Managing Agency System.
5. Organisational culture is the accumulated tradition of the organisational functioning. It is based on certain values, norms and positive attitudes of an organisation.

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### 3.5 SUMMARY

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- According to modern academic scholarship, the word ‘ethics’ was first used by Aristotle based on the teachings of Socrates and the word ‘morality’ was first used by Saint Ambrose.
- One of the most important component in any business is that of culture. The strategic direction of a business is directly impacted by the kind of culture it has.
- It is important to have functional knowledge of rules and behaviors that are considered acceptable in social and professional relationships in the country where the business is set up.
- Organisational culture is the accumulated tradition of the organisational functioning. It is based on certain values, norms and positive attitudes of an organisation.
- Organisational environment becomes a culture if it is used for motivating people to avoid any friction and adopt the valuable tradition of the organisation.
- The barrier to diversity refers to the organisation’s core culture. The core culture inhibits acceptance of new changes.
- Culture of all types must be included in the organisation. Work culture, sympathy, humanity, love, devotion, dedication and development are related to all cultures.
- The ultimate objective of organisational behaviour is to increase productivity. With the given inputs, if production is improved, it is a symbol of productivity improvement.

### NOTES

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### 3.6 KEY WORDS

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- **Manager:** It refers to a person responsible for controlling or administering an organization or group of staff.
- **Entrepreneur:** It refers to a person who sets up a business or businesses, taking on financial risks in the hope of profit.
- **Corporate:** It means relating to a large company or group.

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### 3.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

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#### Short-Answer Questions

1. Write a short note on ethics in business.
2. What is the relationship between business and society?

3. How did Marwaris emerged as a business class in India?
4. Briefly discuss the barriers to culture.

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### Long-Answer Questions

1. One of the most important component in any business is that of culture. Elucidate and give examples.
2. Give a detailed description of Indian business culture.
3. Define organizational culture in detail and give its characteristics.
4. What is organisational behaviour? Describe its role in detail.

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## 3.8 FURTHER READINGS

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## UNIT 4 POLITICAL ENVIRONMENT

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### NOTES

#### Structure

- 4.0 Introduction
- 4.1 Objectives
- 4.2 Political Environment and the Economic System
  - 4.2.1 Types of Political System
  - 4.2.2 Indian Constitution and Business
  - 4.2.3 Business Risks Posed by the Indian Political System
- 4.3 Changing Profile of Indian Economy
  - 4.3.1 Economic Plan Period and the Changes
- 4.4 Answers to Check Your Progress Question
- 4.5 Summary
- 4.6 Key Words
- 4.7 Self Assessment Questions and Exercises
- 4.8 Further Readings

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### 4.0 INTRODUCTION

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To a major extent, the operations of a company or business are affected by the government actions that surrounds it. The level of these actions may vary and may be on local, regional, national or international level. It is imperative that for a business to flourish and be profitable, business owners and managers to observe closely the political environment to gauge how government actions will affect their company.

In this unit, you will study political environment and its impact on business in detail with a special reference to India

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### 4.1 OBJECTIVES

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

- Discuss the relationship between political environment and the economic system
- Explain the different types of political systems
- Assess business risks posed by the Indian political system

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### 4.2 POLITICAL ENVIRONMENT AND THE ECONOMIC SYSTEM

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The economic and political systems of a country are mutually dependent, one reflecting the ideologies of the other. India is a sovereign democratic state operating

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through a two-party parliamentary system of government modelled on the British pattern, majority rule being the basic tenet thereof. There is a ruling party (or coalition of parties such as the currently ruling NPA), and there is the ‘opposition’ (represented in parliament by opposition members who have seats in parliament by virtue of having been elected from their respective constituencies).

The three pillars of the government are

- (i) Legislature
- (ii) Executive
- (iii) Judiciary

The legislature enacts legislation, i.e., creates laws by means of statutes or Acts, after issues are debated and passed by majority vote in parliament and the Bill (as an inchoate Act is called) receives the Presidential assent. The executive branch of government, i.e., the bureaucracy, is entrusted with the task of implementing these statutes (including ordinances or regulations flowing therefrom), while the judiciary adjudicates on issues arising from non-compliance with these laws.

This being the basic structure of our political, judicial and administrative set up, within which all human activities in the State must operate, it follows that business and industry are legally and morally bound to conform to it. How well they do so to a large measure determines their (and the country’s) long-term growth and prosperity. Non-compliance entails punitive measures that are meant to discourage deviations from the standards laid down. As the world shrinks and society becomes increasingly more complex in organization and administration, and as problems multiply across a vast spectrum of human activity, business and industry will need to be more proactive and innovative in managing the fallout.

The political and legal environment exerts its influence on business through:

- (i) Legal obligations for business that determine its decisions and actions
- (ii) Political and ideological postures that underlie defence and strategic positions have a bearing on business moves, vis-à-vis trade pacts, inimical terms with certain countries that restrict scope for trade and economic relations, negative features of international trade that impinge on business initiatives, and regional alliances that foster mutual cooperation and development.
- (iii) Internal strife by aggrieved sections of society that hamper economic activity and development in certain parts of the country; controversial and destabilizing issues can divide society on lines of caste, sex or religion, disrupt normal life, bring economic activity to a virtual halt and cause civil unrest and loss of national property.
- (iv) Political philosophies that stabilize or disrupt economic progress, disbalance the stock markets, encourage nepotism and graft, tolerate bureaucratic inefficiency, foster a nexus between politicians and bureaucrats, and seriously erode the moral fabric of the nation.

- (v) Reaction times of the three pillars of democracy as regards the crying need to address burning (and long pending) issues crippling progress across various fronts including social justice, public health, poverty eradication, employment generation and rise in the standard of living of the people of the Republic.
- (vi) Foreign policy initiatives that strengthen the nation, hold out hope for betterment of the common man's lot, instil a sense of national pride in citizens, and project a positive image of the country and its leadership to other nations of the world.

It goes without saying that policies and decisions of the government should encourage business by creating conditions that act as a tonic for the tired economic system, instead of enacting illogical laws and imposing conditions that act as barriers to progress.

#### 4.2.1 Types of Political System

The term 'political system' consists of two words—political and system. The first word 'political' refers to the subsistence and role of state in empirical terms. The second word 'system' entails a set of parts in interdependence as well as in operation. According to G. A. Almond, a system constitutes 'the interdependence of parts and a boundary of some kind between it and its environment.' In this context, Easton says that a political system allocates values by means of its policies that are binding on the society by virtue of being authoritative.

A policy is visibly authoritative when the feeling exists that it must, or it ought to, be obeyed whether it is formal or effective. It must be accepted as binding. In the words of Almond, political system involves the feature of 'comprehensiveness' which means that when we speak of the political system, we include in it all the interactions (inputs and outputs) which affect the use or the treat of the use of physical coercion. By 'interdependence' we mean that a change in one subset of interactions produces changes in all other concerned subsets. Finally, the existence of 'boundaries' means that where other systems end, political system begins. The result is that while the word 'political' signifies and attempts to separate a certain set of interactions in a society in order to relate it to other sets, by 'system' we mean an attribution to a particular set of properties of these interactions.

We have various definitions of political system:

- A political system comprises an inclusive set of institutions, interest groups (e.g., lobby groups, political parties and trade unions), the relationships among these institutions and the political standards and rules governing their functions (constitution, election law and so on).
- A political system consists of the members of a social organization (group) who are in power.
- A political system is a theoretical concept on which the government formulates policies and makes them more organized in administration.

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- A political system ensures order and sanity in the society and simultaneously enables some other institutions to have their complaints and grievances put across during the course of social existence.
- A political system essentially possesses two properties: a set of inter-reliant components and boundaries towards the environment with which it interacts. According to D. M. Wood, the term 'political system' refers to the study of state and government in the empirical dimensions and also from an interdisciplinary standpoint. Thus, political system becomes a set of inter-related variables conceived to be politically relevant and treated as if they could be separated from other variables not immediately relevant to politics. A set of concepts considered to make up a political system is advanced not to help one to understand the government and politics of a particular country but to aid in understanding the government and politics of any country of the world.

In academic discourse, there are three reasons for using the term 'political system'. First, the word 'state' does not facilitate us in understanding all political situations. As a concept, the state came into common use during the 16th and 17th centuries. Second, the concept of state is not adequate for social analysis, as this has been mainly used like a social myth in the struggle for national unity and sovereignty. Third, this concept does not have satisfactory kind of definition. In this way it's clear that a change from the study of state and government to the study of political system should be attributed to the shift in the emphasis from the formal political institutions to that of the real political processes. It has occurred due to certain developments indigenous to the discipline of political science in which writers have sought to study the state and government in relation to the role of 'extra governmental' agencies.

Beer and Ulam describe political system as 'a structure that performs a certain function for a society.' It includes an arrangement for making decisions which have 'legitimacy', because the members of a society accept them as being in conformity with their conceptions of authority and purpose.

### **Democratic Political System**

In the texicography of political science, no word is more controversial than democracy. There is no individual who does not like it but he may raise its 'question of suitability and efficacy at particular circumstances'. The suitability of democracy is related to the question of the form of government and not to that of principle. Many scholars object to the application of democracy to particular circumstances but they are not opposed to democratic principle. Today many people ask whether the circumstances or environment will be moulded to make them suitable for democracy or democracy will be changed to mould the environment for its own development.

As to the proper meaning of the word, there is also a controversy. As G. C. Field observes, 'In recent years, controversy has arisen about the proper meaning



of the word democracy...' In spite of differences of opinion, democracy is regarded as a useful form of government. Where it does not exist, men are fighting for it and where it already exists, men are striving to make it perfect. Sukarno's Indonesia called itself guided democracy and Ayub's Pakistan called itself basic democracy. The communist and socialist countries call themselves socialist democracies.

According to Maxey, 'Democracy is a search for a way of life in which the voluntary free intelligence and activity of man can be harmonized and coordinated with the least possible coercion.' In the words of Sartori, 'Democracy denotes a political system characterized by the absence of personal power and more particularly, a system that hinges on the principle that no one can proclaim himself as a ruler, that no one can hold power irrevocably in his own name.' Ivor Brown is right when he says that 'the word has come to mean anything; or rather so much that it means nothing at all.' UNESCO questionnaire speaks of the vagueness of democracy. Robert Dahl says that a responsible democracy can exist only if the following institutional guarantees are present:

- Freedom to form and join associations
- Freedom of expression
- Right to vote
- Right to be elected and hold public offices
- Right of political leaders to compete for support and vote
- Alternative sources of information
- Free and fair election
- Institutions for making government policies depend on votes and other expression of preferences

### **Democratic Government, State and Society**

Democracy is not merely a form of government. Some claim it to be a form of state and some regard it as a form of society. A democratic government is one which is based on the accountability of the people; a democratic state is one which is based on popular sovereignty. Democracy, in its wider meaning, is a form of society. A democratic government implies a democratic state, although a democratic state may not imply a democratic government. Example, the United States is a democratic state but does not have daily accountability to the Congress. For a democratic government, there must be a democratic state and democratic society.

Besides, democracy is an order of society and a way of life. It has political, social and economic implications. It has faith in the equality of all men and the recognition of individuality or human beings. A democratic way of life is characterized by tolerance, mutual respect and fraternity. It implies equitable distribution of wealth. If the majority government suppresses the minority opinion, it is contrary to the democratic ideal.

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### **Totalitarian Political System**

It was after the First World War that the totalitarian form of government gained prominence. The Weimar republic in Germany is one form of democratic government that countries tried to set up after the war. A democratic government gave its citizens the right to participate in politics, to vote and even form political parties. However, this kind of freedom to the citizens attracted much negative reactions from different leaders and eventually led to the collapse of governments, even the Weimar Republic. This meant that the democratic governments were replaced by the totalitarian form of government.

### **Features of a Totalitarian Government**

The characteristics of totalitarian systems are said to be in contrast with the authoritarianism and dictatorship systems. Political scientists have defined many such differences. Firstly, it is contended that under such a system, only one political party is existent in a country and all others are either under the control of the state or are eliminated. All companies and organizations also belong to the state. Since communication and other such technologies are also under the state, the ideologies of the government get solidified. The government thus makes the people hear whatever it wants them to hear. Thirdly, such a government has complete control over the weapons of all kinds. This helps the government prevent any revolutions in the country. By keeping the weapons under control, the rulers make sure no revolt takes place. Fourthly, the state also has a total control over the economy. Since the state controls all companies, it has free access to any resources it needs for its own projects which are always not in the interest of the people. In turn, the citizens become even more dependent on the state for jobs and any complaints against the state only serves to leave them jobless. Another significant feature of such a state is that it uses terror to rule over the people.

For instance, the Nazi Germany had the Sturmabteilung (SA) and Schutzstaffel (SS) to inculcate fear in the minds of the people. All threats to their rule, in form of individual, groups or organizations, are effectively eliminated. Even members of the ruling party are at risk and any dissent is followed by police enquiry or even execution. One example is the ruthless 'Night of the Long Knives' as part of which even the members who were loyal to the Nazis were killed if they were perceived as threat or if the state believed they could go against it.

### **Authoritarian System**

The state takes control of many aspects of the citizens' lives under the authoritarian form of government which had led political scientists to define it as a system which erodes people's civil liberties and freedom. However, the degrees of authoritarianism vary and even democratic and liberal states can display some features of authoritarianism. One such area can be national security. Mostly, the authoritarian form of government is not democratic as it governs the people without their consent. Political scientists also establish a link between authoritarianism and collectivism

as under both such systems, group goals and conformities dominate over the right of individuals. Another group of political scientists which supports collectivism also tends to criticize collectivization and term it the opposite of authoritarianism.

### Forms of Authoritarian Government

There are various forms of authoritarian government and they can be broadly categorized as follows:

- Monarchies: Depending upon the monarch, a monarchy can be authoritarian.
- Communism: As per the theory propounded by Lenin: “Communist states must always be authoritarian when on the path to ‘socialism’, because of the special repressive force needed to attain their goals.” A stateless society is the final aspiration of the communists and found supporters in theorists like Karl Marx. Government who rule as part of such systems never term it as a ‘communist’ but call themselves ‘socialist’. All authoritarian governments which are ruled by self-proclaimed communists will mostly be described by Non-communists and anti-communists with the Communist label.
- Dictatorships are mostly authoritarian.
- Authoritarian characteristics can be found in democratic states too.
- Fascist states are always authoritarian.
- Despotism is another name of authoritarianism.
- Those countries which are under military autocracies are almost always authoritarian.
- Theocracies are also authoritarian. In Consensus decision-making, an exception is found the Quaker Consensus: ‘Decision-making arrived at by finding a ‘spiritual consensus’, rather than voting, was developed by the Religious Society of Friends (Quakers) early in the 17th century and is in use to the present day.’
- Authoritarian states hand over extensive control to law enforcement agencies. Where such a responsibility to law enforcement agencies is found in the extreme, it leads to what is called a police state. Rule of law may or may not exist in authoritarian governments.

### Authoritarianism and the Economy

Before 1997, it was widely believed that authoritarian governments were likely to have stronger economies and out-perform democracies. The myth was shattered with the Asian financial crisis. This was the time when political theorists in the East and Southeast Asia strongly believed that authoritarian states were more likely to be economically successful than their democratic counterparts. The examples were given in the form of the states of South Korea, Singapore, Malaysia, and Taiwan. These states were strictly authoritarian and were witnessing bumper economic growth. However, despite the fall brought about by the Asian Financial Crisis, the

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idea that authoritarianism promotes economic development remains very popular, especially in developing countries. For instance, the Communist Party of China which rules over the world's fastest growing economy, uses this argument to continue its authoritarian rule in the country. At the same time, however, there are many examples of other nations where authoritarian rule failed to promote economic growth. One such good historical example is Spain in post-war Europe. Some of the recent examples of nations which have failed economically despite authoritarian regimes are Myanmar and Zimbabwe. It is difficult to establish a link between political authoritarianism and economic growth yet political thinkers in anarchist and anti-authoritarian traditions have used 'economy' as one of the characteristic features of analysis of authoritarianism. The common ground between business corporations and the state have often been cited as examples. This is because both the institutions are hierarchical and collective entities and have clear markings in terms of authority and command.

### Criticism

Authoritarian systems have many critics and most of them are supporters of democracy:

- As compared to poor dictatorships, poor liberal democracies have better education, longer life expectancy, lower infant mortality, access to drinking water and offer better healthcare. This is because liberal democracies are in the knowledge of maximizing their usage of available resources and not because they have the higher levels of foreign assistance or that they spend a larger percentage of GDP on health and education.
- Democratic peace theory has found supporters in numerous studies which have used different kinds of data, definitions, and statistical analyses. As per the original finding, liberal democracies had never initiated war with one another. Recent research has even extended this theory and found that democracies have few Militarized Interstate Disputes. This means there were less than 1000 battle deaths with one another. Democracies have few civil wars and those MIDs that have occurred between democracies have caused fewer deaths.
- Despite an initial decline, most democratic nations that were earlier Communist nations achieved greatest gains in life expectancy.
- Prominent economist Amartya Sen has argued that no functioning democracy has ever suffered a largescale famine. He even included democracies which were never prosperous historically, like India which suffered a great famine in 1943 and many more before this in the 19th century even when it was under the British Rule. Some critics ascribed the Bengal famine of 1943 to the effects of the World War II .
- Liberal democracies are associated with several strong and significant health indicators like life expectancy and infant and maternal mortality than they

have with GDP, per capita income or income inequality or the size of the public sector.

- Research has shown that liberal democratic nations have less instances of democide or murder by government. They also have less genocide and politicide incidents.
- It is in non-democracies that mostly the refugee crises occurs. It was in autocracies that in the last twenty years, the first 87 cases of refugee crises and flows occurred.
- The highest average self-reported happiness in a nation has been reported from liberal democracies.
- The level of corruption in a state is strongly determined by the existence of political institutions in it. This argument is supported by the World Bank research. Where countries have democracy, parliamentary systems, political stability and freedom of the press, the instances of corruption are lesser. Accountability and transparency is ensured through the freedom of information laws. For instance, the Right to Information Act in India “has already engendered mass movements in the country that is bringing the lethargic, often corrupt bureaucracy to its knees and changing power equations completely”.
- With the exception of East Asia, in the last 45 years even poor liberal democracies have had good economic growth, at an average of 50 per cent more speed than non-democracies. For instance, poor democracies such as the Baltic countries, Botswana, Costa Rica, Ghana, and Senegal have registered more swift economic growth than non-democracies such as Angola, Syria, Uzbekistan and Zimbabwe.
- Nations with intermediate political freedom have had more instances of terrorism, as found by research. Democratic nations have much less terrorism and are more equipped to deal with it. Only five of the 80 worst worst financial catastrophes occurred in democracies in the last four decades. It has also been found that poor democracies are half likely as compared to non-democracies to experience a 10 per cent decline in GDP per capita over the course of one year.

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### 4.2.2 Indian Constitution and Business

Laski had rightly remarked that every state is known by the rights that it maintains. The Constitution of India, assuring the dignity of the individual, provided for the deepest meaning and essence and for the greatest motivation to incorporate ‘fundamental rights’. As Granville Austin observed:

The fundamental rights, therefore, were to foster the social revolution by creating a society egalitarian to the extent that all citizens were to be equally free from coercion or restriction by the state or by society privately. Liberty was no longer to be privilege of the few.

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The inclusion of a chapter on fundamental rights in the constitution was symbolic of the great aspirations of the Indian people. In fact, it is these rights that offer the main justification for the existence of a state. The demand for a Charter of Rights in the Indian Constitution had its deep-seated roots in the Indian National Movement. It was most implicit in the formation of the Indian National Congress in 1885 that aimed at ensuring the same rights and privileges for the Indians that the British enjoyed in their own country. However, the first explicitly and systematic demand for fundamental rights appeared in the Constitution of India Bill, 1895. This bill was also known as Swaraj Bill of 1895. A series of Congress resolutions that were adopted between 1917 and 1919 repeated the demands and claims for civil rights and equity of status. Following this, drafting of seven fundamental rights under the Commonwealth of India Bill, 1925 took place. The Congress also passed a resolution in Madras in 1927 that declared that the basis of the future Constitution of India must be a declaration of fundamental rights. This demand was further reiterated in the Nehru Report of 1928. In March 1931, the Congress once again adopted a resolution on fundamental rights and economic and social changes. However, the Simon Commission had considered the question but rejected it. The Government of India Act 1935 did not contain any document pertaining to the declaration of rights. The next major document on rights was the Sapru Report of 1945. On the side of the British, the various British constitutional experts like Wheare, Dicey, Jennings and even Laski did not favour the idea. It was only the Cabinet Mission Plan that conceded to the Indian demand for a Bill of Rights for the first time. The inclusion of rights in the Constitution vested on three major reasons:

- (a) to keep a check on the arbitrary action of the executive
- (b) to reach to the desired goal of socio-economic justice
- (c) to ensure security to minority groups in India

The final shape to the fundamental rights was given by the Advisory Committee for reporting on minorities, fundamental rights and on the tribal and excluded areas, under the Chairmanship of Sardar Patel, which the Constituent Assembly accepted and adopted to make it Part III of the constitution.

The pertinent question that arises here is as to why the rights in Part III alone are considered fundamental? There are other rights as well that are important and even justifiable, for example, the right to vote under Article 325. The justification goes that the rights in Part III are:

- (a) more in consonance with the natural rights
- (b) gifts of the state
- (c) gifts of the Constituent Assembly

The Constitution of India contained seven fundamental rights originally. But the Right to Property was repealed in 1978 by the Forty-Fourth Constitutional Amendment bill during the rule of the Janata Government. These fundamental rights constitute the soul of the Constitution and thereby provide it a dimension of

permanence. These rights enjoy an esteemed position as all legislations have to conform to the provisions of Part III of the Constitution. Not only this, its remarkable feature is these rights encompass all those rights which human ingenuity has found to be essential for the development and growth of human beings.

The salient features of the fundamental rights are:

- Fundamental rights are an integral part of the Constitution and hence cannot be altered or taken away by ordinary legislation. Any law passed by any legislature in the country would be declared null and void to the extent it is derogatory to the rights guaranteed by the Constitution.
- The chapter on fundamental rights in the Constitution is the most comprehensive and detailed one. It not only enumerates the Fundamental Rights guaranteed to the Indian citizens, but also provides comprehensive details of each right.
- Fundamental rights as embodied in our Constitution can be divided into two broad categories, namely, those which impose restrictions of negative character on the State without conferring special titles on the citizens. There are positive rights, which confer privileges on the people, e.g. Article 18 desires the State not to confer any special titles on the citizens. Similarly, Article 17 abolishes untouchability. These can be easily categorized in the former category. Right to liberty, equality or freedom to express or worship come under the second category.
- As being justifiable, if any of these rights are violated, the affected individual is entitled to move the court for the protection and enforcement of his rights. The Supreme Court may declare a law passed by the Parliament or a State Legislature in India or the orders issued by any executive authority as null and void, if these are found to be inconsistent with the rights.
- The Indian Constitution does not formulate fundamental rights in absolute terms. Every right is permitted under certain limitations; and reasonable restrictions can be imposed at any time in the larger interests of the community. In some cases, restrictions have been imposed by the Constitution itself. Article 19, for example, guarantees to all citizens, freedom of speech and expression.
- During the operation of an Emergency, the President may suspend all or any of the Fundamental Rights and may also suspend the right of the people to move the High Courts and the Supreme Court for the enforcement of the fundamental Rights. When a National Emergency is declared under Article 352 on account of war or external aggression, fundamental right to freedom guaranteed under Article 19 stands automatically suspended under Article 358. The President is also empowered under Article 359 to suspend, by order, the enforcement of other Fundamental Rights also, during the period of Emergency.

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- Some of these fundamental rights are only guaranteed to the citizens of India, while the rights relating to protection of life, freedom or religion, right against exploitation are guaranteed to every person whether citizen or alien. This means that our Constitution draws a distinction between citizens and aliens in the matter of enjoyment of fundamental rights.
- The chapter on fundamental rights is not based on the theory of natural or unremunerated rights. The Indian Courts cannot enquire into any fundamental right that is not enumerated in the Constitution.
- The fundamental rights can be amended but they cannot be abrogated because that will violate the basic structure of the Constitution.
- They expressly seek to strike a balance between written guarantee of individual rights and the collective interests of the community.

The Constitution classifies fundamental rights into six categories:

- Right to equality (Articles 14–18)
- Right to freedom (Articles 19–22)
- Right against exploitation (Articles 25–28)
- Right to freedom of religion (Articles 25–28)
- Cultural and educational rights (Articles 29–30)
- Right to constitutional remedies (Article 32)

### Fundamental Duties

The Constitution of India laid disproportionate emphasis on the rights of citizens as against their duties. With the result, the Constitution of India did not incorporate any chapter of fundamental duties. It was during the 'Internal Emergency', declared in 1975, that the need and necessity of fundamental duties was felt and accordingly a Committee under the Chairmanship of Sardar Swaran Singh was appointed to make recommendations about fundamental duties. The Committee suggested for inclusion of a chapter of fundamental duties, provision for imposition of appropriate penalty or punishment for non-compliance with or refusal to observe any of the duties and also recommended that payment of taxes should be considered as one of the fundamental duties. But these recommendations were not accepted by the Congress government.

However, under the Forty-Second Amendment, carried out in 1976, a set of fundamental duties of Indian citizens was incorporated in a separate part added to Chapter IV under Article 51(a). Under this Article, this shall be the duty of every citizen of India:

- To abide by the Constitution and respect the national flag and national anthem
- To cherish and follow the noble ideas, which inspired our national freedom struggle



- To protect the sovereignty, unity and integrity of India
- To defend the country
- To promote the spirit of common brotherhood amongst the people of India transcending religious, linguistic, regional or sectional diversities and laws to renounce practices derogatory to women
- To preserve the rich heritage of our composite culture
- To protect and improve the natural environment
- To develop the scientific temper and spirit of enquiry
- To safeguard public policy
- To strive towards excellence in all spheres of individual and collective activity
- As a parent or guardian to provide opportunities for education to his child or, as the case may be, ward between the age of 6 and 14 years (this clause was inserted through Eighty-Sixth Amendment Act 2002)

Insertion of these Fundamental Duties along with Directive Principles of State Policy suggests that these are not justifiable. In fact, Constitution does not define how these will be implemented. No punishment or compulsive provisions have been mentioned on their violation. According to D.D. Basu, the legal utility of these duties is similar to that of the Directives as they stood in 1949, while the Directives were addressed to the State without any sanction, so are the duties addressed to the citizens without any legal sanction for their violation.

Also the duties enumerated are quite vague and can be interpreted in more than one ways. It is, therefore, very difficult to have their universally acceptable definitions. One of the duties of the citizens is to follow the noble ideals that inspired our freedom struggle, while each section, which participated in freedom struggle, had its own ideals. The term 'noble ideal', therefore, becomes ineffable and vague. Another duty expects every citizen of India to value and preserve the rich heritage of composite culture. A question that can be asked as to which is India's composite culture. Similarly, it is difficult to define scientific temper, humanism or spirit of enquiry.

Notwithstanding these criticisms, the fundamental duties have been the accepted part of the Constitution. These duties may act as a social check on reckless activities indulged in by irresponsible citizens and as a reminder to citizens that while exercising or claiming the right they have also to be conscious of these duties they owe to the nation and to their fellow citizens. In brief, the incorporation of Fundamental Duties in the Constitution was, no doubt, an attempt to balance the individual's civic 'freedoms' with his civic 'obligations' and, thus, to fill a gap in the Constitution.

### **Directive Principles of State Policy**

Directive principles depict the social and economic aspects of human rights. The Directive Principles of State Policy, included in Part IV of our Constitution seek to

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realize the high ideals of justice, liberty, equality and fraternity, enshrined in the Preamble to the Constitution. These principles reflect Gandhi's constructive programme for socio-economic welfare of the people of India. These constitute an instrument of instructions to the legislatures and the executives at all levels as to how they should exercise their respective powers and aim at attaining the economic, educational and social welfare of the people. Behind them is the sanction of public opinion which is stronger, and more effective than even the sanction of the courts.

Incorporating most of these principles, the framers of the Constitution were primarily influenced by the identical provisions in the Irish Constitution which, in its turn, had drawn inspiration from the Spanish Constitution. They were also, to a great extent, influenced by the Character of the United Nations and the Charter of Human Rights. No less was the inspiration drawn by them from the constitutions of socialist democracies, particularly that of the USSR.

These Directives relate to specific socio-economic objectives, calling upon the State to strive to promote the welfare of the people in all fields, especially in social, economic and political. These Directives lay down the lines on which the machinery of the government should function under this Constitution.

These Directives fall into three main categories:

- The ideals, especially economic, which the framers of the Constitution directed the State to strive for
- The instructions and directions to the future legislatures and executives as to the manner in which they should exercise their respective powers; and
- The economic and educational rights which the citizens are authorized to expect from their duly constituted legislatures and executives

### **Relationship between Directive Principles and Fundamental Rights**

Fundamental rights incorporated in Part III and the directive principles in Part IV form an organic unit.

Article 13 provides that any law passed in violation of Part III of the Constitution dealing with Fundamental Rights is void to the extent of such violation. Initially the Supreme Court, however, adopted a legal attitude by declaring that the directive principles cannot abridge, curtail or stand in the way of the fundamental rights. The court, thus, held that the former are subordinated to the latter. But later on the judiciary has substantially modified its attitude towards to directive principles. It started taking note of directive principles in determining the scope of fundamental rights. The directives now command more respect from the judiciary than they initially did.

Article 37 makes the directive principles of the state policy non-justifiable. In case of the state of Madras vs Champakam Dorairajan, 1951, the Court laid down the following principles in describing the relationship of the directive principles with fundamental rights:

- The ‘Directive Principles of State Policy’ cannot override fundamental rights, because the former are unenforceable under Article 37 while the latter are enforceable under Article 32.
- Directive principles cannot abridge, curtail or stand in the way of fundamental rights, because they are sacrosanct and supreme;
- Directive principles have to conform to, and run as subsidiary to fundamental rights.
- The state action under directive principles is subject to legislative and executive powers, i.e. a directive principle can be implemented only by the agency which is authorized to make law on that subject; and
- If the power of the State with respect to the subject relating to directive principles is limited by the Constitution, the state cannot exceed it.

Later the Court accepted that fundamental rights could be amended by the prescribed procedure and thereby directive principles can be implemented. In this period, the court evolves ‘the Principles of Harmonious construction’. This meant that ordinarily the directive principles were subordinate to the fundamental rights and the state could not infringe on fundamental rights of any individual even on the plea of protecting the weaker sections of society as mentioned in the chapter on directive principles. The state, however, could put restrictions on fundamental rights in order to implement directive principles or otherwise by making amendments in the Constitution. This attitude was reflected through *Sajjan Singh vs State of Rajasthan*, 1967, when the court held that directive principles are also fundamental in the government of the country and provisions of Part III must be interpreted harmoniously with these principles.

### 4.2.3 Business Risks Posed by the Indian Political System

In this section, let’s have a brief look at the types of risk posed by the Indian Political System’

#### **Sovereign Risk**

India is a vibrant parliamentary democracy and has been one since its political independence from British rule more than sixty years ago. There is no serious revolutionary movement in India; hence, there is no conceivable possibility of the state collapsing. Sovereign risk in India is therefore zero for both ‘foreign direct investment’ and ‘foreign portfolio investment.’ It is however advisable to avoid investing in the extreme north-eastern parts of India because of terrorist threats. Kashmir in the northern tip is also a troubled area, but investment opportunities in Kashmir are anyway restricted by law.

#### **Political Risk**

India suffered political instability for a few years due to the failure of any party to win an absolute majority in Parliament. However, political stability has returned

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since the previous general elections in 1999. However, political instability did not change India's economic course though it delayed certain decisions relating to the economy.

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The political divide in India is not one of policy, but essentially of personalities. Economic liberalization (which is what foreign investors are interested in) has been accepted as a necessity by all parties including the Communist Party of India (Marxist).

As for terrorism, no terrorist outfit is strong enough to disturb the state. Except for Kashmir in the north and parts of the north-east, terrorist activity is either non-existent or too weak to be of any significance. It would take an extreme stretching of the imagination to visualize a Bangladesh-type state-disrupting revolution in India or a Kuwait-type annexation of India by a foreign power.

Thus, political instability in India, in practical terms, posed no risk to foreign direct investors, because no policy framed by a past government has been reversed by any successive government so far. One can find a comparison in Italy which has had some forty-five governments in fifty years, yet overall economic policy remains unchanged. Even if political instability is to return in the future, chances of a reversal in economic policy are next to nil. Hence, political risk in India is practically non-existent.

### **Risk of Foreign Sanctions**

Another risk faced by India is the risk of sanctions by other countries for example, India did not seem to be in the good books of the United States government due to its nuclear weapons and missiles development policy. However, US President Bill Clinton's state visit to India in 2000 was a massive hit. Subsequent to the visit, visits between the two countries at different levels took place, and the US government has all but come to terms with the reality of a nuclear-armed India.

### **Commercial Risk**

Commercial risk exists in business in any country. Not each and every product or service can be readily sold; hence, it is necessary to study the demand/supply situation for a particular product or service before making any major investment. There is a large number of market research firms in India (including our own) studying the demand/supply situation for any product/service and advise the potential investor accordingly in exchange of a professional fee.

#### **Check Your Progress**

1. What are the three pillars of the government?
2. Define political system.

### 4.3 CHANGING PROFILE OF INDIAN ECONOMY

Some nations are economically highly developed, while some countries are still developing and some of them are under-developed. Quite a few factors are accountable for variations in the states of development of nations in addition to political factors.

These are as follows:

- The availability of enough natural resources.
- The quality and quantity of human resources.
- Abundance of financial resources.
- Efficient management and technological skills among the people.

The USA, UK, Western European nations, Japan, Australia, etc. are the major examples for economically developed countries. India, China, Sri Lanka are the examples for developing countries. African nations, Bangladesh, etc. are the examples for under-developed countries.

#### **Government's Planning: Regional Imbalances in India**

India obtained under development from the British who ruled the country for many years. They did not support industrial development of the country at all. They utilized India as the supplier of raw material for their industries. Therefore, the country used to supply raw materials for the British and used to import the finished products.

For a particular region, the economic development is measured in the name of per capita income, poverty, gross state domestic product, unemployment, etc. Bihar, Orissa, Rajasthan, Madhya Pradesh, Uttar Pradesh, North-eastern states are reasonably backward economically. Maharashtra, Gujarat, Tamil Nadu and Punjab are relatively highly developed.

One of the main results of regional imbalances is the people's migration to the developed areas. For example, many skilful people from India migrate to the developed countries. Likewise, within India, people from under developed regions keep on migrating to highly developed cities or regions. Such migrations lead to violence, law and order problems. Almost all the major cities in India (New Delhi, Kolkata, Chennai, Mumbai, Bangalore, Hyderabad, Pune, Ahmedabad, etc.) face extremely high intensity of population.

To control the migration levels, the government has been putting into practice the national rural employment guarantee scheme, which is used for reducing the migration of rural people to urban areas for work when the agricultural lean season arrives.

Being a plural country, full of diversities of religions, languages, castes, tribes, cultures, etc., India has a number of cultural and linguistic groups. These are

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concentrated in some specific territorial segments. During colonial rule, the British administration was more interested in economic exploitation of the country and least interested in its development; it supported various divisions based on religion, region, caste and language and did not make any plan for a balanced development of India. These factors led to regional imbalances and group identities. Consequently, independent India witnessed the rise of regionalism, language movements, separatism, etc.

### **Regional disparities**

Regional disparities or imbalances manifest into wide differences in literacy rates, per capita income, availability of health and education facilities, stages of industrialisation, etc. between different regions. These regions could be either states or regions within a state. India is a country of regions having enormous imbalances on various accounts. The planning in independent India has not been able to eradicate these regional imbalances.

### **Regional policy in independent India**

The leaders of the independent India quickly recognized the need for the removal of regional disparities. According to the Indian Constitution, it is the duty of the central government to appoint a Finance Commission once at least in every five years. The aim of this commission is to scrutinize the problems arising out of the gaps between expenditure and the revenue and other such matters. Thus, the central government, with the help of its two principal agencies—the Planning Commission and the Finance Commission—is bound to work for balanced regional development of the country. To re-establish the equilibrium between various areas and regions was one of the objectives of planning. Though these institutions were to work within a large socio-economic fabric of the country and the initial political process. Initially planning was chiefly restricted to the national level. The problem of regional disparities hardly got the much-required attention, and the few measures that were taken, were adopted to deal with particular problems faced by certain areas having natural disasters. Thus, the policy makers did not give adequate attention to the problem of regional development. A few of the previously developed regions enjoyed the freedom to develop further at the expense of the backward regions, which continued to languish.

It was in the Third Five-Year Plan that some attention was given to the problem of regional disparities. Efforts were made to recognize the backward regions. Beginning from the Fourth plan, planners have shown more interest in this objective. Planned policy measures are being taken to enhance the status of living standards of the people in the backward regions. However, in reality, despite the increasing consciousness of these aspects, very little has been attained. While the Planning Commission has recognized industrially backward regions, it has not yet attempted any action, which can be deemed to be backward from the viewpoint of total economic development. Actually, the plans of regional policy focus on the

dispersal of industry among the different regions of the country. However, despite several attempts for industrialisation, agriculture continues to be the most important economic activity from the viewpoint of production and employment in most of the states, and within the agricultural sector, due to stress on instant increase in production, interstate disparities in per capita agricultural output have been increasing. Everyone knows that the green revolution and its impact have been confined to comparatively small areas. Therefore, the imbalances in people's socio-economic conditions have been increasing both inside and between different regions of the nation.

### **Regional imbalances and regionalism**

The sense of neglect, deprivation and discrimination is created if the regional inequalities, both among states and within states exist and are not addressed. In a country like India, having a composite culture, and where groups are concentrated in states or regions, these inequalities become the cause of social conflicts resulting in political and administrative problems. In any case, regional imbalances are a chief cause of regionalism. The movements for the creation of separate states in Jharkhand area of Bihar and West Bengal, Uttaranchal and Chattisgarh in Uttar Pradesh and Madhya Pradesh were the result of the underdevelopment of these regions in those states, as a feeling of exploitation and deprivation had set in among people. Finally, the status of separate states was bestowed upon these areas in 2001. Such movements are still going on in the Telengana region of Andhra Pradesh, Vidarbha region of Maharashtra and Darjeeling region of West Bengal. In addition to the feeling of deprivation in the neglected states or regions, there also are regrets because of sectoral inequalities. These consist of lack of industrial development along with agricultural development. These factors are spreading regionalism in developed states. For instance, in areas where Green Revolution was introduced and has been successful, the new rich farmer's class has become financially and politically significant. They are now inclined in perpetuating the concessions and facilities that were given to them at the time of Green Revolution. Despite agriculture having become very much gainful, they want subsidies to persist and income not to be taxed. These rich farmers in such states offer major social basis of regional parties.

The problem of regional disparities is a natural outcome of the development process itself, in which certain regions develop faster than others. Uneven regional development results in the following complications:

- Wastage of resources
- Increase in public costs
- Social injustice
- Deceleration of economic growth
- Threat to national integration
- Political instability

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Many experts in the field of regional and developmental economics have graphically narrated the unfavourable consequences of persisting disparities in various studies. Harvey Armstrong and Jim Taylor argue that severe regional imbalances in levels of employment are risky for social cohesion. If the backward regions exist along with developed ones, the lower purchasing power in the former areas leads to aggravate inflation. According to them, if regional unemployment disparities are reduced, the national employment and output could be considerably enhanced.

When such imbalances are controlled with more geographic distribution of demand for labour, pressures exerted by inflation would be less harsh. There will be best utilization of social overhead capital.

Friedman and Alonso pointed that decline in regional imbalances would pave way for the following:

- Greater national integration
- Increase in economic growth
- Political stability

In contrast, if the imbalances sore, a sense of injustice may kindle regional and parochial movements, as seen in many countries.

Reduction in disparities is also vital to speed up the growth of national economy. This is mainly relevant in the under-developed economies. Moreover, national income can be enhanced only when the resources and potentialities in backward regions are employed for useful activities. Backward regions should be helped so that their potential is correctly tapped enabling them to reach higher level of development. This requires evolving exact strategies for the overall development of such regions.

### 4.3.1 Economic Plan Period and the Changes

Industrial development during the plan period can be divided into the following four phases:

#### Phase I (1951–56): Building strong industrial base

Phase I laid the basis for industrial development in the future. The Second Plan based on Mahalanobis Model, emphasized the development of capital goods industries and basic industries. Accordingly, huge investments were made in industries like iron and steel, heavy engineering and machine-building industries. The same pattern of investment was continued in the Third Plan as well. As a result, there occurred a noticeable acceleration in the compound growth rate of industrial production over the first three Plan periods up to 1965 from 5.7 per cent in the First Plan to 7.2 per cent in the Second Plan and further to 9.0 per cent in the Third Plan. The rate of growth of capital goods industries shot up considerably from 9.8 per cent per annum in the First Plan to 13.1 per cent per annum in the Second Plan and further to 19.6 per cent per annum in the Third Plan.



## Phase II (1965–80): Industrial deceleration and structural retrogression

The period 1965 to 1976 was marked by a sharp deceleration in industrial growth. The rate of growth fell sharply from 9.0 per cent per annum during the Third Plan to a mere 4.1 per cent per annum during the period 1965 to 1976. The last year of Phase II, i.e., 1979–80, recorded negative growth of industrial production of 1.6 per cent over the preceding year.

Several explanations were offered for the phenomenon of deceleration and retrogression in the industrial sector during Phase II. The Government expressed the view that exogenous factors, such as the wars of 1965 and 1971, drought conditions in some years, infrastructural constraints and bottlenecks and the oil crisis of 1973 were responsible for slowdown of growth. K.N. Raj argued that low growth in the agricultural sector accounted for the slowdown of industrial growth by restricting the supply of raw materials on the one hand, and by constraining the demand for industrial goods on the other. T.N. Srinivasan argued that there was a considerable slackening of real investment in Phase II, particularly in the public sector and this brought down the rate of growth in the industrial sector. Some economists like Jagdish Bhagwati blamed the wrong industrial policies, complex bureaucratic system of licensing and irrational and inefficient system of controls for industrial deceleration.

## Phase III (1981–91): Period of industrial recovery

The 1980s can broadly be termed as a period of industrial recovery.

The rate of industrial growth was 6.4 per cent per annum during 1981–85, 8.5 per cent per annum during the Seventh Plan and 8.3 per cent in 1990–91. This is a marked upturn from growth rates of around 4 per cent achieved during the latter half of 60s and 70s.

The main causes of industrial recovery during the 1980s are as follows:

1. ***New industrial policy and liberal fiscal regime:*** One of the main causes of industrial recovery during the 1980s was the liberalization of industrial and trade policies by the government. The most important changes were related to bringing down the domestic barriers to entry and expansion to inject a measure of competition in domestic industry, simplify the procedures and provide easier access to better technology and intermediate material imports, as well as more flexibility in the use of installed capacity with a view to enabling easier supply responses to changing demand conditions. These factors operating from the supply side were helped by the pursuit of what may be termed as a *liberal* fiscal regime. The important features of liberal fiscal regime were:
  - (i) maintenance of high budgetary deficits year after year, (ii) resort to massive borrowing, often at high interest rates and (iii) the encouragement of dissaving. Liberal fiscal regime helped in generating demand for manufactured goods, liberal industrial and trade policies ensured that an adequate supply response was following.

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- 2. Contribution of the agricultural sector:** Increased prosperity of large farmers in certain regions of the country helped to increase additional demand for industrial goods. The rural sector's demand for non-agricultural consumer products rose considerably from 35 per cent in 1967–68 to 47 per cent in 1983.
- 3. Growth of service sector:** There was a significant increase in Government expenditure on all services in the 1980s. The consumption pattern of the service class is less food-intensive and more oriented towards durable consumer goods. Therefore, the consumption pattern of effective demand in 1980s changed in favour of consumer durable goods.
- 4. The infrastructure factor:** There was a market resurgence in infrastructure investment in the 1980s. As against only 4.2 per cent per annum increase in infrastructure investment during 1965–66 to 1975–76, the increase was as high as 9.7 per cent per annum during 1979–80 to 1984–85. Infrastructure investment rose further by 16.0 per cent in 1985–86 and 18.3 per cent in 1986–87.

### Phase IV (1991–92 onwards)

1991 heralded a new era of economic liberalization. Major liberalization measures designed to affect the performance of the industrial sector were—widescale reduction in the scope of industrial licensing, simplification of procedural rules, reductions of areas exclusively reserved for the public sector, disinvestment of equity of selected public sector undertakings, enhancing the limit of foreign equity participation in domestic industrial undertakings, liberalization of trade and exchange rate policies, reduction of customs and excise duties and personal and corporate income tax, etc.

The rate of growth of industrial production which was 7.8 per cent per annum during the pre-reform decade fell to 6.0 per cent per annum during the post-reform decade. This disappointing performance is basically due to a steep fall in the rate of growth of capital goods sector as well as the basic goods sector.

The average annual rate of growth of the industrial sector in the Eighth Plan was 7.4 per cent per annum—the same as the targeted rate of growth.

An important reason for the slowdown of industrial growth in the recent past has been the slowdown of investment. It is a fact that capital formation in the public and private sectors provides a stimulus for industrial growth in the form of both the direct demand that such expenditures involve and the indirect demand resulting from income generation by investments. However, as a result of the adoption of the macroeconomic adjustment programme of the IMF in 1991, the Government of India was forced to cut down public expenditure drastically. Since there is a strong complement between public investment and private investment, a reduction in the rate of growth of public investment had a depressing effect on private investment as well.

The most important reason for unsatisfactory performance of the industrial sector has been the deteriorating state of infrastructure. Industrial production has suffered not only on account of inadequate availability of infrastructure like power and transportation bottlenecks, but also due to poor quality of infrastructure. All these factors added to the real costs of manufacture, and thus, adversely affected the competitiveness of domestic industry. The addition to power capacity in the Eighth Plan was less than in the Seventh Plan, even in absolute terms. The performance of the industrial sector in 1998–99 was particularly disappointing with the rate of growth in this sector being just 41 per cent. The factors responsible for poor industrial growth are listed in Economic Survey under two heads: (i) Domestic and (ii) External. The domestic factors are: (a) The decline in agricultural production in 1997–98 affected rural income, which directly resulted in lowering the demand for certain industrial products, (b) Capital markets have remained depressed for the past couple of years, drying up sources of investment funds for industry, (c) Larger enterprises have been in a better position to access funds. However, some of these units have utilized the resources largely in mergers and acquisitions, rather than additional capacity creation, and (d) Deficiencies in infrastructure services.

The external factors are: (a) Export growth has been sluggish since 1996–97 and the low demand for exports has adversely affected industrial production; (b) Although the Indian rupee has depreciated somewhat since August 1997, there has been much greater depreciation in East Asian currencies following the East Asian crisis in mid-1997. This higher depreciation has eroded the competitiveness of Indian products overseas by making them more expensive; and (c) Several industries like steel, chemicals and electronic components have been subject to competitive pressures from imports.

### Check Your Progress

3. State one results of regional imbalances in India.
4. Define region.

## 4.4 ANSWERS TO CHECK YOUR PROGRESS QUESTION

1. The three pillars of the government are Legislature, Executive and Judiciary.
2. A political system is a theoretical concept on which the government formulates policies and makes them more organized in administration.
3. One of the main results of regional imbalances is the people's migration to the developed areas.

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4. A territory is called a region, as the inhabitants of that territory have an emotional attachment to it due to commonality of historical traditions, religion, etc.

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### 4.5 SUMMARY

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- The economic and political systems of a country are mutually dependent, one reflecting the ideologies of the other.
- The legislature enacts legislation, i.e., creates laws by means of statutes or Acts, after issues are debated and passed by majority vote in parliament and the Bill (as an inchoate Act is called) receives the Presidential assent.
- The executive branch of government, i.e., the bureaucracy, is entrusted with the task of implementing these statutes (including ordinances or regulations flowing therefrom), while the judiciary adjudicates on issues arising from non-compliance with these laws.
- The Constitution of India contained seven fundamental rights originally. But the Right to Property was repealed in 1978 by the Forty-Fourth Constitutional Amendment bill during the rule of the Janata Government.
- The political divide in India is not one of policy, but essentially of personalities. Economic liberalization (which is what foreign investors are interested in) has been accepted as a necessity by all parties including the Communist Party of India (Marxist).
- One of the main results of regional imbalances is the people's migration to the developed areas. For example, many skilful people from India migrate to the developed countries.
- Regional disparities or imbalances manifest into wide differences in literacy rates, per capita income, availability of health and education facilities, stages of industrialisation, etc. between different regions.

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### 4.6 KEY WORDS

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- **Private Sector:** It refers to the part of the national economy that is not under direct state control.
- **Multinational Corporation:** It is a corporate organization which owns or controls production of goods or services in at least one country other than its home country.
- **Constitution:** It is a body of fundamental principles or established precedents according to which a state or other organization is acknowledged to be governed.

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## 4.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

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### Short-Answer Questions

1. Briefly discuss the different types of political system.
2. What are the features of a totalitarian government?
3. Write a short note on authoritarianism and the economy.
4. Describe regional policy in independent India.

### Long-Answer Questions

1. Describe in detail the Indian constitution with respect to business.
2. What are the business risks posed by the Indian political system?
3. Critically comment on the changing profile of the Indian economy.

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## 4.8 FURTHER READINGS

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## BLOCK II

### RULES AND ECONOMIC POLICY

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## UNIT 5 ECONOMIC SYSTEMS

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### Structure

- 5.0 Introduction
- 5.1 Objectives
- 5.2 Capitalist Economy
  - 5.2.1 Socialist Economy
- 5.3 Mixed Economy
- 5.4 Answers to Check Your Progress Questions
- 5.5 Summary
- 5.6 Key Words
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### 5.0 INTRODUCTION

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Economic systems are the means by which countries and governments distribute resources and trade goods and services. They are used to control the five factors of production, including: labour, capital, entrepreneurs, physical resources and information resources. There are four primary types of economic systems in the world: traditional, command, market and mixed.

This unit highlights the features capitalist economy, socialist economy and mixed economy.

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### 5.1 OBJECTIVES

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

- Discuss capitalist economy
- Explain the characteristics of a socialist economy
- Assess the features of a mixed economy

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### 5.2 CAPITALIST ECONOMY

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A capitalist economy is an economy where the laws of demand and supply operate freely. The capitalist system is one which is characterized by private ownership of the means of production, individual decision-making and the use of market-mechanism to carry out the decisions of individual participants and facilitate the flow of goods and services in markets.

The capitalist system has the following features:

1. **Market-mechanisms are the key factors that regulate the capitalist economy:** A market economy is one in which buyers and sellers express their opinions about how much they are willing to pay for goods and services. Prices guide the purchasing decisions of the consumers. At the same time, while they decide to buy or not to buy a product, consumers vote for or against the product by using their money. Thus, market prices, which reflect the desires of millions of consumers, provide guidelines to investors and other business persons. The market system, also called the price system, may therefore, be regarded as the organizing force in a capitalist economy.
2. **Consumers' sovereignty:** This is at its best in the capitalist system where consumers have complete freedom of choice of consumption. The production decisions in the free market economy are based on the consumer's desires which are reflected in the demand pattern. Under capitalism, the consumer is the king.
3. **Competition:** Among sellers and buyers, competition is an essential feature of an ideal capitalist system. Competition reduces market imperfections and related problems. Therefore in a free market economy, a sufficient amount of competition is necessary in a private enterprise economy to keep initiative constantly on alert, to protect the consumer and to maintain a sufficiently flexible price system.
4. **Private ownership:** In a capitalist economy, the factors of production – land, labour and capital are privately owned and production occurs at private initiative. Individuals have their property rights protected and are usually free to use their property as they like, as long as they do not infringe on the legal property rights of others. Private property is protected, controlled and enforced by law.
5. **Free enterprise:** This feature of the capitalist system is merely an extension of the concept of property rights. The term free enterprise implies that private firms are allowed to obtain resources to organize production and to sell the resultant product in any way they choose. In other words, there will not be any restrictions on the freedom and ability of the private individuals to carry out any business.
6. **Freedom of choice of occupation:** In a capitalist economy, the individual is free to choose any occupation he is qualified for. This freedom of choice enables the worker to make the best possible bargain for his labour. This implies that the employers have to competitively bid for labour. Freedom of occupational choice, however, does not mean guarantee of a job a worker opts for; the choice is practically limited by the extent of availability of the jobs.
7. **Freedom to save and invest:** The freedom to save is implied by the freedom of consumption. The term saving implies the sacrifice of

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consumption. The right to save is supported by the right to transmit wealth so that the choice between present and future consumption is not limited to the adult life of one person. The freedom to save, inherit and accumulate wealth is, therefore, a right which is perhaps more typical for the private enterprise system than in free choice of consumption and occupation.

8. **Limited role of government:** Government has no role in economic activities. Capitalism believes that government is an evil necessary and that government is the best which governs the least.

### 5.2.1 Socialist Economy

Within the wide spectrum of socialism, there are indeed a variety of systems. At one end, there are the communist countries characterized by state capitalism and at the other, there are the democratic socialist nations with a dominant private sector. It is therefore, very difficult to clearly define the socialist system. Socialism, however, is generally understood as an economic system, where the means of production are either owned or controlled by the state and where the resource allocation, investment pattern, consumption, income distribution, etc., are directed and regulated by the state.

The salient features of a socialist system are:

1. **Government ownership:** In socialist countries, the major means of production are either owned by the government or their use is controlled by the government. In communist economies, the private sector also plays a very important role. In such cases, the government directs and regulates investment allocation and production patterns in accordance with national priorities. In some countries such as India, some of the basic sectors are in the public sector so that resource allocation and investment pattern of the private sector may be regulated and controlled. When the state owns almost all the means of production, it is easier to achieve the desired pattern of resource allocation.
2. **Central authority:** The socialistic economies generally have a central authority like the central planning agency to formulate the national plan for development and to direct resource mobilization, allocation and investment to achieve the plan targets. Socialist economies are sometimes called command economies, because the central planning authority commands the pattern of resource utilization and development. They are also called centrally-planned economies.
3. **Restriction on consumption:** In communist countries, there is no consumer sovereignty because the state decides what may be made available to consumers, unlike in the market economies where the consumers have the freedom to choose from a wide variety. The consumers in a communist system, thus, have to be content with what the state thinks is sufficient for them.



4. **Restriction on occupation:** The freedom of occupation is absent or restricted in socialist countries. An individual may not have the freedom to choose any occupation he is qualified for. Similarly, individual freedom of enterprise is absent.
5. **Fixation of wages and prices:** The wages and prices in a communist economy are fixed by the government and not by market forces. Non-communist socialist countries may also fix wages and prices by certain means.
6. **Distribution of income:** An equitable distribution of income is an important feature of the socialist system. This does not mean, however, that socialist systems aims at perfect equality in income distribution. Wage differentials, depending on the nature and requirements of the job, are recognized in socialist economies. The objective of equitable income distribution may be achieved by fixing the wage rates and other economic rewards or by means of fiscal and other appropriate measures.

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### Check Your Progress

1. Define capitalist economy.
2. State an important feature of the socialist system.

## 5.3 MIXED ECONOMY

Mixed economy is the outcome of compromise between two diametrically opposite schools of thought — one which champions the cause of laissez-faire capitalism and the other which espouses the cause of socialization of all means of production. The vast economic development of UK, USA and all free nations of Europe and Australia was due to private enterprise. The economic system worked through the operation of invisible hands. Karl Marx did not accept the capitalist ideas and pleaded for socialization of all the means of production and the state to direct the economy.

It was the failure of the capitalist system that led to the emergence of the mixed economy. Prof. Laski declared that laissez-faire as a principle ended with the outbreak of World War I in 1914. The World War I led to the near total government control of every aspect of economy in nearly all western countries. The worldwide depression brought unemployment and economic misery on an unprecedented scale and led to vigorous demands for state intervention. Keynes' *General Theory* which was published in 1936 is a repudiation of the foundations of laissez-faire. Keynes remarked that the outstanding faults of the economic system in which we all live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and income.

Keynes recommended the establishment of certain controls in matters which are now left in the main to individual initiative in order to exercise a guiding influence

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on the propensity to consume partly through its scheme of taxation and partly in other ways, and also in order to ensure a somewhat comprehensive socialization of investment which will prove the only means of securing an approximation to full employment. The central controls necessary to ensure full employment will, of course, involve a large extension of traditional functions of government.

Keynes thought neither pure capitalism nor pure socialism could survive as a stable social system. And so came the philosophy of mixed economy. Keynes is the originator of the concept of mixed economy or the controlled economy. Mixed economy operates through a combination of planning and pricing.

Considering the limitations of both maximum role of government under socialism and minimum role of government under capitalism, the world politico-economic order has moved towards mixed economy with optimum role of government. The increasing government intervention in business is justified for welfare capitalism. Government is expected not to end, but to mend capitalist patterns of development in accordance with the principle of maximum social advantage. Government is required to supplement the individual entrepreneurs whenever they fail.

In a mixed economy, private, public and joint sectors and the like all have some say in the major decisions that influence the functioning of an economy.

There are four important economic roles played by the government in a mixed economy.

- The regulatory role
- The promotional role
- The entrepreneurial role
- The planning role

1. **The regulatory role:** A large part of the economy is regulated by the government. The government cuts across all broad categories of economic enterprises.

First, the government may determine the conditions under which persons or associations may enter certain lines of business as in the granting of a charter, a franchise or a licence or permitting them to use public resources.

Second, the government may regulate the conduct of economic ventures of any kind.

Third, public control may extend to the results of business operations as in the limitations of public utility profits, ceilings on dividends and the imposition of excess profits tax.

Fourth, the government controls the relationships between various segments of the economy, the purpose being to settle conflicts of interests and to prevent undue concentration of economic powers in a few hands.

2. **The promotional role:** The promotional role played by the government is very important both in the developed and developing economies. In developing countries, where the infrastructural facilities for development are inadequate and experimental activities are scarce, the promotional role of the government assumes special significance. The state will have to assume direct responsibility to build and strengthen the necessary development infrastructures such as power, transport, finance, marketing, institutions for training and other promotional activities.

The promotional role of the state also encompasses the provision of various fiscal, monetary and other incentives for the development of certain priority sectors.

3. **The entrepreneurial role:** The growing importance of the entrepreneurial role of the state is evident from the rapid expansion of the public sector in most countries.

Dimock mentions the following reasons for the growth of public ownership in free societies:

- (i) The growth of public ownership in a free society depends on a combination of belief systems plus practical necessities.
  - (ii) In a democracy, the national emergency of war inevitably causes an expansion in state activity, including public ownership. This is because modern requirement of total war causes people to forsake their convictions concerning private responsibility and to concentrate on massed power.
  - (iii) Major economic dislocations such as the Great Depression of the 1930s tend to stimulate state activity again, leaving a residue of public ownership that takes time and effort to dissipate.
  - (iv) In the economic growth of nations, governments are called on to act as bankers or owners of infant industries and generally to expand their central concern for the economy, thus quoting a considerable degree of public ownership at the outset.
  - (v) When private undertakings become unprofitable, but the need for their service continues, the government may be prevailed upon to acquire and manage such non-profitable business concerns.
  - (vi) Governments are also required to extend the owner-manager relationship when there has been pronounced wastage of national resources.
  - (vii) Government ownership may be extended when the private management fails to deliver the goods.
4. **The planning role:** In developing countries, the state plays a very important role as planner. The modern state is the custodian of the welfare of society. The welfare government has the responsibility for fulfilling the aspirations of

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the people by bringing about all-round prosperity. The ends to be achieved and the purposes to be served, are many. In the pursuit of the task, the most important problem is the scarcity of resources. The available resources are quite insufficient to meet all the ends. The resource constraints demand that some of the purposes should go unserved. This calls for the determination of the more urgent needs or national priorities and the optimal allocation of the available resources to subserve the common goods. And this is the principal objective of national planning.

### Check Your Progress

3. What led to the emergence of the mixed economy?
4. What is the basis of Keynes' *General Theory*?

## 5.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. A capitalist economy is an economy where the laws of demand and supply operate freely.
2. An equitable distribution of income is an important feature of the socialist system.
3. It was the failure of the capitalist system that led to the emergence of the mixed economy.
4. Keynes' *General Theory* which was published in 1936 is a repudiation of the foundations of laissez-faire.

## 5.5 SUMMARY

- A capitalist economy is an economy where the laws of demand and supply operate freely.
- The capitalist system is one which is characterized by private ownership of the means of production, individual decision-making and the use of market-mechanism to carry out the decisions of individual participants and facilitate the flow of goods and services in markets.
- A market economy is one in which buyers and sellers express their opinions about how much they are willing to pay for goods and services.
- Within the wide spectrum of socialism, there are indeed a variety of systems. At one end, there are the communist countries characterized by state capitalism and at the other, there are the democratic socialist nations with a dominant private sector.

- An equitable distribution of income is an important feature of the socialist system. This does not mean, however, that socialist systems aims at perfect equality in income distribution.
- Mixed economy is the outcome of compromise between two diametrically opposite schools of thought — one which champions the cause of laissez-faire capitalism and the other which espouses the cause of socialization of all means of production.
- There are four important economic roles played by the government in a mixed economy.
- In developing countries, the state plays a very important role as planner. The modern state is the custodian of the welfare of society.

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### 5.6 KEY WORDS

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- **Consumer:** It refers to a person who purchases goods and services for personal use.
- **Socialism:** It refers to a political and economic theory of social organization which advocates that the means of production, distribution, and exchange should be owned or regulated by the community as a whole.
- **Income:** It refers to money received, especially on a regular basis, for work or through investments.

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### 5.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

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#### Short-Answer Questions

1. What is free enterprise?
2. Discuss government ownership in brief.
3. Who was Keynes?
4. Write a short note on mixed economy.

#### Long-Answer Questions

1. Discuss all the features of a capitalist system.
2. Give a detailed description of a socialist economy. What are its salient features?
3. What are the four important economic roles played by the government in a mixed economy?

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## 5.8 FURTHER READINGS

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### NOTES

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## UNIT 6 FINANCIAL ENVIRONMENT

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### Structure

- 6.0 Introduction
- 6.1 Objectives
- 6.2 An Overview of the Financial System
  - 6.2.1 Components of Financial System
- 6.3 Financial Institutions and their Roles
  - 6.3.1 Classification of Financial Institutions
  - 6.3.2 Role of Financial Institutions
  - 6.3.3 Importance and Limitations of Financial Institutions
- 6.4 Financial Institutions in India
- 6.5 Role of Foreign Direct Investment
- 6.6 Answers to Check Your Progress Questions
- 6.7 Summary
- 6.8 Key Words
- 6.9 Self Assessment Questions and Exercises
- 6.10 Further Readings

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## 6.0 INTRODUCTION

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The global financial system is a network of financial institutions and regulations functioning at the international level. In this unit, you will study components of financial system in detail. This unit further explains the role of financial institutions and discusses financial institutions in India in detail.

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## 6.1 OBJECTIVES

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

- Describe the components of financial system
- Classify financial institutions and discuss their role
- Describe the financial institutions in India
- Discuss the role of Foreign Direct Investment

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## 6.2 AN OVERVIEW OF THE FINANCIAL SYSTEM

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In an economy, a financial system refers to a system that organizes the settlement of payments, raises and allocates finance, and manages the risks associated with financing and financial exchange. A developed financial system has a secure and efficient payment system, security markets and financial intermediaries to arrange finances and financial institutions to provide access to risk management instruments.

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The key players in the global financial system are global financial institutions such as the International Monetary Fund (IMF) and the World Bank; national agencies and government departments like central banks and finance ministries; and private financial institutions like private banks and mutual funds.

Financial institutions are an integral part of the structure of a financial system, and thus play an important role in the growth and smooth functioning of an economy.

### 6.2.1 Components of Financial System

The financial system, also known as the financial sector of a country, is like a well-framed structure, which consists of the following components:

- **Financial institutions:** In layman's terms, a financial institution is a public or private institution that collects funds from the public or other institutions and invests them in financial assets. In more specific economic terms, a financial institution acts as an agent that provides financial services to its clients. Financial institutions generally fall under the financial regulation of a government authority. Financial institutions commonly include banks, credit unions and stock brokerages.
- **Financial markets:** This is a generic term for markets where financial instruments are traded or the transactions of financial assets take place. The key participants on the demand and supply sides of the financial markets are financial institutions, agents, brokers, dealers, savers, borrowers and lenders, etc.
- **Financial instruments and services:** This is a term used to denote any form of funding medium which is used for borrowing finance in financial markets. A financial instrument is also referred to as a document having a monetary value or a record of some monetary transaction. Examples of financial instruments are cheques, drafts, bills of exchange and promissory notes.

All the components of a financial system that constitute its structure are not mutually exclusive, i.e., they are interdependent and interrelated to each other. For example, financial institutions operate in a financial market and make use of various financial instruments and services to carry on their business. Here, it should also be kept in mind that various procedures, rules, regulations, policies and practices prevailing in the financial markets and adopted by the financial institutions are also part of a financial system.

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## 6.3 FINANCIAL INSTITUTIONS AND THEIR ROLES

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Broadly, in an economy two types of business organizations exist—non-financial and financial. Non-financial organizations manufacture products such as automobiles, technological equipment and food products and/or provide services that are not financial in nature such as legal services, electricity supply, and so on. However,



financial organizations, better known as financial institutions, do not manufacture any goods but provide financial services. The various financial services provided by financial institutions are as follows:

- Acquisition of financial assets that are less preferred by the public through the market and converting them into more preferable assets. This service is generally provided by financial intermediaries—the most important type of financial institutions.
- Exchange of financial assets on behalf of their customers. For example, if an individual possessing shares of a company wants to sell his shares, he need not directly deal with the buyer of the shares. The stock exchange can sell and buy shares on behalf of its customers.
- Exchange of financial assets not only on behalf of their customers, but also for their own accounts.
- Assistance to customers in creating financial assets and then selling these assets to other participants in the financial market.
- Investment advice such as how and where to invest money to other financial market participants.
- Management of portfolios of other market participants.

### **Objectives of financial institutions**

Financial institutions are set up for a specific purpose and to achieve certain objectives. Some of the objectives of financial institutions are as follows:

- Providing long and medium-term financial assistance to industrial enterprises.
- Ensuring balanced regional growth in socio-economic terms by attaining balanced industrial growth.
- Accelerating the pace of industrial growth.
- Building and strengthening the capital market. Capital market refers to the market where funds in the form of stocks, bonds and other securities are invested for a long-term.
- Assisting in the creation, expansion and modernization of industrial enterprises.
- Encouraging and promoting the participation of private capital.
- Providing managerial, technical and administrative services to Indian industry.

### **6.3.1 Classification of Financial Institutions**

Financial institutions can be broadly classified into the following two categories based on their field of specialization:

- Banking and non-banking institutions
- Intermediaries and non-intermediaries

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## Banking and non-banking institutions

Banking institutions are marked by the following three characteristics:

- They participate in or contribute to the payments mechanism of the economy, which means that they provide transaction services.
- Their deposit liabilities comprise a major part of the national money supply.
- They can create deposits or credit, which means that they actually create money in the financial market.

The banking institutions in India function under the aegis of the Reserve Bank of India (RBI) and mainly consist of commercial banks and cooperative banks.

The non-banking institutions also carry out financial activities, but their resources do not come to depositors in the form of savings. Instead, they mobilize public savings for providing other financial services, including investments. Mutual fund companies and insurance companies such as the Unit Trust of India (UTI), Life Insurance Corporation (LIC) and General Insurance Corporation (GIC) fall under this category.

The non-banking institutions are actually financial intermediaries and when they lend money to the public, they are known as non-banking financial intermediaries (NBFIs) or investment institutions.

### Intermediaries and non-intermediaries

Intermediaries, as the term suggests, act as a link between savers and investors. The main functions of intermediaries include lending money to the public and mobilizing public savings. Although they are liable towards the ultimate savers, their assets generally come from the investors and borrowers. All banking institutions are actually intermediaries and, some non-banking institutions are also intermediaries.

Non-intermediary institutions provide loans but they do not acquire their resources directly from the savers. Major non-intermediary institutions like the Industrial Development Bank of India (IDBI) and National Bank for Agriculture and Rural Development (NABARD) have been set up by the government to provide assistance to specific sectors and regions for specific causes. As they are set up by the government they are also known as Non-Banking Statutory Financial Organizations (NBSFOs). The main idea behind setting up these non-intermediary institutions was to fulfil the credit needs of the borrowers, especially rural, who are not adequately assisted by the private financial institutions.

### Role of Financial Intermediaries

Financial intermediaries being the most important type of financial institutions, it is important to understand their role and functioning. Financial intermediaries acquire funds by issuing financial claims to the interested financial market participants and

then invest the collected funds in loans and/or securities. This investment made by the financial intermediaries is referred as direct investment. Since the financial intermediaries actually utilize the money of market participants who have bought the financial claims issued by financial intermediaries, market participants have also invested their money indirectly, which is referred to as indirect investment. This can be better understood with the help of an example. Consider that an investment company—a financial intermediary—obtains funds from market participants by issuing its financial claims. It then uses these funds to buy securities such as stocks and bonds, which is a kind of investment. Investors or market participants who have provided money to the investment company also get a share in the securities bought in proportion to the investment they have made. In this case, the securities purchased by the investment company represent the direct investment and the share owned by the investors in the securities represents indirect investment.

From this example it is clear that the main role of financial intermediaries is to convert less desirable financial assets into other financial assets, which are readily preferred by a large public. This transformation involves one or more of the following four economic functions:

1. Providing maturity intermediation
2. Reducing risk via diversification
3. Reducing the costs of contracting and information processing
4. Providing a payments mechanism

### **1. Providing maturity intermediation**

Borrowing funds for a short-term and lending the acquired funds for a longer-term is known as maturity intermediation. For instance, a commercial bank generally has two types of deposits—deposits that it has to pay back as and when demanded and deposits that have a certain maturity period, say two years. But the loans given by the commercial bank have a maturity period of more than two years, i.e., the bank will get back its complete money after two years. If all the savings in the bank are demanded back by the depositors within two years and the loans have not been received back yet, the bank will be left with no money to lend. Thus, the commercial bank issues its own financial claims and transforms a longer-term asset into a shorter-term asset. It does so by giving the borrower a loan for the time period as desired by him and by allowing the investor to invest his saving for as long as he wants. This function of a financial intermediary is called maturity intermediation.

### **2. Reducing risk via diversification**

The economic function of financial intermediaries, wherein they transform more risky assets into less risky assets is called diversification. For example, an investor invests his funds in an investment company and the investment company invests

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the acquired funds in purchasing stocks of a number of companies. By investing the funds of its investors in a large number of companies, the investment company has actually diversified the investment, thus reducing the risk in getting returns on investment. An individual investor might not be able to achieve the same level of diversification with the same cost-effectiveness because of limited funds to invest in more than one company.

### 3. Reducing the costs of contracting and information

#### *Processing*

The cost incurred in obtaining and processing information about the financial assets that an individual or an investor wants to acquire is called information processing cost. In case an investor wants to invest his money by lending it as a loan, he has to write a loan contract or hire a professional to do it. This cost of writing a loan contract is termed as contracting cost.

Though it is difficult for an individual investor to reduce the contracting and information processing costs because of the lack of required knowledge and skills, financial intermediaries help reduce these costs to a large extent. Financial intermediaries are able to do so because analysing costs and reducing them is their daily business; they do it on a large scale, which provides them the benefit of economies of scale and they hire skilled and qualified professionals to do so.

### 4. Providing a payments mechanism

It is a well-known fact that economies today no longer run on the barter system and transactions are done through money. But with the advent of payment mechanisms like cheques, credit cards, debit cards and electronic money transfer through the Internet, use of cash has been reduced to a large extent. These payment mechanisms or methods of making payments are provided by financial intermediaries.

#### 6.3.2 Role of Financial Institutions

As you are now clear about the role of financial intermediaries in an economy, it will be easier to understand the role of financial institutions at large. You are well aware of the importance of money and finance to run a nation and its economy. Plans and policies can be formulated related to any developmental aspect of the country, but to successfully implement these plans and policies, finance is needed. Thus, in order to understand the role of financial institutions in a better perspective, it is important to understand their role in different fields. The various fields, which are focussed upon, are as follows:

- **Role of financial institutions in small and medium enterprises (SMEs):** Finance has always been a major problem for SMEs in India. Lack of availability of finance on affordable terms and conditions and rampant red-tapism have also increased the problem of SMEs in obtaining finance on time. This is one of the biggest obstacles in their way of accessing and

adopting new, cost-effective technologies and improving their way of working. One solution to this problem is to provide venture capital to the needy SMEs. To put simply, venture capital is the capital invested in a risky business where the chances of success are uncertain. Venture capital not only helps in promoting access to new technologies, but also indirectly promotes the development of new indigenous technologies. Many financial institutions like IDBI, Industrial Credit and Investment Corporation of India (ICICI), Industrial Finance Corporation of India (IFCI) and other commercial banks are helping SMEs in collaboration with venture capital companies. Many other financial institutions like the Small Industries Development Bank of India (SIDBI) are also assisting SMEs in their research and development programmes, which are very essential to develop and assimilate new, resource-efficient technologies with minimum waste output.

- **Role of financial institutions in long-run economic growth:** Various studies have shown that an efficient financial system, including its financial institutions, help a nation's economy to grow. This has been made possible by the well-functioning financial institutions and banks that provide funds to various enterprises to develop new technology and implement innovative products and production processes. The higher the production rates are, the better is the economic growth. However, it is worth mentioning here that economic growth does not solely depend on production rates, but also on a number of other factors such as the level of savings and investments. Financial institutions also promote the desire to save in individuals. A dearth of financial institutions in an economy makes it difficult for the people to save at a higher level which results in low saving rates. The low saving rates further leads to low investment rates, which ultimately leads to slow or no economic growth. Thus, it is clear how important the role of financial institutions in long-term economic growth of a country is.
- **Role of financial institutions in industrial infrastructure upgradation schemes (IIUS):** Financial institutions play a crucial role during the various implementation stages of the schemes aimed at upgrading the industrial infrastructure. The different stages are as follows:
  - o **Structuring the project:** Here, project refers to the scheme for industrial infrastructure upgradation. Financial institutions help in assessing the commercial scope of the project, determining the risks associated by using risk evaluation and mitigation methods and in preparing various financial models such as banking capital structure and cash flow model.
  - o **Arranging finance:** Financial institutions help in identifying the available sources of finance to provide funds for the implementation of the selected project. They also help in evaluating the return on investment and risks involved in getting returns.

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- o **Monitoring the project:** Financial institutions also assist in designing a monitoring and evaluation method to independently evaluate the project against the set standards.

- **Role of financial institutions in financial education:** For an individual it is not only important to earn money, but he should also be well informed and educated to be able to use the earned money judiciously. If the money is not used properly and in a planned manner, it can result in increase in debt, misuse of credit facilities and all this will eventually lead to slow economic growth.

On the contrary, financial education will help an individual in improving his standard of living as he will be in a position to utilize his money well. Financial institutions play an important role in imparting financial education as they can do the following things:

- o Financial institutions should realize their social responsibility and act in the interest of society. They should not forget that financial markets are the cause and effect of the business carried on by a society and thus, the financial institutions should educate the society, which is their potential market participant.
- o Financial institutions should encourage and support financial education programmes running throughout the world by providing them with financial support so that a greater number of people can have access to financial education.
- o Financial institutions can also collaborate with other organizations, which are in the business of imparting financial education.
- o Financial institutions can develop an interactive website for the purpose of imparting financial education. One such website is [www.teachmefinance.com](http://www.teachmefinance.com).

### 6.3.3 Importance and Limitations of Financial Institutions

From the various roles of financial institutions that we have discussed we know how important they are to an economy. It will not be an exaggeration to say that an economy cannot survive for too long and is handicapped if financial institutions do not exist. According to a report of the Reserve Bank of India published in August 2003, 'Financial institutions have initiated economic development in the country. There is a further boost in economic development because of liberalization, as it has enabled the financial institutions to cater to a large population, which was otherwise out of their reach and impact.'

The report further goes on to state, 'There has been a general improvement in the efficiency of the financial sector reflected by factors such as reduced cost of intermediation, increased profitability and reduced operating expenditure of financial entities. The stability of the financial institutions has also improved significantly as testified by factors such as strengthened capital base and improved asset quality.'

The importance of financial institutions can also be assessed from the fact that they are considered to be the only regulatory mechanism and source of finance to fund mega projects related to socio-economic and infrastructural development of the country. Financial institutions are the instruments of channelizing public savings and national resources at subsidized rates towards those sectors, which are given preference and priority in the Five Year Plans. They also use their brand and expertise to take advantage of the emerging growth opportunities to the fullest.

Another reason why financial institutions are so important is because there are certain advantages of obtaining funds from these specialized institutions. Some of the advantages offered are as follows:

- They provide funds to industrial undertakings at lower rates of interest with easy repayment facility.
- They are specially designed to facilitate the growth of the small-scale sector.
- They help industrial enterprises in the issue of shares and debentures.
- They provide guarantee of loans raised by industrial enterprises in the open market.
- They subscribe to shares and debentures issued by public companies.
- They act as an agent of the government in respect of loans sanctioned to industrial concerns.
- They help the nation in the process of development by making it economically sound.

### **Limitations of Financial Institutions**

The most crippling problem faced by financial institutions has always been the issue of autonomy. Though financial institutions have gone into the reform and liberalization phase, they still do not enjoy much independence when it comes to decision-making. For instance, IDBI provides an assistance of about Rs 28,300 crore on an average annually and has the capacity to bring a drastic change in the Indian economy, but it is managed and controlled by the government. The major areas where the financial institutions face difficulties because of lack of autonomy are as follows:

- **Tackling non-performers:** Though the financial institutions deal easily and efficiently with small companies, they are not able to do so in case of large companies because of the inability to take independent decisions. In the case of large companies, the decisions are largely influenced by political pressure. Financial experts believe that financial institutions should take decisions based on economic rationale only, but this is not possible due to interference of the government. Moreover, financial institutions become unable to punish the non-performing and corrupt business entities.
- **Hampering investments:** As financial institutions do not enjoy much of autonomy and are controlled by the government, they are unable to exercise

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their powers in the companies in which they have major stakes as shareholders. Not only this, their growth plans also suffer to a large extent. Financial institutions also play a major role in mergers and acquisitions (M&A). But they are not being able to play this role well, because they are not market driven and suffer from bureaucratic bottlenecks.

- **Limited exposure:** This means that the financial institutions can have exposure in limited companies only. To support this fact, Section 2(c) of the IDBI Act 1964 can be stated. This section of the act specifies the companies with whom IDBI can do business and this list does not include housing, real estate and trade. The fact that these sectors are growing and are very profitable cannot be denied and everybody would like to invest in these sectors, but the financial institutions do not have a way out. Another reason for the limited exposure is that the financial institutions do not want to involve themselves in new ventures because they avoid the cumbersome process of getting their proposals cleared from the respective ministries.
- **Operational obstacles:** Lack of autonomy also comes in the way of operations of financial institutions. These institutions have to hire experienced, skilled and qualified personnel for their day-to-day functioning. To employ such people, there should be flexibility in recruiting and willingness to pay huge, attractive packages, which might also include employee share-ownership plans. Here also, government interference creates havoc, as the financial institutions do not have the freedom to offer such plans and packages without consulting the government.
- **Generating inefficiency:** Even if financial institutions want to enjoy the advantages of efficient risk management and optimization of returns on investment, they cannot do so because they do not have the freedom to change or shuffle their portfolios. All this makes financial institutions complacent, unambitious and ineffective.

Nobody actually knows when this issue of autonomy will be resolved. Till financial institutions are given autonomy they should consider some other options to work efficiently towards their objectives. The need of the hour is that they work as small development banks and strike a balance between social responsibilities and commercial interests. They should develop a business model, which is commercially feasible and help them perform their developmental functions simultaneously.

### Check Your Progress

1. What is a financial system?
2. What are the main functions of intermediaries?



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## 6.4 FINANCIAL INSTITUTIONS IN INDIA

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During the recent past, the Indian financial system has undergone structural transformation. With a view to enhance the macroeconomic performance of the economy, wide ranging reforms were initiated during the early 1990s focused on creating efficient and stable financial institutions and markets. The approach to reforms was one of gradual and non-disruptive progress through a consultative process. The authorities have been successful enough to put in place a proper regulatory framework coupled with prompt and effective supervision and development of technological and institutional infrastructure comparable with global standards. Interest rate regime has been largely deregulated with a view towards better price discovery and efficient resource allocation.

The Indian banking sector, in particular, witnessed many positive developments during the recent past. The policy makers (comprising the RBI, Ministry of Finance, and related government and financial sector regulatory entities), have taken a number of steps to improve regulation and supervision in the sector. The number of banks successful in establishing an outstanding track record of innovation, growth and value creation has been on the increase. Over the last few years, banking institutions in India have compared favourably with other regional banks in the matter of growth, asset quality and profitability. Policy makers have put in place some notable changes in policy and regulation to help strengthen the banking sector. These changes include strengthening prudential norms, enhancing the payments and settlement system, and integrating regulations between commercial and cooperative banks.

The next section is a brief description of each of these components which, it is hoped, will be useful for a fuller appreciation of the current picture relating to the Indian financial system.

### **Banking Sector/Institutions**

The various banking institutions are discussed below.

#### ***Indian joint stock banks***

Indian joint stock banks form an important constituent of the Indian financial system. These banks are classified into *scheduled* and *non-scheduled* banks. They follow branch banking and perform all the typical functions of commercial banks. The branch expansion policy in the recent past has resulted in correcting the regional maldistribution of branch network. Today the banking system covers a much larger segment than it did a few years ago. As a result, growth in deposits has been substantial. In 1969, the RBI introduced the Lead Bank Scheme with the twin objective of mobilization of deposits on a massive scale and stepping up of lending to weaker sections of the economy.

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Since the early 1950s, there has been an earnest attempt to strengthen the banking system.

Various measures have been taken to strengthen the capital base of banks. Capital adequacy has been the corner stone of prudential regulatory framework in India. With the onset of financial sector reforms, banks have started diversifying their activities through (i) entry into insurance business, (ii) increasing the volume of retail banking, (iii) development of housing finance, (iv) investment in capital market, (v) formation of subsidiaries for para-banking activities, (vi) equity investment in commodity exchange, and so on.

Technological development and the use of information technology have transformed the functioning of Indian banks. Instances of technological development include: provision of core banking solutions, installation of ATMs, use of electronic payment systems, introduction of RTGS (real time gross settlement, or **RTGS**, system is a funds transfer mechanism where transfer of money takes place from one bank to another on a 'real time' and on 'gross' basis).

### **Foreign banks**

Foreign banks are those which are foreign in origin and have their head offices located outside India. The requests of new foreign banks for conducting business in India are considered keeping in view the financial soundness of the bank concerned along with certain other crucial factors. The capital adequacy ratio of foreign banks is, by and large, satisfactory. The main business of foreign banks is the financing of India's foreign trade.

There are certain complaints against the working of some of the foreign banks. The minimum lending of foreign banks to the priority sector shall be 32 per cent of their net credit. Any shortfall in the target shall be compensated by depositing an amount equivalent to the shortfall with SIDBI.

### **Cooperative banks**

Cooperative banking movement received momentum after the World War II. Under the Banking Regulation Act, only urban cooperative banks, state cooperative banks and district central cooperative banks are qualified to be addressed as banks in the cooperative sector.

Rural areas are served by two distinct sets of institutions extending short-term credit and long-term credit. Short-term cooperative credit institutions comprise state cooperative banks, district central cooperative banks and primary agricultural credit societies. Long-term cooperative credit institutions comprise state cooperative agriculture and rural development banks and primary cooperative agriculture and rural development banks.

Urban areas are served by urban cooperative banks. Urban cooperative banks are registered under Cooperative Societies Acts of the respective state governments. They are required to channelize 40 per cent of their adjusted bank

credit towards priority sector. Reserve Bank is the regulatory authority for state cooperative banks and central cooperative banks. Their supervision is entrusted with National Bank for Agriculture and Rural Development (NABARD).

### ***NABARD***

Agricultural Refinance and Development Corporation (ARDC) came into existence in 1972. NABARD was established in 1982. It took over the functions of the erstwhile Agricultural Credit Department (ACD) and Rural Planning and Credit Cell (RPCC) of RBI, and ARDC. **NABARD** is an apex institution accredited with all matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas. It is an apex refinancing agency for the institutions providing investment and production credit for promoting the various developmental activities in rural areas. It takes measures towards institution building for improving absorptive capacity of the credit delivery system, including monitoring, formulation of rehabilitation schemes, restructuring of credit institutions, training of personnel, and so on. It coordinates the rural financing activities of all the institutions engaged in developmental work at the field level and maintains liaison with Central Government, state governments, RBI and other national level institutions concerned with policy formulation. It promotes research in the fields of rural banking, agriculture and rural development.

### ***State Bank of India***

State Bank of India (SBI) is the founder and the flagship member of the State Bank Group; which has the largest banking branch network in India with over 16,000 branches. SBI has a market share among Indian commercial banks of about 20 per cent in deposits and loans. SBI is the largest Indian banking and financial services company (by turnover and total assets). It provides a range of banking products through its vast network of branches in India and overseas, including products aimed at non-resident Indians (NRIs). The bank also has around 130 branches overseas. SBI is the only Indian bank that figures in *Fortune* top 100 banks. In addition to banking services, SBI offers an entire range of financial services. It has adopted and is pursuing vigorously its information technology policy. The bank's central board is primarily responsible for management of risk. SBI plays a vital role in priority sector, export credit and agricultural financing.

### ***Reserve Bank of India***

The preamble to the Reserve Bank of India Act, 1934, lays down the object of apex bank to be 'to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in British India, and generally to operate the currency and credit system to its advantage'. Originally, the bank was constituted as a shareholders' bank. Subsequently, it was nationalized. From 1949, Reserve Bank of India (RBI) began functioning as a state-owned and state-controlled central bank.

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RBI performs all the typical functions of a central bank. These include monopoly of note issue and currency management, implementation of monetary policy, acting as bankers' bank and lender of the last resort, acting as banker to the Government and exchange control functions.

Maintenance of price stability and ensuring availability of adequate credit to the productive sectors are the major objectives of monetary policy in India. The conduct of monetary management has undergone significant changes in the 1990s. The process of making monetary policy in India is an elaborate one. Bank Rate policy coupled with liquidity adjustment facility and open market operations, variable reserve ratio method, qualitative controls such as selective credit controls, moral suasion, credit rationing and direct action are the major instruments of monetary policy.

Government accepted the major recommendations of the Committee to Review the Working of the Monetary System appointed in 1982. The current developmental role of the bank encompasses an extensive canvas. Several measures have been taken to develop a bill market in India. The notable ones include the establishment of the Discount and Finance House of India Limited.

### **Non-Banking Financial Institutions**

Non-banking financial institutions consist of development finance institutions, non-banking financial companies, primary dealers, and capital market intermediaries such as mutual funds. EXIM Bank, NABARD, NHB and SIDBI are development finance institutions. The growth of non-banking financial companies has been rapid since the 1990s.

Components of the non-banking sector include non-banking financial companies, equipment leasing companies, hire-purchase finance companies, investment companies, loan companies, miscellaneous non-banking companies such as chit fund companies, residuary non-banking companies, non-banking non-financial companies, and housing finance companies.

The regulatory framework for non-banking financial companies has been in existence since 1963. It is only since 1990s that the entire gamut of regulation and supervision has been redefined. Capital adequacy norms have been made applicable to non-banking financial companies in 1998.

In the matter of supervision, the focus is on prudential supervision. A four pronged supervisory framework has been put in place. This is based on on-site inspection, off-site monitoring, market intelligence and exception reports of statutory auditors.

### ***Indigenous bankers and moneylenders***

***Indigenous bankers*** are individuals or firms who deal in 'hundis' (basically, a parallel or alternative remittance system that exists or operates outside of, or parallel to traditional banking or financial channels), whether they accept deposits or not.

Indigenous banking is the monopoly of certain castes. Indigenous bankers may be divided into those whose principal business is banking and whose principal business is trade. Though the importance of indigenous bankers is declining in recent years, they still occupy a not-so-negligible position in the Indian financial scene.

*Moneylenders* may be broadly classified into professional moneylenders and non-professional moneylenders. Methods of doing business of moneylenders are not uniform. There are certain defects in the working of moneylenders.

The important point of distinction between indigenous bankers and moneylenders is that the latter do not deal in hundis.

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### 6.5 ROLE OF FOREIGN DIRECT INVESTMENT

Foreign direct investment is one of the most effective methods of cross-border investing. A foreign national may want to invest in a country offering new markets, higher returns or cheaper factor costs.

Generally, there are two kinds of cross-border investments, which are mentioned as follows:

- **Foreign Direct Investment (FDI):** Investments made by a company or entity based in one country, into a company or entity based in another country
- **Foreign Portfolio Investment (FPI):** Investments undertaken for the purpose of returns without any burden of decision-making

United Nations Conference on Trade and Development (UNCTAD) defines FDI as an ‘investment made to acquire lasting interest in enterprises operating outside of the economy of the investor.’

Foreign direct investment is an important source of capital for a country. It is especially important for developing countries where the rate of capital formation is low and the requirement for capital is high. FDI is a method by which the residents of a country may invest in another country. FDI, along with providing returns, also has decision-making rights in the entity where the investment is made. FDI often entails acquiring a factory or facility or even starting one with the intention of forming a base in that country.

FDI leads to investing directly in the production process or any other business (retail or service sector) of any country other than the one where the investor resides. FDI entails the transfer of ownership along with the transfer of other factors like management and technology. FDI investments worldwide have seen a downturn following the financial crisis and the recessionary trends in the world economy.

FDI is the flow of long-term capital from one economy to another. FDI flowing in and out of an economy is reflected in the Balance of Payments (BoP) of that country. The FDI is placed in the second account of the BoP, the capital

account. The income generated through FDI investment is reflected in the current account.

*Table 6.1 Difference between FDI and FPI*

## NOTES

Basis of Difference	Foreign Direct Investment (FDI)	Foreign Portfolio Investment (FPI)
Management and Control	Involved in management and ownership control	No active involvement in management. Investment instruments are more easily traded and do not represent controlling stake
Liquidation of investment	Difficult to liquidate interest or pull-out	Interest easily liquidated and easy to pull-out
Liquidity	Investments have low liquidity	Highly liquid investments
Origin	Undertaken by multinational corporations	Diverse sources like mutual funds, equity and debt instruments as well as pension funds
Investment	Investment of financial and non-financial (technology and management skills) assets	Only financial investment
Volatility	Low level of volatility	High level of volatility

Source: [www.diffen.com/difference/FDI\\_vs\\_FPI](http://www.diffen.com/difference/FDI_vs_FPI)

### Types of Foreign Direct Investment

Foreign direct investment can take place in the following ways:

1. **Vertical:** When a company invests in a different country in the same industry but in a process that is either after or before the one it is currently involved in, it is a case of vertical FDI. There are two categories of vertical FDI, which are as follows:
  - **Backward Vertical:** It is the investment in procedures that bring the company a step closer to the actual raw materials. For example, a readymade clothes manufacturer of China buys a textile factory in India.
  - **Forward Vertical:** It is the investment in procedures that bring the company a step closer to the direction of the market it caters. For example, the readymade garments manufacturer of China buys a retail chain dealing in readymade garments in Australia.

2. **Horizontal:** The company invests in the same activity it has been conducting in the home country. For example, readymade garments manufacturer invests in a garment manufacturing factory in Germany.
3. **Conglomerate:** This is an investment into an unrelated field. This type of FDI carries a double element of risk as not only is the company entering a new country but it is also investing in a field which might not be related to its core competencies. Therefore, the company encounters twice the amount of barriers. Investing in a new country and diversification cannot be considered complementary strategies. They are, in fact, most often thought of as alternative strategies.
4. **Greenfield entry:** When a company invests and establishes facilities as well as elements from the initial stage, it is called a Greenfield entry. For example, if the garment manufacturer were to start a facility by buying land, hiring people, building the factory, installing machinery and ultimately manufacturing garments, it is called a Greenfield entry.
5. **Foreign takeovers:** The company takes over an already functional facility and does not have to go through the effort of establishing one themselves. For example, the manufacturer from China may takeover a garment manufacturing unit in South Africa.

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### Methods of Foreign Direct Investment

The various methods and strategies of foreign direct investment are enlisted as follows:

1. **License/franchisee:** The company may decide to limit its FDI to technological or other license or franchisee. The company may be unsure of the market size or even undertake the strategy to test the market before making any further moves.
2. **Joint venture:** The company may decide to go a step further than just supplying the technology or external support and may decide to commit capital on a larger scale. In such cases, the company should enter into a joint venture with another company from that country or another country with some experience in the local markets.
3. **Wholly owned subsidiary:** The company may decide to set up a wholly owned subsidiary in the new country.

### Motives or Benefits of Foreign Direct Investment

The various benefits of foreign direct investment are as follows:

- (a) **Benefits to investor (MNC):** Investors are interested in investment opportunities outside their own country due to the following reasons:
  - Diversification of systematic risk
  - Earning higher returns as compared to the ones available at home

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- Opportunity to take advantage of new markets
  - Chances of tax saving
  - Long-term opportunities of expansion and profitability
  - Benefits of economies of scope
  - Reduction in transportation costs
- (b) **Benefits to investor's economy:** The economy of the investor also stands to gain from the investment of funds in the form of FDI to other economies. These benefits are as follows:
- Inflow of foreign currency in the form of returns
  - Increase in taxable income in terms of foreign exchange
- (c) **Benefits to the economy receiving FDI:** The benefits for the economy receiving FDI are self-evident and are discussed as follows:
- Development of infrastructure
  - Creation of jobs
  - Enhancement of technology due to the import of latest technology
  - Increase in productive capacity
  - Positive effect on capital account
  - Increase in GDP due to increased production
  - Lesser importing of goods

### Effects of Foreign Direct Investment

FDI benefits are characterized by increased capital inflow, domestic skill development, competitive markets, and improvement in balance of trade, higher forex reserves, and building operational efficiencies. Let us now understand the effects of FDI particularly in the Indian context.

FDI in India increased by around 29 per cent in 2015/16 to \$40 billion. However, it still forms around 1.8 per cent of GDP, as opposed to gross fixed capital formation being 29.3 per cent of GDP. When a foreign firm invests in domestic markets, it creates positive cascade effects by engaging with local vendors and distributors. This results in higher domestic investment, in both technology and human resources. Thus, while FDI route has opened, domestic investment would continue to grow with better technology, competition and subsequent spillovers.

Maruti has seen multiple labour strikes; Nestlé's market cap was eroded by almost \$1 billion during a single session in June 2015, when Maggi was engulfed in a controversy. Foreign investors will have to provide favourable working conditions, comply with the law of the land just like domestic enterprises, and adapt to Indian industrial climate while they envisage long-term growth. FDI does not license investors to carry out business while exploiting national resources.



In the quest to attract FDI, the overall macro-economic climate is expected to be more business friendly. There has been continual focus on improving ease of business in the country, both, for domestic and foreign investors. India's ranking in doing business improved from 134 (2015) to 130 (2016). Other initiatives such as simplification of application process for industrial licence, time bound processing of applications, and eBiz platform to facilitate single window clearance are bound to improving business climate in India.

### Check Your Progress

3. Classify Indian joint stock banks.
4. What are foreign banks?

## NOTES

### 6.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. In an economy, a financial system refers to a system that organizes the settlement of payments, raises and allocates finance, and manages the risks associated with financing and financial exchange.
2. The main functions of intermediaries include lending money to the public and mobilizing public savings.
3. Indian joint stock banks classified into *scheduled* and *non-scheduled* banks.
4. Foreign banks are those which are foreign in origin and have their head offices located outside India.

### 6.7 SUMMARY

- In an economy, a financial system refers to a system that organizes the settlement of payments, raises and allocates finance, and manages the risks associated with financing and financial exchange.
- In layman's terms, a financial institution is a public or private institution that collects funds from the public or other institutions and invests them in financial assets.
- Broadly, in an economy two types of business organizations exist—non-financial and financial.
- The banking institutions in India function under the aegis of the Reserve Bank of India (RBI) and mainly consist of commercial banks and cooperative banks.
- Intermediaries, as the term suggests, act as a link between savers and investors. The main functions of intermediaries include lending money to the public and mobilizing public savings.

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- Non-intermediary institutions provide loans but they do not acquire their resources directly from the savers.
- Indian joint stock banks form an important constituent of the Indian financial system. These banks are classified into *scheduled* and *non-scheduled* banks. They follow branch banking and perform all the typical functions of commercial banks.
- Cooperative banking movement received momentum after the World War II. Under the Banking Regulation Act, only urban cooperative banks, state cooperative banks and district central cooperative banks are qualified to be addressed as banks in the cooperative sector.
- Agricultural Refinance and Development Corporation (ARDC) came into existence in 1972. NABARD was established in 1982.

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### 6.8 KEY WORDS

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- **Investment:** It refers to the action or process of investing money for profit.
- **Subsidiary:** It refers to a company controlled by a holding company.
- **Mortgage:** It is a legal agreement by which a bank, building society, etc. lends money at interest in exchange for taking title of the debtor's property, with the condition that the conveyance of title becomes void upon the payment of the debt.

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### 6.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

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#### Short-Answer Questions

1. List the importance and limitations of financial institutions.
2. Write a short note on:
  - a) Reserve Bank of India
  - b) NABARD
  - c) Flexi Bank Account
3. What are the limitations of financial institutions?
4. What are the effects of foreign direct investments?

#### Long-Answer Questions

1. Discuss the various components of financial system.
2. Classify financial institutions. What are their roles?
3. Assess the developments in the financial system in India.
4. What is the role of Foreign Direct Investment? Elucidate in detail.

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## 6.10 FURTHER READINGS

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## UNIT 7 LEGAL ENVIRONMENT

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### NOTES

#### Structure

- 7.0 Introduction
- 7.1 Objectives
- 7.2 Legal Environment: An Introduction
- 7.3 Laws Impacting Industry in India
- 7.4 Intellectual Property Rights
- 7.5 Major Regulations Pertaining to Business
- 7.6 Answers to Check Your Progress Question
- 7.7 Summary
- 7.8 Key Words
- 7.9 Self Assessment Questions and Exercises
- 7.10 Further Readings

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### 7.0 INTRODUCTION

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A free-market economy, India has a robust and well-established legal system as well, modelled after that of the United Kingdom. The legal system is responsible for maintaining a balance between the proper functioning of the economy and private businesses.

In this unit, you will study about the legal environment and laws impacting industry in India. Intellectual property rights and major regulations pertaining to business are also discussed in this unit.

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### 7.1 OBJECTIVES

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

- Describe legal environment
- Assess laws impacting industry in India
- Explain intellectual property rights
- Discuss major regulations pertaining to business

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### 7.2 LEGAL ENVIRONMENT: AN INTRODUCTION

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Over the years, there has been an increasing consciousness and realisation that environmental quality and economic development are complementary and not mutually exclusive. This is because, with technological advancements, environmental challenges are also on the rise. As a result, there is a need to bring about necessary changes in the industrial and agricultural production patterns, utility services,

consumer behaviour and life styles of the people keeping in view our social and developmental priorities for conservation and sustainable use of natural resources. Hence, environmental regulations and standards have been set up by environmental bodies the world round. Indian industry and business too are under increasing pressure of meeting these environmental standards and regulations.

Legal aspects are an indispensable part of a successful business environment in any country. They reflect the policy framework and the mindset of the Governmental structure of that country. They ensure that every company is functioning as per the statutory framework of the country. Every enterprise must take into account this legal setup while framing the basic aims and objectives of its company. This is because, it is necessary for efficient and healthy functioning of the organization and helps it to know the rights, responsibilities as well as the challenges that it may have to face.

In India, the most important law, which regulates all aspects relating to a company, is the Companies Act, 1956. It contains provisions relating to formation of a company, powers and responsibilities of the directors and managers, raising of capital, holding company meetings, maintenance and audit of company accounts, powers of inspection and investigation of company affairs, reconstruction and amalgamation of a company and even winding up of a company.

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### 7.3 LAWS IMPACTING INDUSTRY IN INDIA

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The government has to take a series of initiatives in respect of the policies relating to the following areas:

- (i) Industrial Licensing
- (ii) Foreign Investment and Technology Agreements
- (iii) Public Sector Policy
- (iv) MRTP Act

A package for the small and tiny sectors of industry was announced separately.

1. **Industrial Licensing Policy:** Industrial licensing will henceforth be abolished for all industries, except a few industries (18 sectors) which need regulation because of security and strategic concerns, social reasons, chemical hazards, environmental protection and curbing elitist consumption. Among these industries are cars, sugar, cigarettes, colour TV and VCRs, white goods like air conditioners, refrigerators and electronic washing machines.

All registration schemes including DGTD are to be abolished, entrepreneurs have to only file an information memorandum on new projects and expansions.

Eight areas, where strategic and security concerns predominate, continue to be reserved for public sector.

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The exemption from licensing will be particularly helpful to the many dynamic small and medium entrepreneurs who have been unnecessarily hampered by the licensing system. As a whole, the Indian economy will benefit by becoming more competitive, more efficient and modern and will take its rightful place in the world of industrial progress.

No industrial approvals will be required for putting up plants in locations other than cities with a population of more than one million. Where the population is more than one million, industries (with the exception of electronics, computer software and printing) will have to set up units outside a 25 km radius, except in prior designated industrial areas.

As per the industrial policy statement, the mandatory convertibility clause will no longer be applicable for term loans from financial institutions for new projects put by large houses.

With the sweeping liberalization measures, the existing procedures have been streamlined accordingly. All existing registration schemes have been abolished.

- 2. Foreign Investment and Technology Agreements:** While freeing Indian industry from official controls, opportunities for promoting investments in India should also be fully exploited. Foreign investment would bring attendant advantages of technology transfer, marketing expertise, introduction of modern managerial techniques and new possibilities for promotion of exports. This is particularly necessary in the changing global scenario of industrial and economic cooperation marked by mobility of capital. The government will therefore, welcome foreign investment, which is in the interest of the country's industrial development.

In order to invite foreign investment in high priority industries requiring large investment and advanced technology, it has been decided to provide approval for direct foreign investment up to 51 per cent foreign equity in thirty-four groups of high priority industries. These include commercial vehicles and two-wheelers, inorganic fertilizers, chemicals, man-made fibres, drugs and pharmaceuticals, paper, tyres, portland cement, hotels, many food-processing industries, soya products and industrial and agricultural machinery. There shall be no bottlenecks of any kind in this process. This change will go a long way in making Indian policy on foreign investment transparent. Such a framework will make it attractive for companies abroad to invest in India.

Foreign equity up to 51 per cent in trading companies which are primarily engaged in export; these companies are to be treated on par with domestic trading and export houses as per the import-export policy.

Special Empowered Board to be set up to negotiate with large international firms for direct investment in select areas; the aim is to attract substantial investment that would provide access to high technology and world markets.

With a view to injecting the desired level of technological dynamism in Indian industry, the government will provide automatic approval for technology agreements related to high priority industries within specified areas, subject to certain conditions. Similar facilities will be available for other industries as well, if such agreements do not require the expenditure of free foreign exchange. Indian companies will be free to negotiate the terms of technology transfer with their foreign counterparts according to their own commercial judgement.

3. **Public Sector Policy:** The public sector has been central to our philosophy of development. Public ownership and control in critical sectors of the economy has played an important role in preventing the concentration of economic power, reducing regional disparities and ensuring that planned development serves the common good.

The industrial policy resolution of 1956 gave the public sector a strategic role in the economy. Massive investments have been made over the past five decades to build public sector which has a commanding role in the economy. Recently, a number of problems have begun to manifest themselves in many of the public enterprises. In addition, public enterprises have shown a very low rate of return on the capital invested. Many of the public enterprises have become a burden rather than being an asset to the government. The original concept of the public sector has also undergone considerable dilution. The most striking example is the takeover of sick units from the private sector. This category of public sector units accounts for almost one-third of the total losses of central public enterprises.

It is time that the government adopt a new approach to public enterprises. The priority areas for growth of public enterprises in the future will be as follows:

- (a) Essential infrastructure goods and services.
- (b) Exploration and exploitation of oil and mineral resources.
- (c) Technology development and building manufacturing capabilities in areas which are crucial in the long-term development of the economy and where private sector investment is inadequate.
- (d) Manufacture of products where strategic considerations predominate such as defence equipment. At the same time, the public sector will not be barred from entering areas not specifically reserved for it.

The government will strengthen those public enterprises which fall in the reserved areas of operation or are generating good or reasonable profits. Such enterprises will be provided a much greater degree of management autonomy through the system of memorandum of understanding. Competition will be induced in these areas by inviting private sector participation. In the case of selected enterprises, part of government holdings in the equity share capital of these enterprises will be disinvested in order to provide further

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market discipline to the performance of public enterprises. There are a large number of chronically sick public enterprises incurring heavy losses and serve little public purpose. These need to be attended to.

**New Public Sector Policy:** The low rate of return on capital invested has reduced the ability of the public enterprise 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. The new Industrial Policy of 1991 has redefined the role of the public sector. Public sector will be in the future restricted to essential infrastructure, goods and services, exploration of oil and mineral resources and manufacture of products, where strategic considerations predominate such as defence equipment.

The number of industries reserved for the public sector has been reduced to eight. The scrapping of the schedule B which contained a list of twelve industries, where public sector was to play a dominant role, is also an important policy change.

The government is thinking of throwing open to the private sector most of the industries reserved for the public sector. In other words, monopoly in any sector has to be abolished.

4. **MRTP Act:** The principal objectives sought to be achieved through the MRTP Act are as follows:

- (i) *Prevention of concentration of economic power to the common detriment.*
- (ii) *Control of monopolies*
- (iii) *Prohibition of monopolistic and restrictive and unfair trade practices*

With the growing complexity of industrial structure and the need for achieving economies of scale for ensuring higher productivity and competitive advantages in the international market, the interference of the government through the MRTP Act in investment decision of large companies has become deleterious in its effects on Indian industrial growth. The pre-entry scrutiny of investment decisions by so-called MRTP Companies will no longer be required. The provisions relating to merger, amalgamation, and takeover will also be repealed. Similarly, the provisions regarding restrictions on acquisition and transfer of shares will be appropriately incorporated in the Companies Act.

Thus, the government has decided to take a series of measures to unshackle the Indian industrial economy from the cobwebs of unnecessary bureaucratic control.

**Evaluation:** Captains of industry and apex trade bodies have welcomed the new industrial policy, particularly the decisions to do away with licensing for most industries, liberalization of foreign investment and lifting the threshold limit for MRTP.



The new industrial policy is a major step in ushering the country into a new era of development and progress. The new policy will change the structure of Indian industry. It is directed towards making Indian industry internationally competitive. According to the FICCI president, many retrograde restrictions have been either removed or amended and conditions created for a market friendly system, which will enable India to join the international mainstream on the basis of efficiency and competitiveness. The president of the Associated Chamber of Commerce and Industry described the policy as a landmark in the opening up of the Indian Economy. He complemented the government for replacing the command and controlled economy which has been discarded all over the world with competitive and market economy. Market is more important than Marx.

The new policy is pragmatic, bold, innovative, and growth-oriented and the onus now lies with the industry to take advantages of these changes and rise to the occasion before demanding further liberalization.

On the other hand, the new industrial policy come in for some sharp criticism by opposition leaders all over the country. The general reaction was that, the policy was a sell out to the IMF and the World Bank and hit the common man. Former Prime Minister Chandrashekhar assailed the new policy and described it as a total drift from the Gandhian path. He feared the policy would generate more unemployment. Former Finance Minister Madhu Dandavate said that, by abolishing the limits on MRTP companies, the government had put the small-scale sector in a tight corner. This would seriously affect employment potential and poverty alleviation.

### **Industrial Development in India: Trends, Problems and Prospects**

Before the First Plan, industrial development in India was confined largely to the consumer goods sector, the important industries being cotton textiles, sugar, salt, soap, paper and leather goods. Thus, the industrial structure exhibited the features of an underdeveloped economy. Industries manufacturing coal, cement, steel, power, non-ferrous metals, chemicals, etc., were also established, but their production was small. As far as the capital goods sector was concerned, only a small beginning was made. On the whole, while consumer goods industries were well-established, producer goods industries lagged considerably behind.

The First Plan did not envisage any large-scale programmes of industrialization. Only ₹ 55 crore out of the total expenditure of ₹ 1960 crore in the First Plan was spent on industry and minerals. The Second Plan accorded top priority to programmes of industrialization which would be clear from the fact that the expenditure on industry and minerals was increased to ₹ 938 crore under this plan which was 20.1 per cent of the total expenditure of ₹ 4672 crore. Based on Mahalanobis Model, the Second Plan set out to establish basic and capital goods industries on a large-scale, so that a strong base for industrial development in the future could be built. Three steel plants, of one million tonnes ingot capacity, were set up in the public sector.

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The third Plan also emphasized the establishment of basic capital and producer goods industries. Expenditure on industry in the Third Plan was ₹ 1726 crore which was 20.1 per cent of the total expenditure of ₹ 8577 crore under the plan. The structure of industrial development was further nurtured in the Fourth and Fifth Plans with minor changes. The expenditure on industry was hiked to 22.8 per cent in the Fifth Plan. The Sixth Plan emphasized optimum utilization of existing capacities and improvement of productivity and enhancement of manufacturing capacity. Of the total expenditure of ₹ 109,292 crore under the Sixth Plan, the share of the industrial sector was ₹ 15,002 crore which was about 13.7 per cent. During this period, industrial and trade policies were substantially liberalized.

Objectives for the industrial sector in the Seventh Plan were kept as follows: (i) to ensure adequate supply of wage goods at reasonable prices, (ii) to maximize the utilization of the existing facilities through restructuring and upgradation of technology, (iii) to concentrate on development of industries with large domestic market and export potential, (iv) to usher in ‘sunrise’ industries with high growth potential and relevance to our needs, and to evolve an integrated policy towards self-reliance in strategic fields and open up avenues for employment. The overall outlay envisaged in the Seventh Plan for industrial and mineral programmes in the public sector was ₹ 22,416 crore. Industrial production was targeted to grow at the rate of 8.7 per cent per annum. The actual average rate of growth during the Seventh Plan was 8.5 per cent per annum. As far as the Eighth Plan is concerned, the overall outlay for industrial and mineral programmes in the public sector was kept at ₹ 40,588 crore. This is only 9.3 per cent of the total outlay of ₹ 434,100 crore in the Plan. The Ninth Plan envisaged an industrial growth of 8.2 per cent per annum. Policies advocated to achieve this growth rate are (i) ensuring adequate availability and requisite quality of infrastructure; (ii) adoption of special measures to promote the development of industries in backward areas, (iii) introducing a special package for the industrial development of the North Eastern States; (iv) reviewing the working of Board for Industrial and Financial Reconstruction (or BIFR) and bringing about necessary changes to make it an effective instrument of reviving sick industrial units, (v) initiating steps to close down potentially unrevivable public units, (vi) promoting production and productivity in the small-scale industries through technological upgradation and (vii) adoption of a cluster approach in the unorganized sector for provision of training, upgradation of skills and improvement in toolkits, equipment and production techniques to increase production and income levels of artisans and workers.

**Check Your Progress**

1. Name two laws impacting industry in India.
2. State one principal objective of the MRTP Act.

## 7.4 INTELLECTUAL PROPERTY RIGHTS

The term ‘intellectual property’ (IP) reflects the idea that its subject matter is the product of the mind or the intellect. These could be in the form of copyrights; patents; trademarks; geographical indications, industrial designs, layout-designs (topographies) of integrated circuits; plant variety protection and copyright.

IP, protected through law like any other form of property, can be a matter of trade, that is, it can be owned, bequeathed, sold or bought. The major features that distinguish it from other forms are their intangibility and non-exhaustion by consumption.

IP is the foundation of knowledge-based economy. It pervades all sectors of the economy and is increasingly becoming important for ensuring competitiveness of enterprises.

### International organisations and treaties

A UN agency, namely World Intellectual Property Organisation (WIPO) based in Geneva administers treaties in the field of intellectual property. India is a member of WIPO.

The Department of Industrial Policy and Promotion is the nodal department in the Government of India for all matters concerning WIPO.

India is also member of two major treaties, namely the Paris Convention for the protection of Industrial Property (relating to patents, trademarks, designs, etc.) of 1883 and the Berne Convention for the Protection of Literary and Artistic Works (relating to copyright) of 1886. Apart from these, India is also a member of the Patent Cooperation Treaty (PCT) which facilitates obtaining of patents in several countries by filing a single application.

India is also a member of the World Trade Organisation (WTO). The WTO agreement, *inter alia*, contains an agreement on IP, namely, the agreement on Trade Related Aspects of Intellectual Property (TRIPS). This agreement made the protection of intellectual property an enforceable obligation of the member states. The TRIPS agreement sets out minimum standards of intellectual property protection for member states.

India has complied with the obligations contained in the TRIPS agreement and amended/enacted IP laws.

### The department of industrial policy and promotion (DIPP) and intellectual property rights (IPRs)

DIPP is concerned with legislations relating to patents, trademarks, designs and geographical indications. These are administered through the Office of the Controller General of Patents, Designs and Trade Marks (CGPDTM), subordinate office, with headquarters at Mumbai, as under:

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- (a) The Patents Act, 1970 (amended in 1999, 2002 and 2005) through the Patent Offices at Kolkata (HQ), Mumbai, Chennai and Delhi.
- (b) The Designs Act, 2000 through the Patent Offices at Kolkata (HQ), Mumbai, Chennai and Delhi.
- (c) The Trade Marks Act, 1999 through the Trademarks Registry at Mumbai (HQ) Chennai, Delhi, Kolkata and Ahmedabad.
- (d) The Geographical Indications of Goods (Registration & Protection) Act, 1999 through the Geographical Indications Registry at Chennai.

The Controller General of Patents, Designs and Trademarks (CGPDTM) is also in-charge of the Office of the Patent Information System and the Intellectual Property Training Institute, both at Nagpur. The office has a staff of 446 in the Patents and Designs Offices and 291 in the Trademarks and Geographical Indication Offices.

Necessary safeguards have been built into the IP laws, in particular in the patents law, for the protection of public interest, including public health.

Along with the legislation, rules have also been amended to install a user-friendly system for processing of IP applications. All rules and forms are available on the website: <http://www.ipindia.nic.in/>.

### Copyright

**Works in which copyright subsists:** Copyright subsists throughout India in the following classes of work:

- (a) original literary, dramatic, musical and artistic works;
- (b) cinematograph films; and
- (c) sound recording

Copyright shall not subsist—

- (i) in any cinematograph film if a substantial part of the film is an infringement of the copyright in any other work;
- (ii) in any sound recording made in respect of a literary, dramatic or musical work, if in making the sound recording, copyright in such work has been infringed (Sec. 13).

The term ‘literary work’ includes computer programmes, tables and compilation including computer databases [Sec. 2(o)]. The term ‘dramatic work’ includes any piece of recitation, choreographic work or entertainment in dumb show, the scenic arrangement or acting, form of which is fixed in writing or otherwise but does not include a cinematograph film [Sec. 2 (h)]. The term ‘musical work’ means a work consisting of music.

**Meaning of copyright:** For the purposes of this Act, ‘copyright’ means the exclusive right to do or authorise the doing of any of the following acts in respect of a work or any substantial part thereof, namely:

- (a) in the case of a literary, dramatic or musical work, not being a computer programme,
  - (i) to reproduce the work in any material form including the storing of it in any medium by electronic means;
  - (ii) to issue copies of the work to the public not being copies already in circulation;
  - (iii) to perform the work in public, or communicate it to the public;
  - (iv) to make any cinematograph film or sound recording in respect of the work;
  - (v) to make any translation of the work;
  - (vi) to make any adaptation of the work;
  - (vii) to do, in relation to a translation or an adaptation of the work, any of the acts specified in relation to the work in subclauses (i) or (vi);
- (b) in the case of a computer programme—
  - (i) to do any of the acts specified in clause (a);
  - (ii) to sell or give on commercial rental or offer for sale or for commercial rental any copy of the computer programme:  
Provided that such commercial rental does not apply in respect of computer programmes where the programme itself is not the essential object of the rental.
- (c) in the case of an artistic work—
  - (i) to reproduce the work in any material form including depiction in three dimensions of a two-dimensional work or in two dimensions of a three-dimensional work;
  - (ii) to communicate the work to the public;
  - (iii) to issue copies of the work to the public not being copies already in circulation;
  - (iv) to include the work in any cinematograph film;
  - (v) to make any adaptation of the work;
  - (vi) to do in relation to an adaptation of the work any of the acts specified in relation to the work in subclauses (i) to (iv);
- (d) in the case of a cinematograph film—
  - (i) to make a copy of the film including a photograph of any image forming part thereof;
  - (ii) to sell or give on hire or offer for sale or hire, any copy of the film, regardless of whether such copy has been sold or given on hire on earlier occasions;
  - (iii) to communicate the film to the public;

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- (e) in the case of a sound recording—
  - (i) to make any other sound recording embodying it;
  - (ii) to sell or give on hire, or offer for sale or hire, any copy of the sound recording, regardless of whether such copy has been sold or given on hire on earlier occasions;
  - (iii) to communicate the sound recording to the public (Sec. 14)

**Licences**

***Licence by owner of copyright***

The owner of the copyright in any existing work or the prospective owner of the copyright in any future work may grant any in the right by licence in writing signed by him or his duly authorised agent. In the case of a licence relating in any future work, the licence shall take effect only when the work comes into existence. Such licence is normally for re-publication, performance in public or communication to public (Sec. 30).

***Compulsory licence in works withheld from public***

If at any time during the term of the copyright of any Indian work the owner does not grant permission for re-publication, performance or communication to public, the copyright board can direct the registrar of copyrights to grant compulsory licence to the complainant on such terms and conditions as it deems fit. Where two or more persons have made complaint, the licence shall be granted to the complainant who in the opinion of the copyright board would best serve the interests of the general public (Sec. 35).

If the owner of the copyright is dead or unknown or cannot be traced or found, the copyright board can grant licence to any applicant on such terms and conditions as it deems fit. The registrar of copyrights can direct the applicant to deposit the amount of the royalty determined by the copyright board in the public account of India with the central government, so that if at any time the owner of the copyright is traced, he can claim the royalty (Sec. 31 A).

***Licence to produce the published translations***

Any person may apply to the copyright board for a licence to produce and publish translations of a literary or dramatic work in any language after a period of seven years from the first publication of the work. A licence to translate foreign literary or dramatic work may be applied after three years from its publication, if such translation is required for the purposes of teaching, scholarship or research. Every application shall be made in such form as may be prescribed and the applicant shall deposit with the registrar of copyrights such fee as may be prescribed. The copyright board can grant non-exclusive right on terms and conditions and payment of royalty as it deems fit (Sec. 32).

**Termination of licence**

The licence can be terminated by the copyright board, after giving three months' notice, if the owner of copyright publishes translation in the same language at a reasonable price and of the same standard. However, copies of the licensed work produced and published by the person holding such licence before the termination of the licence takes effect may continue to be sold or distributed until the copies already produced and published are exhausted [Sec. 32(B)].

**Infringement of copyright****When is copyright infringed?**

Copyright in a work shall be deemed to be infringed—

- (a) when any person, without a licence granted by the owner of the copyright or the Registrar of Copyrights under this Act or in contravention of the conditions of a licence so granted or of any condition imposed by a competent authority under this Act –
  - (i) does anything, the exclusive right to do which is by this Act conferred upon the owner of the copyright, or
  - (ii) permits for profit any place to be used for the communication of the work to the public where such communication constitutes an infringement of the copyright in the work, unless he was not aware and had no reasonable ground for believing that such communication to the public would be an infringement of copyright; or
- (b) When any person—
  - (i) makes for sale or hire, or sells or lets for hire, or by way of trade displays or offers for sale or hire, or
  - (ii) distributes either for the purpose of trade or to such an extent as to affect prejudicially the owner of the copyright, or
  - (iii) by way of trade exhibits in public, or
  - (iv) imports into India, any infringing copies of the work. However, this shall not apply to the import of one copy of any work, for the private and domestic use of the importer (Sec. 51).

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## **7.5 MAJOR REGULATIONS PERTAINING TO BUSINESS**

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Capital market is one of the most important segments of the Indian financial system. It is the market available to the companies for meeting their requirements of long-term funds. It refers to all the facilities and the institutional arrangements for borrowing and lending funds. In other words, it is concerned with the raising of money capital for purposes of making long-term investments. The market channelize

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of a number of individuals and institutions (including the Government) that canalise the supply and demand for long-term capital and the claims on it. The demand for long-term capital comes predominantly from private sector manufacturing industries, agriculture sector, trade and the Government agencies. While, the supply of funds for the capital market comes largely from individual and corporate savings, banks, insurance companies, specialised financing agencies and the surplus of Governments.

### Regulatory Framework

In India, the capital market is regulated by the Capital Markets Division of the Department of Economic Affairs, Ministry of Finance. The division is responsible for formulating the policies related to the orderly growth and development of the securities markets (i.e., share, debt and derivatives) as well as protecting the interest of the investors. In particular, it is responsible for (i) institutional reforms in the securities markets, (ii) building regulatory and market institutions, (iii) strengthening investor protection mechanism, and (iv) providing efficient legislative framework for securities markets, such as Securities and Exchange Board of India Act, 1992 (SEBI Act 1992); Securities Contracts (Regulation) Act, 1956; and the Depositories Act, 1996. The division administers these legislations and the rules framed thereunder.

The Securities and Exchange Board of India (SEBI) is the regulatory authority established under the SEBI Act 1992, in order to protect the interests of the investors in securities as well as promote the development of the capital market. It involves regulating the business in stock exchanges; supervising the working of stock brokers, share transfer agents, merchant bankers, underwriters, etc; as well as prohibiting unfair trade practices in the securities market. The following departments of SEBI take care of the activities in the secondary market:-

- Market Intermediaries Registration and Supervision Department (MIRSD)—concerned with the registration, supervision, compliance monitoring and inspections of all market intermediaries in respect of all segments of the markets, such as equity, equity derivatives, debt and debt related derivatives.
- Market Regulation Department (MRD)—concerned with formulation of new policies as well as supervising the functioning and operations (except relating to derivatives) of securities exchanges, their subsidiaries, and market institutions such as Clearing and settlement organizations and Depositories.
- Derivatives and New Products Departments (DNPD)—concerned with supervising trading at derivatives segments of stock exchanges, introducing new products to be traded and consequent policy changes.



## 1. Law on Consumer Protection

According to the Consumer Protection Act, a Consumer means:

- (i) any person who buys any goods for a consideration which has been paid or promised or partly paid and partly promised, or under any system of deferred payment, and includes any person who uses such goods with the approval of the buyer. It does not include a person who buys goods for resale or for any commercial purpose; or
- (ii) any person who hires or avails any services for a consideration which has been paid or promised or partly paid and partly promised, or under any system of deferred payment, and includes any person who is a beneficiary of such services with the approval of the hirer. It does not include a person who avails of such services for any commercial purpose.

*Explanation:* ‘Commercial purpose’ does not include use by a person of goods bought and used by him and services availed by him exclusively for the purpose of earning his livelihood, by means of self-employment.

The term ‘person’ includes a firm, Hindu undivided family, company, cooperative society, and every other association of persons whether registered under the Societies Registration Act, 1860 or not.

It may be observed that the aforesaid definition of the term ‘consumer’ is in two parts:

- I. Consumer of goods
- II. Consumer of services

### Consumer of Goods

The important features of the definition of ‘consumer of goods’ may be stated as follows:

1. **Buying goods for consideration:** There must be a contract of sale of goods between a seller and a buyer. The seller should be a ‘business seller’, i.e., a trader or manufacturer, and the buyer should be a ‘consumer buyer’, i.e., one who buys goods for consumption or private use. The buying of goods must be for consideration, which may be paid immediately or promised to be paid later—even in instalments. Thus, it includes credit sale and hire purchase transactions also. Consideration may be in terms of money or other goods and services.

The meaning of the term ‘goods’ is to be construed according to the Sale of Goods Act. According to Section 2(7) of the Sale of Goods Act, “goods means every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale.” Thus, goodwill, trade marks, copyrights, patents-right, are all regarded as goods.

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2. **User of goods with the approval of the buyer:** The term ‘consumer’ also includes any person who uses the goods with the permission of the buyer though he is himself not a buyer. When a person buys goods, they may be used by his family members, relatives and friends. The actual user of the goods may come across the defects in goods. Thus, the law treats the rightful user of the goods as the consumer.

**Illustration:** *A* purchases a scooter. One of his family members *B* was using it from the date of purchase. *B* had a complaint regarding the scooter. *B* sued the seller. The seller pleaded that since *B* did not buy the scooter, he was not a consumer under the Act. The Delhi State Consumer Disputes Redressal Commission held that *B*, the complainant was using it with the approval of *A*, the buyer, and therefore he was a consumer under the Act (*Dinesh Bhagat vs Bajaj Auto Ltd.*).

3. **Goods should not be purchased for resale or for any commercial purpose:** The term ‘consumer’ does not include a person who buys goods for ‘resale’ or for any ‘commercial purpose’. The expression ‘commercial purpose’ implies that the goods are bought to commercially exploit them with the object to earn profits. Thus, where a company purchases a computer system to facilitate its work, the said purchase is a purchase for ‘commercial purpose’ and the company is not a ‘consumer’ under the Act.

**Illustration:** A charitable trust was running a diagnostic centre, where patients taking advantage of X-ray, CT scan etc., were ordinarily required to pay for the same and only 10 per cent of them being provided free service. It was held that the machines purchased by the ‘Trust’ for use in the diagnostic centre were meant for ‘commercial purpose’ and therefore the ‘Trust’ was not a consumer [*Kalpavraksha Charitable Trust vs Toshniwal Brothers (Bombay) (P) Ltd.*].

4. **Person buying goods for self-employment is a consumer:** When the goods are bought and used by the buyer himself, exclusively for the purpose of earning his livelihood, by means of self-employment, then such buyer/user is also recognised as a consumer under the Act. Thus, a person who purchases a taxi, or a sewing machine or a photostat machine exclusively for the purpose of earning his livelihood by means of self-employment, will be a consumer.

**Illustration:** *P*, an eye surgeon, purchased a machine from *R* for his private nursing home. The machine was found to be defective one. *P* sued *R* for damages. *R* contended that *P* was not a consumer under the Act as the machine was bought for commercial purposes. The National Commission rejected this contention and held that *P* is a medical practitioner, a professional working by way of self-employment by using his knowledge to earn his livelihood and therefore he is a ‘consumer’ (*Rampion Pharmaceuticals vs Dr. Preetam Shah*).

## Consumer of Services

The second category of 'consumer' is that of 'consumer of services'. A person is a 'consumer of service' if he satisfies the following criteria:

1. **Hiring of services for consideration:** There must be a transaction of hiring or availing of service for consideration. However, the payment of consideration need not necessarily be immediate. It may be paid later. If the service is provided without charging anything in return, the person availing the service is not a 'consumer'.
  2. **Beneficiary of service is also a 'consumer':** A beneficiary of service, though not the hirer himself, is also regarded as a 'consumer' provided the beneficial use is made with the approval of the person who hired the service. Thus, a nominee under an insurance policy and an actual user of the subscriber's telephone have been held to be 'consumers'.
- Illustration:** *R* takes his wife *S* to a doctor to get his wife treated for a fracture. The doctor charged ₹ 1200 for the treatment. Here *R* is a hirer of services of the doctor and *S* is beneficiary of the service. For the purpose of the Act, both *R* and *S* are 'consumers'.
3. **Service should not be availed for any commercial purpose:** The term 'consumer of service' does not include a person who avails service for any 'commercial purpose'. Thus, where a person hires the services of a goods carrier and starts plying it on hire as public carrier with the object to earn profits, the said hiring of services of a goods carrier is for 'commercial purpose' and the person is not a 'consumer' under the Act.

**'Service' defined:** Section 2(1) (O) defines the term 'service' as follows:

'Service' means service of any description which is made available to potential users and includes, but not limited to, the provision of facilities in connection with banking, financing, insurance, transport, processing, supply of electrical or other energy, boarding or lodging or both, housing construction, entertainment, amusement or the purveying of news or other information. However, it does not include the rendering of any service free of charge or under a contract of personal service.

The expression 'contract of personal service' means contract to render service in a private capacity to an individual. For example, where a servant enters into a contract with a master for employment, it is a contract of personal service. The rationale for excluding a 'contract of personal service' from the definition of 'service' is that the master can discontinue the service at any time according to his will, he need not approach Consumer Forum to complain about deficiency in service.

**Complaint.** Literally the word 'complaint' means a formal allegation against a party. In the present context, 'complaint' is an allegation made in writing to the National Commission, the State Commission or the District Forum, by a person competent to file it, with a view to obtaining relief provided under the Act.

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## Unfair Trade Practice

Section 2(1) (r) defines ‘unfair trade practice’ as follows:

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‘**Unfair trade practice**’ means a trade practice which, for the purposes of promoting the sale, use or supply of any goods or for the provision of any service, adopts any unfair method or unfair or deceptive practice including any of the following practice, namely,—

1. The practice of making any statement, whether orally or in writing or by visible representation which, —
  - (i) falsely represents that the goods are of a particular standard, quality, quantity, grade, composition, style or model;
  - (ii) falsely represents that the services are of a particular standard, quality or grade;
  - (iii) falsely represents any rebuilt, second-hand, renovated, reconditioned or old goods as new goods;
  - (iv) represents that the goods or services have sponsorship, approval, performance, characteristics, accessories, uses or benefits which such goods or services do not have;
  - (v) represents that the seller or the supplier has a sponsorship or approval or affiliation which such seller or supplier does not have;
  - (vi) makes a false or misleading representation concerning the need for, or the usefulness of, any goods or services;
  - (vii) gives to the public any warranty or guarantee of the performance, efficacy or length of life of a product or of any goods that is not based on an adequate or proper test thereof;
  - (viii) makes to the public a representation in a form that purports to be —
    - (a) a warranty or guarantee of a product or of any goods or services; or
    - (b) a promise to replace, maintain or repair an article or any part thereof or to repeat or continue a service until it has achieved a specified result.

If such purported warranty or guarantee or promise is materially misleading or if there is no reasonable prospect that such warranty, guarantee or promise will be carried out;
  - (ix) materially misleads the public concerning the price at which a product or like products or goods or services, have been or are, ordinarily sold or provided, and, for this purpose, a representation as to price shall be deemed to refer to the price at which the product or goods or services has or have been sold by sellers or provided by suppliers generally in the relevant market unless it is clearly specified to be the price at which the product has been sold or services have been

provided by the person by whom or on whose behalf the representation is made;

- (x) gives false or misleading facts disparaging the goods, services or trade of another person.

*Explanation.* For the purpose of this clause, a statement that is:

- (a) expressed on an article offered or displayed for sale, or on its wrapper or container; or
- (b) expressed on anything attached to, inserted in, or accompanying, an article offered or displayed for sale, or on anything on which the article is mounted for display or sale; or
- (c) contained in or on anything that is sold, sent, delivered, transmitted or in any other manner whatsoever made available to a member of the public.

Shall be deemed to be a statement made to the public by the person who had caused the statement to be so expressed, made or contained.

2. Permits the publication of any advertisement whether in any newspaper or otherwise, for the sale or supply at a bargain price, of goods or services that are not intended to be offered for sale or supply at the bargain price, or for a period that is, and in quantities that are, reasonable, having regard to the nature of the market in which the business is carried on, the nature and size of business, and the nature of the advertisement.

*Explanation.* For the purpose of this clause, “bargain price” means:

- (a) a price that is stated in any advertisement to be a bargain price, by reference to an ordinary price or otherwise, or
  - (b) a price that a person who reads, hears or sees the advertisement, would reasonably understand to be a bargain price having regard to the prices at which the product is advertised or like products are ordinarily sold.
3. Permits: (a) the offering of gifts, prizes or other items with the intention of not providing them as offered or creating impression that something is being given or offered free of charge when it is fully or partly covered by the amount charged in the transaction as a whole; (b) the conduct of any contest, lottery, games of chance or skill, for the purpose of promoting, directly or indirectly, the sale, use or supply of any product or any business interest.
  4. Withholding from the participants of any scheme offering gifts, prizes or other items free of charge, on its closure the information about final results of the scheme.

*Explanation.* For the purpose of this clause, the participants of a scheme shall be deemed to have been informed of the final results of the scheme where such results are within a reasonable time published prominently in the same newspapers in which the scheme was originally advertised.

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5. Permits the sale or supply of goods intended to be used, or are of a kind likely to be used, by consumers, knowing or having reason to believe that the goods do not comply with the standards prescribed by competent authority relating to performance, composition, contents, design, constructions, finishing or packaging as are necessary to prevent or reduce the risk of injury to the person using the goods.
6. Permits the hoarding or destruction of goods, or refuses to sell the goods or to make them available for sale or to provide any service, if such hoarding or destruction or refusal raises or tends to raise or is intended to raise, the cost of those or other similar goods or services.
7. Manufacture of spurious goods or offering such goods for sale or adopting deceptive practices in the provision of services.

### **2. The Environment (Protection) Rules, 1986**

These rules lay down the procedures for setting standards of emission or discharge of environmental pollutants. The Rules prescribe the parameters for the Central Government, under which it can issue orders of prohibition and restrictions on the location and operation of industries in different areas. The Rules lay down the procedure for taking samples, serving notice, submitting samples for analysis and laboratory reports. The functions of the laboratories are also described under the Rules along with the qualifications of the concerned analysts.

### **3. The National Environment Appellate Authority Act, 1997**

This Act provided for the establishment of a National Environment Appellate Authority to hear appeals with respect to restriction of areas in which any industry operation or process or class of industries, operations or processes could not carry out or would be allowed to carry out subject to certain safeguards under the Environment (Protection) Act, 1986.

In addition to these, various Acts specific to the coal sector have been enacted. The first attempts in this direction can be traced back to the Mines Act, 1952, which promoted health and safety standards in coal mines. Later the Coal Mines (Conservation and Development) Act (1974) came up for conservation of coal during mining operations. For conservation and development of oil and natural gas resources a similar legislation was enacted in 1959.

### **4. Public Liability Insurance Act (PLIA), 1991**

The Act covers accidents involving hazardous substances and insurance coverage for these. Where death or injury results from an accident, this Act makes the owner liable to provide relief as is specified in the Schedule of the Act. The PLIA was amended in 1992, and the Central Government was authorized to establish the Environmental Relief Fund, for making relief payments.

## 5. National Environment Tribunal Act, 1995

The Act provided strict liability for damages arising out of any accident occurring while handling any hazardous substance and for the establishment of a National Environment Tribunal for effective and expeditious disposal of cases arising from such accident, with a view to give relief and compensation for damages to persons, property and the environment and for the matters connected therewith or incidental thereto.

### Check Your Progress

3. Which organization administers treaties in the field of intellectual property?
4. What is the function of SEBI?.

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## 7.6 ANSWERS TO CHECK YOUR PROGRESS QUESTION

1. Two laws impacting industry in India are Industrial Licensing and Foreign Investment and Technology Agreements.
2. One principal objective sought to be achieved through the MRTP Act is that of prevention of concentration of economic power to the common detriment.
3. A UN agency, namely World Intellectual Property Organisation (WIPO) based in Geneva administers treaties in the field of intellectual property.
4. The Securities and Exchange Board of India (SEBI) is the regulatory authority established under the SEBI Act 1992, in order to protect the interests of the investors in securities as well as promote the development of the capital market.

## 7.7 SUMMARY

- Legal aspects are an indispensable part of a successful business environment in any country. They reflect the policy framework and the mindset of the Governmental structure of that country.
- In India, the most important law, which regulates all aspects relating to a company, is the Companies Act, 1956.
- It contains provisions relating to formation of a company, powers and responsibilities of the directors and managers, raising of capital, holding company meetings, maintenance and audit of company accounts, powers of inspection and investigation of company affairs, reconstruction and amalgamation of a company and even winding up of a company.

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- Industrial licensing has been abolished for all industries, except a few industries (18 sectors) which need regulation because of security and strategic concerns, social reasons, chemical hazards, environmental protection and curbing elitist consumption.
- According to the Foreign Investment and Technology Agreements, While freeing Indian industry from official controls, opportunities for promoting investments in India should also be fully exploited.
- The term ‘intellectual property’ (IP) reflects the idea that its subject matter is the product of the mind or the intellect. These could be in the form of copyrights; patents; trademarks; geographical indications, industrial designs, layout-designs (topographies) of integrated circuits; plant variety protection and copyright.
- A UN agency, namely World Intellectual Property Organisation (WIPO) based in Geneva administers treaties in the field of intellectual property. India is a member of WIPO.
- India is also member of two major treaties, namely the Paris Convention for the protection of Industrial Property (relating to patents, trademarks, designs, etc.) of 1883 and the Berne Convention for the Protection of Literary and Artistic Works (relating to copyright) of 1886.
- In India, the capital market is regulated by the Capital Markets Division of the Department of Economic Affairs, Ministry of Finance. The division is responsible for formulating the policies related to the orderly growth and development of the securities markets (i.e., share, debt and derivatives) as well as protecting the interest of the investors.

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## 7.8 KEY WORDS

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- **Dispute:** It refers to an argument or disagreement between people or groups.
- **Trade:** It refers to the action of buying and selling goods and services.
- **Manufacturer:** It refers to a person or company that makes goods for sale.

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## 7.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

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### Short-Answer Questions

1. Write a short note on industrial licensing policy.
2. Define intellectual property rights.
3. Write a short note on World Intellectual Property Organisation (WIPO).
4. Who are consumer of services according to the consumer Protection Act?



### Long-Answer Questions

1. Give a detailed description of four policies impacting industry in India.
2. Elucidate the trends, problems and prospects of industrial development in India.
3. Discuss various forms of intellectual property rights in detail.
4. Explain major regulations pertaining to business in India.

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### 7.10 FURTHER READINGS

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## **UNIT 8 ECONOMIC ROLE OF GOVERNMENT**

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### **NOTES**

#### **Structure**

- 8.0 Introduction
- 8.1 Objectives
- 8.2 Economic Role of Government: An Introduction
  - 8.2.1 Regulatory Role of Government
  - 8.2.2 Promotional Role of Government
  - 8.2.3 Participatory Role of Government
  - 8.2.4 Conciliatory and Judicial Role of Government
- 8.3 Impact of India's Industrial Policy on Economic Reforms
- 8.4 Answers to Check Your Progress Questions
- 8.5 Summary
- 8.6 Key Words
- 8.7 Self Assessment Questions and Exercises
- 8.8 Further Readings

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### **8.0 INTRODUCTION**

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The role of government in an economy is that to help correct market failures in situations where private markets cannot maximize the value that they could create for society. Other roles of government include promoting business, formulating policies related to the economy, ensuring laws are being followed by businesses, and so on.

This unit discusses the regulatory, promotional, participatory and conciliatory role of government in detail. It also assesses the impact of India's Industrial Policy on economic reforms.

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### **8.1 OBJECTIVES**

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

- Describes the regulatory, promotional, participatory and conciliatory role of government
- Lists the phases of industrial policies
- Discusses the impact of India's Industrial Policy on economic reforms

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## **8.2 ECONOMIC ROLE OF GOVERNMENT: AN INTRODUCTION**

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Let us begin by studying the regulatory role of business.

### **8.2.1 Regulatory Role of Government**

Today, there is practically no aspect of business which is free of State regulation or control. The State is ready to intervene if the occasion arises to do so and popular and legislative support exists. In the past, the state had never been involved in so many details of business, except in wartime. The growing government intervention has resulted in constant encroachment on the freedom of business to take decisions.

The criticisms of business are mounting. They relate to several specific business activities, e.g., product safety, pricing, advertising, pollution, safety and welfare of workers, etc. The State has increasingly responded to these criticisms with specific legislations constraining business. Further, there is growing tendency towards the formation of consumer societies and other groups which have arisen to protect consumers, the environment, morality, etc. The State power is being more frequently used over business to achieve the objectives of such groups and societies.

#### **Bases for government Intervention**

- 1. To provide non-market products or indivisible services:** Certain products and services are consumed by all members of the society collectively and exclusion of certain individuals from their consumption is impossible even in principle. Such products and services may be called 'non-excludable goods'. They include national defence and related functions, police protection, of flood control, protection of public buildings. The provision of such services cannot be left to the market mechanism.
- 2. To provide the basic infrastructure:** The creation of infrastructure is the pre-condition for the 'take off'. Advocacy of investment in infrastructure tends to lay particular emphasis on efficacy of external economies springing from it in stimulating new economic activities. The provision for basic infrastructure like coal, power, communication, banking, etc., is absolutely essential for the growth of an economy and may involve huge capital outlays. It may not be feasible for the market participants, particularly in developing countries, to bear the burden. In such a situation, State agencies may be called upon to finance such activities. But the socio-economic policies of a government may not favour such financing and may justify direct State intervention.
- 3. To improve the functioning of markets:** There always exist certain imperfections in the operation of the market system. Developed market

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economies are no exception. The imperfections are capable of at least partial correction by government action. The State can help in this regard:

(i) *By providing perfect information:* Market system may work perfectly only if the individual participants have perfect information to use in their decision-making. They need information regarding quality and prices of raw materials and finished goods, factors costs, labour exchanges, etc. In a developed market, perhaps, much information may be available without state help. But in a developing economy, the information may not be so available.

(ii) *By promoting competition:* The functioning of the markets may be improved by controlling monopoly on the associated trade practices which create economic inefficiency by distorting the pattern of production. State may help in this regard by (i) attacking enormity, i.e., controlling size of private enterprises and (ii) regulating and prohibiting monopolies, restrictive and unfair trade practices.

To promote competition, government may prevent merger of competing units or order partition of large private enterprises, where economies of scale do not justify bigness, open domestic market to foreign competition, and so on.

#### **4. By encouraging movement of resources among alternative uses:**

Resources are capable of being used to produce different products. Market system encourages use of the resources in accordance with the desires of resource owners and entrepreneurs who will ordinarily have 'profit' as the criterion of their decision-making. To enhance their profit resource-owners would combine to restrict competition and raise prices; entrepreneurs would avoid investment in areas which may be socially desirable but less profitable. Such activities restrict movement of resources among alternative uses, which is undesirable from the competition point of view. Government may through incentives encourage movement of productive resources among alternative uses. Suitable legislation may also be enacted to deal with monopolistic and restrictive trade practices.

#### **5. By rectifying institutional arrangements and defective government policies:**

Government agencies provide inexpensive credit facilities to favoured clients, e.g., small business, agriculture, etc. On the other hand, it may be difficult for some of the other borrowers to obtain credit at reasonable prices. Besides, the fragmentation of the capital market may sometimes make it difficult to transfer savings to the sectors where the returns are highest. Such anomalies may be removed by suitable modifications in the institutional arrangements and government policies.

#### **6. By standardizing practices and preventing force and fraud:**

State is a competent agency which standardizes business practices. The great body of doctrine which defines the 'law of contract' establishes the meaning of 'private property' or implements the 'rule of reason', represents the

standardizing activities of government as the articulate instrument of custom. This body of rules governs the procedures for buying and selling, fixes the liabilities of shareholders and others, ascertains the means for collecting debts and establishes individual property rights. Such standard practices bring stability in commercial interchange.

It is the legitimate business of government to hold private force in check and prevent fraud.

7. **By stabilizing aggregate demand:** The government may facilitate smooth functioning of the market by stabilizing demand at the full employment level through monetary or fiscal measures.
8. **Correcting inherent defects in the market mechanism:** Certain defects in the market mechanism cannot be repaired and the attempt to prevent the misallocations that result must proceed by supplementing the market with direct government intervention.

### **8.2.2 Promotional Role of Government**

Encouragement to entrepreneurship is an extremely important role of any government which is concerned with the future economic health of its country. That is why there is a strong relationship between economic growth and the ease of doing business in a country. If the government of a country is entrepreneurial, the country's business environment would be progressive. It has nothing to do with the political system of the country. It may be observed that non-democratic governments are sometimes more successful at understanding the advantage of entrepreneurship. The countries with less bureaucratic formalities for doing business naturally attract more businessmen. In the interest of their domestic economies, politicians must take an active role in making the reforms needed to help fuel entrepreneurship.

Traditional bureaucratic governments favour and encourage the people with tendencies to defend their position, oppose change, erect authority, expand their sphere of control and protect the schemes irrespective of their relevance to present conditions. Briefly speaking, such governments promote the feeling of status quo among the people. On the other hand, an entrepreneurial government initiates more efficient and effective ways of managing systems and organizations. It recognizes the importance of discarding old and irrelevant programmes and methods and encourages taking timely and necessary action. Entrepreneurial governments are creative and innovative. They are business oriented. They do not hesitate to privatize wherever it makes realistic sense and where private operators can provide the same service much more efficiently.

### **Catalytic Role of Government**

Sometimes, governments do not play a direct role in business activities. They play the role of catalysts. They believe in steering rather than rowing. Government should be a catalyst for the development of business environment; it cannot

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compensate or substitute for its absence. Governments, as effective catalysts, do not do anything directly for business. They encourage businessmen to do things as their own. Business communities drive their own development; governments facilitate the process. This implies a number of practical activities that are far easier to talk about than to do. In their role as catalysts, governments enable a business community to look realistically at itself. Because businessmen are well conditioned to focus on their problems, facilitators (governments) emphasize analytic tools and exercises that help the community to identify and recognize strengths and capacities which they may have overlooked or ignored in the past. Governments connect business people with each other and their existing resources. In doing so, they emphasize inclusiveness.

### **Supportive and Competitive Roles of Government**

The government of a country also plays the supportive and competitive role in the development of business. The primary economic role of the government is to create an enabling environment where competitive private activity can flourish. For example, the government, in its effort to protect the consumer and promote open competition in the market, requires companies to reveal to the consumer the contents of its products, and its methods of operation and corporate organizations.

The government guards against monopolistic business practices, such as the formation of trusts. It has also to protect its citizens against market failures, which occur when one or all of the following conditions exist:

- When adequate competition does not exist
- Resources are not free to move from one industry to another
- Prices do not reasonably reflect the costs of production
- Buyers and sellers are not well informed

Another important function of the government is to maintain the stability and the well being of the country. For this, it needs to keep a sufficient level of competition in the markets by regulating some monopolists' prices and directing the quality of public services. The objective of the government is to establish the same prices that might exist if there were competition.

### **8.2.3 Participatory Role of Government**

Government is involved in different types of business activities. Electricity, water, postal, transport services etc. are some of the services that government organizations provide. Government owns and manages many manufacturing industries like machine tools, watches, locomotives etc. Indian economy has got its sound base and self-reliance because of the government. Government helped economy by initiating large number of industrial activities.

It was government who took care of sick enterprises and never allowed the private entrepreneurs to close down such units. An element of ideology is found in the role which it plays in business today. Government has always played a role of

path finder or initiator in business activities. Role of government is justified in Indian Business by many economic and social reasons. Government continues to stay in business due to ideological, economic and social considerations. Government has always given a helping hand to private enterprises, air transport business, insurance business, commercial banks, coal and oil industry and various other kinds of business.

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### **8.2.4 Conciliatory and Judicial Role of Government**

With the advancing industrial development, there has been a parallel increase in the disputes between employers and employees for the furtherance of each of their individual interest. Evidences show that such disputes have resulted into hampering of economic development of the country. Therefore, it becomes the responsibility of the state to interfere in such matters and ensure that the dispute of some does not produce grave consequences for the society at large. With the increase in globalisation, the role of the state has become very crucial. With increasing complexities, it is not necessary that the state may be able to deal with all the matter so that a proper conclusion can be reached.

Industrial Disputes are of two kinds: interest disputes and rights disputes. The former category of disputes is related to the determination of the wage rate, salary levels and working conditions of employment whereas the latter category deals with determination, interpretation or application of the already existing standards. Such kinds of dispute are popularly known as grievance dispute. In these disputes, it is claimed that the workers have not been dealt in accordance with the rules or contracts, laws and regulations or collective agreements that govern individual employment. Such grievances may be regarding retrenchment, dismissal, payment of wages, working time, overtime, demotion, promotion, transfer, seniority, job classification, work rules and fulfilment of obligation relating to safety and health laid down in agreement.

In such cases where the parties have to come to a solution which establishes a win – win situation for both the parties. It is not necessary that the state intervention will be able to bring about this objective. The best alternative to this situation can be brought about through conciliation or arbitration.

Conciliation refers to the reconciliation of the interests or differences of the two parties. It is a process through which each of the parties first appoints their representatives. These representatives are brought before a third party. The mutual discussion takes place between the representatives of workers and employers so that they can be persuaded to come to a common solution. An alternative name for this process is known as mediation. The third party can be an individual or a group of people. Functions of this mediator include-

Remove the differences between the two parties.

Persuading the two parties to think in a manner that is based on an approach of give and take i.e. a problem-solving approach

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Persuade both the parties to necessarily reach a solution and refrain from imposing his viewpoint

Change his approach depending on the need in each case and depending upon other factors

### **Arbitration or Judicial Role of Government**

Arbitration is in some terms similar to Conciliation. In this method of dispute resolution also, the unresolved dispute is referred by the parties to a dispute to a third party who stands to be neutral and is commonly known as the arbitrator. This method is different from conciliation because the judgement is given by the third party in the former whereas parties themselves come to an agreement in the latter category.

Unlike judges, the arbitrators do not enjoy judicial powers. The function of an arbitrator is to listen to the viewpoints of both the parties and then deliver his judgement. The decision is sent to the government who publishes it. The judgement becomes enforceable and binding on both the parties.

Arbitration is of two kinds:

1. Voluntary Arbitration – It includes those situations where the two parties to a dispute mutually agree to refer their matter to a third party. One drawback of this method of arbitration is that the judgement would not necessarily become binding on both the parties. In India, there are lot of factors that work against the successful working of voluntary arbitration such as legal obstacles, limited availability of trained arbitrators, scarcity in the amount of confidence in the eyes of general public, complicated procedure, lack of appellate procedure in case of non-satisfaction of the award, absence of recognised unions which could bind the workers. According to Section 10-A of the Industrial Disputes Act, 1947, in cases where the conciliation process fails, then it is advised that the parties opt for voluntary arbitration.
2. Compulsory Arbitration – In cases where the government instructs the two parties to opt for the process of arbitration. The judgement produced by the arbitrator is binding on both the parties.

The disputes which are resolved by way of arbitration have certain advantages such as it ensures the two parties that they have faith in each other, the process is informal and flexible and nature, arbitration provides justice at minimum cost and time, lastly mutual consent leads to building of trust and healthy relations between the two parties.

#### **Check Your Progress**

1. State one instance of government intervention.
2. What is the primary economic role of the government?



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## **8.3 IMPACT OF INDIA'S INDUSTRIAL POLICY ON ECONOMIC REFORMS**

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Industrial policy is a statement which defines the role of government in industrial development. It is a statement of objectives to be achieved in the area of industrial development and the measures to be adopted towards achieving these objectives. The industrial policy thus formally indicates the spheres of activity of the public and the private sectors. It lays down rules and procedures that would govern the growth and pattern of industrial activity. The industrial policy is neither fixed nor inflexible.

It is amended, modified and redrafted according to the changed situations, requirements and perspectives of developments.

### **Objectives of the Industrial Policy of the Government**

The objectives are as follows:

- To maintain a sustained growth in productivity
- To enhance gainful employment
- To achieve optimal utilisation of human resources
- To attain international competitiveness
- To transform India into a major partner and player in the global arena

Policy focus is on:

- Deregulating Indian industry
- Allowing the industry freedom and flexibility in responding to market forces and
- Providing a policy regime that facilitates and fosters growth of Indian industry.

### **Major Policy Measures**

Some of the important policy measures announced and procedural simplifications undertaken to pursue the above objectives are as under:

#### **1. Liberalization of Industrial Licensing Policy**

The list of items covered under compulsory licensing under the Industries (Development & Regulation) Act, 1951 is reviewed on an ongoing basis. At present, only five industries are under compulsory licensing mainly on account of environmental, safety and strategic considerations. They are as follows:

- Distillation and brewing of alcoholic drinks. (Licensing ceased by DIPP in compliance with Supreme Court Order of 29.1.1997 in Bihar Distillery case which ruled that industries engaged in manufacture of potable alcohol would be under the jurisdiction of the States).

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- Cigars and cigarettes of tobacco and manufactured tobacco substitutes.
- Electronic Aerospace and defense equipment: all types.
- Industrial explosives including detonating fuses, safety fuses, gun powder, nitrocellulose and matches.
- Specified Hazardous chemicals, i.e., (i) Hydrocyanic acid and its derivatives, (ii) Phosgene and its derivatives and (iii) Isocyanates & diisocyanates of hydrocarbon, not elsewhere specified (example Methyl isocyanate).

Similarly, from 8 industries reserved for the public sector in 1991, there are only following two industries reserved for public sector at present:

- Atomic energy — Production, separation or enrichment of special fissionable materials and substances and operation of the facilities, specified in DIPP Notification No. S.O.2630 (E) dated 19.10.2009
- Railway transport

### **2. Industrial Entrepreneurs' Memorandum (IEM)**

Industries not covered under compulsory licensing are to file an Industrial Entrepreneurs' Memorandum (IEM) with the Secretariat for Industrial Assistance (SIA). No industrial approval is required for such exempted industries. Amendments are also allowed to IEMs filed w.e.f. 1st July, 1998.

### **3. Policy for Small Scale Industries**

At present, the SSI is defined under the Micro, Small & Medium Enterprises (MSMED) Act, 2006. Though reservation of items exclusively for the Small Scale sector forms a significant aspect of the industrial policy, review for dereservation of such items is also undertaken by the government at periodic intervals, in order to enhance competitiveness of such products in the domestic/global markets. Review of reserved items is thus a continuous process. During the last 5 years itself more than 600 items have been dereserved. At present 20 items are reserved for manufacture in the small scale sector. All undertakings other than the small scale industrial undertakings engaged in the manufacture of items reserved for manufacture in the small scale sector are required to obtain an industrial licence and undertake an export obligation of 50 per cent of the annual production. This condition of licensing is, however, not applicable to those undertakings operating under 100 per cent Export Oriented Undertakings Scheme, the Export Processing Zone (EPZ) or the Special Economic Zone Schemes (SEZs). In tune with the provisions of the MSMED Act, 2006 and policy of liberalization, the provision of restricting equity participation by non-SSI undertakings in SSI undertakings upto 24 per cent has been removed by way of rescinding notification No.S.O. 857(E) dated 10.12.1997 vide Notification No.S.O.563(E) dated 27.2.2009.

#### **4. Non-Resident Indians Scheme**

The general policy and facilities for Foreign Direct Investment are applicable to NRIs as well. In addition, government has extended some additional facilities to NRIs, which include investment in the real estate and civil aviation sectors upto 100 per cent, besides a liberal investment regime on non-repatriation basis.

#### **5. Electronic Hardware Technology Park (EHTP)/Software Technology Park (STP) Scheme**

For building up strong electronics industry and with a view to enhancing export, two schemes viz. Electronic Hardware Technology Park (EHTP) and Software Technology Park (STP) are in operation. Under EHTP/STP scheme, the inputs are allowed to be procured free of duties. The Directors of STPs have powers to approved fresh STP/EHTP proposals and also grand post-approval amendment in respect of EHTP/STP projects as have been given to the Development Commissioners of Export Processing Zones in the case of Export Oriented Units. All other application for setting up projects under these schemes, are considered by the Inter-Ministerial Standing Committee (IMSC) Chaired by Secretary (Information Technology). The IMSC is serviced by the SIA.

#### **6. Policy for Foreign Direct Investment (FDI)**

Promotion of Foreign Direct Investment (FDI) forms an integral part of the Industrial Policy. FDI helps in accelerating economic growth by means of infusion of capital, technology and modern management practices. Government has put in place a liberal and transparent foreign investment regime, wherein FDI, upto 100 per cent, is allowed, under the automatic route, in most sectors/activities. The FDI policy is announced through issue of Consolidated FDI Policy Circulars. The Department has also strengthened investment facilitation measures through Foreign Investment Implementation Authority (FIIA).

#### **Phases of Industrial Policies**

Industrial development during the plan period can be divided into the following four phases:

**Phase I (1951–56) Building Strong Industrial Base:** Phase I laid the basis for industrial development in the future. The Second Plan based on Mahalanobis Model, emphasized the development of capital goods industries and basic industries.

**Phase II (1965–80) Industrial Deceleration and Structural Retrogression:** The period 1965 to 1976 was marked by a sharp deceleration in industrial growth. The rate of growth fell sharply from 9.0 per cent per annum during the Third Plan to a mere 4.1 per cent per annum during the period 1965 to 1976. The last year of Phase II, i.e., 1979–80, recorded negative growth of industrial production of 1.6 per cent over the preceding year.

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Several explanations were offered for the phenomenon of deceleration and retrogression in the industrial sector during Phase II. The government expressed the view that exogenous factors such as the wars of 1965 and 1971, drought conditions in some years, infrastructural constraints and bottlenecks and the oil crisis of 1973 were responsible for slowdown of growth. K. N. Raj argued that low growth in the agricultural sector accounted for the slowdown of industrial growth by restricting the supply of raw materials on the one hand, and by constraining the demand for industrial goods on the other. T. N. Srinivasan argued that there was a considerable slackening of real investment in Phase II, particularly in the public sector and this brought down the rate of growth in the industrial sector. Some economists like Jagdish Bhagwati blamed the wrong industrial policies, complex bureaucratic system of licensing and irrational and inefficient system of controls for industrial deceleration.

**Phase III (1981–1991) Period of Industrial Recovery:** The 1980s can broadly be termed as a period of industrial recovery.

The rate of industrial growth was 6.4 per cent per annum during 1981–85, 8.5 per cent per annum during the Seventh Plan and 8.3 per cent in 1990–91. This is a marked upturn from growth rates of around 4 per cent achieved during the latter half of 60s and 70s.

**Phase IV (1991–92 to 2000):** 1991 heralded a new era of economic liberalization. Major liberalization measures designed to affect the performance of the industrial sector were— wide scale reduction in the scope of industrial licensing, simplification of procedural rules, reductions of areas exclusively reserved for the public sector, disinvestment of equity of selected public sector undertakings, enhancing the limit of foreign equity participation in domestic industrial undertakings, liberalization of trade and exchange rate policies, reduction of customs and excise duties and personal and corporate income tax, etc.

The rate of growth of industrial production which was 7.8 per cent per annum during the pre-reform decade fell to 6.0 per cent per annum during the post-reform decade. This disappointing performance is basically due to a steep fall in the rate of growth of capital goods sector as well as the basic goods sector.

The average annual rate of growth of the industrial sector in the Eighth Plan was 7.4 per cent per annum—the same as the targeted rate of growth.

An important reason for the slowdown of industrial growth after that was the slowdown of investment. It is a fact that capital formation in the public and private sectors provides a stimulus for industrial growth in the form of both the direct demand that such expenditures involve and the indirect demand resulting from income generation by investments. However, as a result of the adoption of the macroeconomic adjustment programme of the IMF in 1991, the Government of India was forced to cut down public expenditure drastically. Since, there is a strong complement between public investment and private investment, a reduction in the rate of growth of public investment had a depressing effect on private investment as well.

The most important reason for unsatisfactory performance of the industrial sector was the deteriorating state of infrastructure. Industrial production suffered not only on account of inadequate availability of infrastructure like power and transportation bottlenecks, but also due to poor quality of infrastructure. All these factors added to the real costs of manufacture, and thus, adversely affected the competitiveness of domestic industry. The addition to power capacity in the Eighth Plan was less than in the Seventh Plan, even in absolute terms. The performance of the industrial sector in 1998–99 was particularly disappointing with the rate of growth in this sector being just 41 per cent. The factors responsible for poor industrial growth were listed in Economic Survey under two heads (i) Domestic and (ii) External. The domestic factors were: (a) The decline in agricultural production in 1997–98 affected rural income, which directly resulted in lowering the demand for certain industrial products, (b) Capital markets remaining depressed for the past couple of years, drying up sources of investment funds for industry, (c) Larger enterprises were in a better position to access funds. However, some of these units utilized the resources largely in mergers and acquisitions, rather than additional capacity creation and (d) Deficiencies in infrastructure services.

The external factors were: (a) Export growth was sluggish since 1996–97 and the low demand for exports adversely affected industrial production; (b) Although, the Indian rupee depreciated somewhat since August 1997, there was much greater depreciation in East Asian currencies following the East Asian crisis in mid-1997. This higher depreciation eroded the competitiveness of Indian products overseas by making them more expensive; and (c) Several industries like steel, chemicals and electronic components were subject to competitive pressures from imports.

#### **Phase V (2000 onwards)**

The post reform period up to 2000-01 was marked by considerable fluctuations and thus showed a total lack of consistency in industrial growth performance. Industrial growth fell to 4.1 per cent in 1998-99. The slowdown of industrial growth was mainly due to the poor performance of electricity generation, mining, and decline in agriculture production in 1997-98. It also affected rural incomes which directly resulted in lower demand for certain industrial product, capital markets remained depressed for the past couple of years, drying up source of investment funds for industry, export growth had been sluggish in 1996-97, low demand for exports adversely affected industrial production and several industries had been subject to competitive pressure from imports. After a turnaround in 1999-2000, industrial growth slowed down during 2000-01. Overall, industrial growth during 2000-01 at 5.0 per cent was lower than 6.7 per cent during the corresponding period in 1999-2000. The average rates of growth of Indian Industry in the post reform period (1991-92 to 2000-01) were 6.0 per cent, the growth of manufacturing sector was 6.3 per cent, mining 3.3 per cent, and electricity was 6.6 per cent. The average annual growth rate of industrial production which was 7.8 per cent in the pre-reform decade (1981-82 to 1990-91) fell to 6.0 per cent

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during the period 1991-92 to 2000-01. The main causes of unsatisfactory industrial performance in post reform period up to 2000-01 were exposure to external competition, slowdown in investment, infrastructure constraints, and difficulties in obtaining funds for expansion, sluggish growth in exports, anomalies in tariff structure and contraction in consumer demand. The rate of growth of industrial production was 2.7 per cent in 2001-02, 5.7 per cent in 2002-03 and picked up considerably to 7.0 per cent in 2003-04, 8.4 per cent in 2004-05, 8.2 per cent in 2005-06 and to as high as 11.6 per cent in 2006-07. The rate of growth of industrial production in 2007-08 slowed down as compared with 2006-07. The year 2008-09 witnessed marked slowdown due to global recession and the rate of growth of industrial production in this year fell to just 2.8 per cent. Deceleration in industrial growth was seen across most sectors of industrial activity. However, the year 2009-10 recorded a revival of industrial growth at 10.3 per cent and 8.2 per cent in 2010-11.

### Check Your Progress

3. Define industrial policy.
4. State one objective of the industrial policy of the government.

## 8.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. One instance of government intervention is to provide non-market products or indivisible services
2. The primary economic role of the government is to create an enabling environment where competitive private activity can flourish.
3. Industrial policy is a statement which defines the role of government in industrial development.
4. One objective of the industrial policy of the government is to maintain a sustained growth in productivity.

## 8.5 SUMMARY

- Today, there is practically no aspect of business which is free of State regulation or control. The State is ready to intervene if the occasion arises to do so and popular and legislative support exists.
- Encouragement to entrepreneurship is an extremely important role of any government which is concerned with the future economic health of its country.
- Sometimes, governments do not play a direct role in business activities. They play the role of catalysts.

- They believe in steering rather than rowing. Government should be a catalyst for the development of business environment; it cannot compensate or substitute for its absence. Governments, as effective catalysts, do not do anything directly for business.
- The primary economic role of the government is to create an enabling environment where competitive private activity can flourish.
- Industrial Disputes are of two kinds: interest disputes and rights disputes.
- The former category of disputes is related to the determination of the wage rate, salary levels and working conditions of employment whereas the latter category deals with determination, interpretation or application of the already existing standards.
- Industrial policy is a statement which defines the role of government in industrial development. It is a statement of objectives to be achieved in the area of industrial development and the measures to be adopted towards achieving these objectives.
- Promotion of Foreign Direct Investment (FDI) forms an integral part of the Industrial Policy. FDI helps in accelerating economic growth by means of infusion of capital, technology and modern management practices.

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### 8.6 KEY WORDS

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- **Judicial:** It means of, by, or appropriate to a law court or judge; relating to the administration of justice.
- **Import:** It refers to a commodity, article, or service brought in from abroad for sale.
- **Bureaucratic:** It relates to a system of government in which most of the important decisions are taken by state officials rather than by elected representatives.
- **Liberalization:** It is the removal or loosening of restrictions on something, typically an economic or political system.

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### 8.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

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#### Short-Answer Questions

1. What is the regulatory role of government?
2. Briefly discuss the conciliatory and judicial role of government.
3. What are the bases for government intervention?

4. List objectives of the industrial policy of the government.
5. Write a short note on liberalization of Industrial Licensing Policy.

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### Long-Answer Questions

1. Discuss in detail the promotional and participatory role of government.
2. What is the impact of India's industrial policy on economic reforms?
3. Elucidate all the important phases of industrial policies.

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## 8.8 FURTHER READINGS

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**BLOCK III**  
**GROWTH AND DEVELOPMENT**

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*New Economic Policy*

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**UNIT 9 NEW ECONOMIC POLICY**

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**NOTES**

**Structure**

- 9.0 Introduction
- 9.1 Objectives
- 9.2 Impact of India's Industrial Policy on Economic Reforms
  - 9.2.1 The Crisis of June 1991
  - 9.2.2 Objectives of New Economic Policy-1991
  - 9.2.3 Initiatives Taken under NEP
- 9.3 Emphasis of NEP
  - 9.3.1 Emphasis of NEP on Liberalization
  - 9.3.2 NEP and Privatization
  - 9.3.3 NEP Effect on Globalization
- 9.4 Answers to Check Your Progress Questions
- 9.5 Summary
- 9.6 Key Words
- 9.7 Self Assessment Questions and Exercises
- 9.8 Further Readings

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**9.0 INTRODUCTION**

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In previous units you studied about the various relationships between business and its surroundings. You also learnt about the role of government in a business.

To further augment knowledge around business environment, this unit discusses the new economic policies that have been adopted through the years and the negative and positive effects that it has levied. These policies were put into place post the balance of payment crises of 1990-91

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**9.1 OBJECTIVES**

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

- Discuss the objectives of New Economic Policy (NEP)
- Assess the initiatives taken under NEP
- Interpret the emphasis of NEP on liberalization
- Describe the effects of NEP

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## 9.2 IMPACT OF INDIA'S INDUSTRIAL POLICY ON ECONOMIC REFORMS

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**The Industrial Policy of 1948:** The first industrial policy statement was issued in the Government's Industrial Policy Resolution of April 1948. *The resolution contemplated a mixed economy. There was a sphere reserved for private enterprise and another for public ownership.* The Government of India felt that for some time the state could continue to increase national wealth by expanding its present activities wherever it was already operating and by concentrating on new units of production in other fields rather than on acquiring and running existing units. Meanwhile, private enterprise, properly directed and regulated, had a valuable role to play. *Thus, ours is a mixed economy in which both the public and private enterprises would work side by side for the economic development of the country. It is a compromise between private capitalism and state socialism.* Private enterprise is actuated by the profit motive which may be looked upon as an index of efficiency, while public enterprise has a social end. Therefore, we may say that a mixed economy is a combination of efficiency with social end. To secure the objective of rapid industrialization, the public sector has not only to initiate development which the private sector is either unwilling or unable to undertake; it has also to play the dominant role in shaping the entire pattern of investments in the economy, whether it makes the investments directly or whether these are made by the private sector.

**Mixed economy:** The Industrial Policy of 1948 envisaged a mixed economy. Mixed economy is the outcome of compromise between two diametrically opposite schools of thought—one which champions the cause of *laissez faire* capitalism and another which supports the cause of socialization of all means of production.

It was the failure of capitalism which led to the emergence of the mixed economy. Laski declared that *laissez faire as a principle ended with the outbreak of war in 1914*. The First World War led to the near total government control of every aspect of economic life in nearly all western countries. The worldwide depression brought unemployment and economic misery on an unprecedented scale and led to vigorous demands for state intervention.

Keynes' General Theory is a repetition of the foundations of *laissez faire*. Keynes himself played an important part in the evolution of the concept of mixed economy. He believed that capitalism without its defects was the best system. Socialism of the authoritarian type would kill individual freedom. But state control and direction was inevitable in a mixed economy. A mixed economy is a compromise between socialism and capitalism. Neither pure capitalism nor pure socialism could survive as a stable social order. And so came the philosophy of mixed economy. Keynes is the originator of the concept of mixed economy. Mixed economy operates through a combination of planning and pricing.

Considering the limitations of both *maximum role* of the government under socialism and *minimum role* of the government under capitalism, the world politico-economic order has moved towards mixed economy with *optimum role* of the government. The increasing government intervention in business is justified for *welfare capitalism*. The Government is expected not to end but to mend the capitalist pattern of development in accordance with the principle of *maximum social advantage*. Today, there is no country either of pure capitalism or pure socialism. Everywhere it is a mixed form of economy.

*Ours is a mixed economy in which both the public and the private enterprises work side by side. It is a compromise between private capitalism and state socialism.*

In a mixed economy the entire economic system is divided into three parts:

- (i) Sectors exclusively controlled and managed by the private enterprise subject to the general control and regulation by the state;
- (ii) Sectors which are exclusively controlled and managed by the state; and
- (iii) Sectors which are jointly managed and controlled by the State and private enterprise.

**Industrial Policy of 1956:** The 1956 industrial policy has six objectives: (i) to accelerate economic growth and industrial development of the country, (ii) to expand the public sector, (iii) to prevent the growth of monopolies and the concentration of economic powers in the hands of a few people, (iv) to develop a large cooperative sector, (v) to develop heavy and machine-made industries, and (vi) to reduce disparities in wealth and income.

The most important difference between the 1948 and the 1956 policy statements is with regard to the policy of nationalization. In the first policy, it was laid down that industries in the second category would be permitted to operate for 10 years, at the end of which the Government would decide whether to nationalize them or not. This provision discouraged private enterprise and created uncertainty in the industrial field. The 1956 policy statement removed the threat of nationalization from the minds of private entrepreneurs operating in the predominantly public sector. Thus, private enterprise was given a new opportunity to justify its existence in a socialist democracy.

**Industrial Policy of July 1980:** While sticking to the spirit of the 1956 Industrial Policy Resolution, the Congress Government announced on July 23, 1980 the new industrial policy which included major relaxations and concessions benefiting the small, medium as well as large-scale sector with the triple objects of modernization, expansion and spread to backward areas. The thrust of the concessions is in doubling the investment limit of tiny, small and ancillary sectors, regularization of the excess capacity and permitting automatic expansion facilities for large units in the priority sector and setting up of several nucleus industrial centres in industrially backward areas.

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The following were the highlights of the New Industrial Policy of 1980:

- (i) In order to promote the development of small-scale industries and ensure their rapid growth, the Government has decided to increase the limit of investment in case of tiny units from ₹ 1 lakh to ₹ 2 lakh. In the case of small-scale units the limit has been raised from ₹ 10 lakh to ₹ 20 lakh and from 15 lakh to 25 lakh in the case of ancillary units.  
In March 1985, the investment limit for small-scale industries was raised further from ₹ 20 lakh to ₹ 35 lakh. For ancillary units, the investment limit is ₹ 45 lakh.
- (ii) The Government decided to pursue a goal of vibrant, self-reliant and modern economy in which all sectors had a positive role to play. Therefore, the Government recognized that it was desirable to allow private sector undertakings to grow in consonance with targets and objectives of national plans and policies but would not permit growth of monopolistic tendencies or concentration of economic powers and wealth in a few hands.
- (iii) The Government has decided to revive the efficiency of public sector undertakings. Industrial undertakings in this sector will be closely examined on a unit-by-unit basis and corrective action will be taken in terms of a timebound programme wherever necessary.
- (iv) As regards automatic growth, the Government feels that no avoidable restrictions should be placed on the fullest utilization of the existing industrial capacities. In 1975, the Government had permitted the facility for automatic expansion in respect of only 15 industries. The extent of increased capacity permitted in these industries was limited to 5 per cent per annum or 25 per cent in a Five-Year Plan period and could be undertaken in one or more stages. The Government announced that this facility would be extended to other industries also.
- (v) *The 'district industrial centre' idea which was introduced by the Janata Government has not received full support from the 1980 Industrial Policy Statement.* On the district industrial centre programme, the 1980 policy points out that the scheme has not produced benefits commensurate with the expenditure incurred. The Government therefore, decided to initiate more effective schemes.
- (vi) In the context of development of backward areas, the New Policy Statement has mentioned *nucleus plants* which should radiate industrial impulses all round. The so-called concept of *nucleus plants* when implemented, is expected to concentrate mainly on assembling the products of ancillary units falling within their orbit.
- (vii) The 1980 policy refers to considerable simplification and streamlining of licensing procedures and concedes that there is scope for further improvement in reducing the time taken for disposal of applications for the creation of new capacities, proposal for substantial expansion and

production of new items. It is proposed to speed up the process of examination and decision-making in the sphere of industrial licensing.

- (viii) The Government would endeavour to ensure that the process of modernization percolated down to small units and the villages. For this purpose, the incentives available to the large-scale sector might also be made available to the decentralized sector.
- (ix) Industrial processes and technologies which would aim at optimal utilization of energy or the exploitation of alternative sources of energy would be given special assistance, including finance on concessional terms. The Industrial Policy of July 1980 hits hard at the Janata Party's policy statement of December 1977 and its record in promoting industrial growth. But on close examination it will be found that the 1980 Industrial Policy has made no serious departure from the earlier policies. For instance, though the 1980 policy deplores the *artificial divisions* between the small and large-scale sectors promoted by the Janata Government, it also wants to continue the policy of reservation of items for the small-scale sector. It has also retained the distinction between the tiny and the small-scale sectors though the investment limits for both have been doubled. Moreover, the *nucleus plants* idea is good but it will be difficult to achieve. As we get it in the 1980 policy statement, it appears to be just another new appealing word.

The so-called excess capacities and excess production above licensed limits are expected to be regularized for more industrial units. This encourages and boosts the industrial growth. Induction of new technology is to be encouraged by allowing additional capacities to be created, if necessary, in more cases. This is certainly a step in the right direction.

**Elements in the industrial policy of Rajiv Gandhi's government:** We give below the elements of the Rajiv Gandhi Government's Liberalized Industrial Policy, as enunciated from time to time by ex-Prime Minister late Rajiv Gandhi himself or his senior cabinet ex-colleagues:

- (i) Upward revision of asset limit of MRTP companies from ₹ 20 crores to ₹ 100 crores. In the Union Budget for 1985-86, the Finance Minister announced a steep upward revision in the threshold limit of MRTP Companies from ₹ 20 crores to ₹ 100 crores.
- (ii) Automatic Expansion Permission is currently being granted for expansion of existing industrial units up to 1/3rd of their capacity in case the industries have already utilized 93 per cent of their installed capacity.
- (iii) Upward revision in delicensing of investments under the Industries (Development and Regulation) Act, 1951 from ₹ 3 crores to ₹ 5 crores subject to the formal requirement of registration of such units. In April 1983, the exemption limit for industrial licensing was raised from ₹ 3 crores to ₹ 5 crores.

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- (iv) Complete delicensing of twenty-five industries in March 1985.
- (v) Redefinition of investment criteria of small-scale and ancillary industries. The investment limit of ₹ 20 lakh for small-scale industries has been raised to ₹ 35 lakh and that of ancillary units has been enhanced from ₹ 25 lakh to 45 lakh. These limits have been further raised for small-scale industries to ₹ 60 lakh and for ancillary units to ₹ 75 lakh.
- (vi) Industries exempt from Section 21 and 22 of the MRTP Act for MRTP/ FERA companies for backward areas. The Government of India earlier delicensed broad categories of industries along with 82 bulk drugs for non-MRTP and non-FERA companies subject to production of items reserved for the small-scale sector and certain locational considerations. Later, it was decided to extend the scheme of delicensing also to MRTP and FERA companies in respect to 22 out of 27 industries exempted under section 22A of the MRTP Act provided such undertakings apply for locating these units in centrally declared backward areas.
- (vii) *Setting up of industries by MRTP companies in no-industry districts and other backward districts:* According to the earlier policy, MRTP and FERA companies were permitted to set up industrial units in areas of high technology. Their entry into other fields has been subject to export obligation of 60 per cent with a view to industrializing backward regions within the country. The level of export obligation was reduced to 50 per cent for categories B and C districts and 30 per cent for category A districts in 1983. In order to give an impetus to the industrialization of backward areas it has now been decided to reduce the level of export obligation to only 25 per cent for category B and C districts and to totally dispense with export obligations in respect of category A backward districts.
- (viii) *Revision of foreign exchange limits for imports of new materials and components for the purpose of exemption from licensing:* Industrial undertakings with investment below ₹ 5 crores are not required to obtain any industrial license under the Industries (Development and Regulation) Act but one of the conditions of the exemption from licensing was that the foreign exchange requirement for import of raw materials and components in such cases should not exceed 15 per cent of the ex-factory value of industrial production or ₹ 40 lakh, whichever was less. If the import requirement exceeded this limit, even units with investments below ₹ 5 crores would require an industrial license. On account of a rise in the cost of raw materials, it has now been decided to raise the limit to ₹ 75 lakh subject to a ceiling of 15 per cent of the cost of ex-factory value of industrial production. This limit would not however, apply in case of industries in respect of which specific phased manufacturing programmes have been approved by the Government.

## New Industrial Policy, 1991

Jawaharlal Nehru laid the foundations of modern India. The aims and objectives set out for the nation by Nehru on the eve of independence were rapid agricultural and industrial development of the country, rapid expansion of opportunities for gainful employment, progressive reduction of social and economic disparities, removal of poverty and attainment of self-reliance. These remain as valid as at the time Nehru set them before the nation. Any industrial policy must be contribute to the realization of these aims and objectives. Though the present statement of industrial policy is inspired by these concerns, actually it bids farewell to Nehruvian socialism and brings the public sector at par with the private sector in several areas. Hence, in core areas like steel, power and several other industries, the public sector will have to climb down from the commanding heights to street level commercialism where it has to compete with private enterprise.

In 1948, the Government adopted the industrial policy resolution which emphasized the importance to the economy of securing a continuous increase in production and ensuring its equitable distribution. After the adoption of the Constitution and the socio-economic goals, the industrial policy was revised and adopted in 1956. To meet new challenges from time to time, it was modified through statements in 1973, 1977 and 1980.

The 1956 policy resolution had as its objective the achievement of a socialist pattern of society. In 1956, capital was scarce and the base of entrepreneurship not strong enough. Hence, the 1956 industrial policy resolution gave primacy to the role of the state to assume a predominant and direct responsibility for industrial development.

The industrial policy statement of 1973 identified high-priority industries where investment from large industrial houses and foreign companies would be permitted.

The industrial policy statement of 1977 laid emphasis on decentralization and on the role of small-scale, tiny and cottage industries.

The industrial policy statement of 1980 focussed attention on the need for promoting competition in the domestic market, technological upgradation and modernization. The policy laid the foundation for an increasingly competitive export base and for ensuring foreign investment in high technology areas. These policies created a climate for rapid industrial growth in the country. Basic industries had been established. New growth centres of industrial activity had emerged as had a new generation of entrepreneurs. A number of policy and procedural changes was introduced in 1985 and 1986 under the leadership of late prime minister Rajiv Gandhi, which aimed at increasing productivity, reducing costs and improving quality. The public sector was freed from a number of constraints and given a large measure of autonomy.

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In the 1950s and 1960s the principal instrument for controlling the commanding heights of the economy was investment in the capital of key industries. Today, the state has other instruments of intervention, particularly fiscal and monetary instruments. The state also commands the bulk of the nation's savings. Bank and financial institutions are under state control. Where state intervention is necessary, these instruments will prove more effective.

The Government will fully protect the interests of labour, enhance their welfare and equip them to deal with the inevitability of technological change. Labour will be made an equal partner in progress and prosperity. Workers' participation in management will be promoted.

The Government will continue to visualize new horizons. The major objectives of the new industrial policy will be to build on the gains already made, correct the distortions that may have crept in, maintain a sustained growth in productivity and gainful employment and attain international competitiveness. The government's policy will be in continuity with change.

### **9.2.1 The Crisis of June 1991**

The crisis was caused by currency devaluation; the current account deficit, and investor confidence played significant role in the sharp exchange rate depreciation.

The economic crisis was primarily due to the large and growing fiscal imbalances over the 1980s. During the mid-eighties, India started having balance of payments problems. Precipitated by the Gulf War, India's oil import bill swelled, exports slumped, credit dried up, and investors took their money out. Large fiscal deficits, over time, had a spillover effect on the trade deficit culminating in an external payments crisis. By the end of the 1980s, India was in serious economic trouble.

The gross fiscal deficit of the government (centre and states) rose from 9.0 percent of GDP in 1980-81 to 10.4 percent in 1985-86 and to 12.7 percent in 1990-91. For the centre alone, the gross fiscal deficit rose from 6.1 percent of GDP in 1980-81 to 8.3 percent in 1985-86 and to 8.4 percent in 1990-91. Since these deficits had to be met by borrowings, the internal debt of the government accumulated rapidly, rising from 35 percent of GDP at the end of 1980-81 to 53 percent of GDP at the end of 1990-91. The foreign exchange reserves had dried up to the point that India could barely finance three weeks worth of imports.

In mid-1991, India's exchange rate was subjected to a severe adjustment. This event began with a slide in the value of the Indian rupee leading up to mid-1991. The authorities at the Reserve Bank of India took partial action, defending the currency by expending international reserves and slowing the decline in value. However, in mid-1991, with foreign reserves nearly depleted, the Indian government permitted a sharp devaluation that took place in two steps within three days (1 July and 3 July 1991) against major currencies.



With India's foreign exchange reserves at \$1.2 billion in January 1991 and depleted by half by June, barely enough to last for roughly 3 weeks of essential imports, India was only weeks away from defaulting on its external balance of payment obligations.

Government of India's immediate response was to secure an emergency loan of \$2.2 billion from the International Monetary Fund by pledging 67 tons of India's gold reserves as collateral security. The Reserve Bank of India had to airlift 47 tons of gold to the Bank of England and 20 tons of gold to the Union Bank of Switzerland to raise \$600 million. National sentiments were outraged and there was public outcry when it was learned that the government had pledged the country's entire gold reserves against the loan. It was later revealed [according to whom?] that the van transporting the gold to the airport broke down en route and panic followed. A chartered plane ferried the precious cargo to London between 21 May and 31 May 1991, jolting the country out of an economic slumber. The Chandra Shekhar government had collapsed a few months after having authorised the airlift. The move helped tide over the balance of payment crisis and kick-started P.V. Narasimha Rao's economic reform process.

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### 9.2.2 Objectives of New Economic Policy-1991

Economic Reforms in India were started by Prime Minister Rajiv Gandhi. He said, 'the public sector has entered into too many areas where it should not be. We shall open the economy to the private sector in several areas hitherto restricted to it.' Consequently, a number of measures were taken to remove control open areas to private sector players. However, Rajiv Gandhi did not take a very strong and categorical position on the issue of privatization and globalization, though some liberalization of the economy did take place. It was when Mr. Narasimha Rao took over as Prime Minister in 1991 that a new industrial policy was announced which marked a sharp departure from the earlier industrial policy of 1956.

There were three aims of the *New Economic Policy*—Liberalization, Globalization and Privatization.

### 9.2.3 Initiatives Taken under NEP

In 1991, the government took a series of initiatives in respect of the policies relating to the following areas:

- (i) Industrial Licensing
- (ii) Foreign Investment and Technology Agreements
- (iii) Public Sector Policy
- (iv) MRTP Act

A package for the small and tiny sectors of industry was announced separately.

1. **Industrial Licensing Policy:** Industrial licensing will henceforth be abolished for all industries, except eighteen sectors which need regulation

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because of security and strategic concerns, social reasons, chemical hazards, environmental protection and curbing elitist consumption. Among these industries are cars, sugar, cigarettes, colour TV and VCRs, white goods like air conditioners, refrigerators and electronic washing machines.

All registration schemes including Director General of Technical Development are to be abolished, entrepreneurs have to only file an information memorandum on new projects and expansions.

Eight areas, where strategic and security concerns predominate, continue to be reserved for public sector.

Attaining exemption from licenses will especially aid many dynamic small and medium entrepreneurs who have been unnecessarily hampered by the licensing system. On the whole, the Indian economy will benefit if it becomes more competitive, efficient and modern.

No industrial approvals will be required for putting up plants in locations other than cities with a population of more than one million. Where the population is more than one million, industries (with the exception of electronics, computer software and printing) will have to set up units outside a 25-km radius, except in prior designated industrial areas.

As per the industrial policy statement, the mandatory convertibility clause will no longer be applicable for term loans from financial institutions for new projects put by large houses.

With the sweeping liberalization measures, the existing procedures have been streamlined accordingly. All existing registration schemes have been abolished.

- 2. Foreign Investment and Technology Agreements:** While liberalizing the Indian industry from the control and domination of the government, opportunities for promotion of investments should also be fully explored. Foreign investment would bring its associated advantages of marketing expertise, technology transfer, introduction of modern managerial techniques and new possibilities for promotion of exports. This is especially important in the changing global scenario of industrial and economic cooperation marked by mobility of capital. The government will therefore welcome foreign investment, which is in the interest of the country's industrial development. These include commercial vehicles and two wheelers, inorganic fertilizers, chemicals, man-made fibres, drugs and pharmaceuticals, paper, tyres, Portland cement, hotels, many food-processing industries, soya products and industrial and agricultural machinery. There shall be no bottlenecks of any kind in this process. This change will go a long way in making Indian policy on foreign investment transparent. Such a framework will make it attractive for companies abroad to invest in India.

A special empowered board is to be set up to negotiate with large international firms for direct investment in select areas—the aim is to attract substantial investment that would provide access to high technology and world markets.

To attain the desired technological dynamism in the Indian industry, the government will provide default approval, subject to certain conditions, for technology agreements for high-priority industries within specified areas. Other industries will be provided with similar provisions as well, if such agreements do not require spending of free foreign exchange. Indian companies will be free to negotiate the terms of technology transfer with their foreign counterparts according to their own commercial opinions.

3. **Public Sector Policy:** Public sector enterprises have been central to the development philosophy. Public ownership and control in critical sectors of the economy has played an important role in preventing the concentration of economic power, reducing regional disparities and ensuring that planned development serves the common good.

The Industrial Policy Resolution, 1956, gave the public sector a strategic role in the economy. Substantial investments have been made over the past five decades to build the public sector. Recently, several issues have cropped up in many of the public enterprises. In addition, these enterprises have shown a very low rate of return on the capital invested. Many of the public enterprises have become a burden to the government. This category of public sector units accounts for almost one-third of their total losses.

It is time that the government undertook new measures to develop public enterprises. The key areas for the growth of public enterprises will be as follows:

- (i) Vital infrastructure goods and services
- (ii) Exploitation and exploration of oil and mineral resources
- (iii) Development of technology and building of manufacturing capabilities in areas crucial for the long-term development of the economy and where private sector investment is inadequate
- (iv) Manufacturing products where strategic considerations predominate, such as defence equipment. At the same time, the public sector will not be prevented from entering areas not specifically reserved for it.

The government will strengthen those public enterprises that come under the reserved areas or are generating good profits. Such enterprises will be provided much greater managerial autonomy through memorandums of understanding. Competition can be introduced by encouraging private sector participation. In the case of selected enterprises, part of government holdings in these enterprises will be disinvested to discipline the performance of public enterprises. There are a large number of chronically sick public enterprises that are incurring heavy losses and serve little purpose. These need to be tended to.

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**New Public Sector Policy:** The low rate of return on capital invested reduced the ability of the public enterprise to regenerate themselves in terms of new investments as well as in new technology developments. This resulted in many of the public enterprises becoming a burden rather than an asset to the government. The new Industrial Policy of 1991 has redefined the role of the public sector. Public sector will be in future restricted to essential infrastructure, goods and services, exploration of oil and mineral resources and manufacture of products, where strategic considerations predominate such as defence equipment.

The number of industries reserved for the public sector have been reduced to eight. The scrapping of the schedule B which contained a list of twelve industries, where public sector was to play a dominant role, is also an important policy change.

The government is thinking of throwing open to the private sector most of the industries reserved for the public sector. In other words, monopoly in any sector has to be abolished.

4. **MRTPA Act:** The principal objectives sought to be achieved through the MRTPA Act are as follows:
- (i) Prevention of concentration of economic power to the common detriment.
  - (ii) Control of monopolies
  - (iii) Prohibition of monopolistic and restrictive and unfair trade practices

The need to achieve economies of scale and the growing complexity of industrial structure ensure higher productivity and competitive advantages in the international market. The MRTPA Act's role in investment decisions of large companies has become deleterious in its effects on Indian industrial growth. The scrutiny of investment decisions by so-called MRTPA companies will no longer be needed. The provisions relating to mergers, acquisitions, amalgamations and takeovers will also be repealed. Similarly, the provisions regarding restrictions on acquisition and transfer of shares will be appropriately incorporated in the Companies Act.

Hence, the government has decided to take adequate measures to liberalize the Indian industrial economy from the tangle of unrequired bureaucratic control.

**Evaluation:** Captains of industry and apex trade bodies have welcomed the new industrial policy, particularly the decisions to do away with licensing for most industries, liberalization of foreign investment and lifting the threshold limit for MRTPA. The new industrial policy is a major step in ushering the country into a new era of development and progress. The new policy will change the structure of Indian industry. It is directed towards making Indian industry internationally competitive. According to the FICCI president, many retrograde restrictions have been either removed or amended and conditions created for a market-friendly system, which

will enable India to join the international mainstream on the basis of efficiency and competitiveness. The president of the Associated Chamber of Commerce and Industry described the policy as a landmark in the opening up of the Indian economy and complemented the government for replacing the command and controlled economy which has been replaced all over the world with competitive and market economy.

The new policy is pragmatic, bold, innovative, and growth-oriented and the onus now lies with the industry to take advantages of these changes and rise to the occasion before demanding further liberalization.

On the other hand, the new industrial policy comes in for some sharp criticism by opposition leaders all over the country. The general reaction was that, the policy was a sell out to the IMF and the World Bank and hit the common man. Former Prime Minister Chandrashekhar assailed the new policy and described it as a total drift from the Gandhian path. He feared the policy would generate more unemployment. Former Finance Minister Madhu Dandavate said that, by abolishing the limits on MRTP companies, the government had put the small-scale sector in a tight corner. This would seriously affect employment potential and poverty alleviation.

#### **Check Your Progress**

1. When was the first industrial policy statement issued?
2. Give any two objectives of the 1956 industrial policy.

### **9.3 EMPHASIS OF NEP**

This section discusses the emphasis of NEP in detail.

#### **9.3.1 Emphasis of NEP on Liberalization**

The main aim of liberalization was to dismantle the excessive regulatory framework which acted as a shackle on freedom of enterprise. Over the years, the country had developed a system of *licence-permit-control raj*. The aim of the new economic policy was to save the entrepreneur from unnecessary harassment of seeking permission from the bureaucracy to start an undertaking.

Similarly, the big business houses were unable to start new enterprises because the MRTP Act had prescribed a ceiling on the asset ownership to the extent of ₹ 100 crores. In case a business house had assets of more than ₹ 100 crores, its application was rejected. It was believed that on account of the rise in prices, this limit had become outdated and needed a review. The second objection by the private sector lobby was that it prevented big business houses from investing in heavy industry and infrastructure which required lumpsum investment. The NDA in its election manifesto had suggested that the asset limit of MRTP companies

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should be raised to ₹ 1000 crores. The government thought it wise to abolish the limit altogether so that big business could establish big projects in the core sectors— heavy industry, petrochemicals, electronics, etc. The Government was of the view, that in the context of liberalization, the MRTP limit had become irrelevant and needed to be scrapped.

The major purpose of liberalization was to free large private corporate sector from bureaucratic controls. It therefore, started dismantling the regime of industrial licensing and control. In pursuance of this policy, the industrial policy of 1991 abolished industrial licensing for all projects except for a short set of eighteen industries.

### 9.3.2 NEP and Privatization

Globalization intends to integrate the Indian economy with the world economy. Globalization is considered to be an important element in the reforms package. It has four parameters:

- (i) Reduction of trade barriers so as to permit free flow of goods and services across national frontiers;
- (ii) Creation of an environment in which free flow of capital can take place;
- (iii) Creation of an environment permitting free flow of technologies among nation-states; and
- (iv) Creation of an environment in which free movement of labour can take place in different countries of the world.

The advocates of globalization limit the definition of globalization to only three components viz.; unhindered trade flows, capital flows and technology flows. They insist that the developing countries accept their definition of globalization and conduct the debate on globalization within the boundaries set by them. But many economists in developing countries believe that this definition is incomplete. If the ultimate aim of the globalization movement is to integrate the world into one global village, then the fourth component of unrestricted movement of labour cannot be left out.

To pursue the objective of globalization, the following measures have been taken.

- (i) **Reduction of import duties:** There has been a considerable reduction in import during the last five years. The maximum rate was reduced from 150 per cent in 1991–92 to 110 per cent in 1992, to 85 per cent in 1993–94 and 50 per cent in 1995–96. Custom duties on imports of capital goods were reduced to 80 per cent in July 1991, to 55 per cent in 1992 and to 25 per cent in 1995. Tariffs on imports of raw materials and manufactured intermediates have been reduced. Besides this, the government has attempted to rapidly dismantle quantitative restrictions on imports and exports. It has also undertaken adjustment of exchange rate so as to remove over-valuation of currency. This has helped in stepping-up exports.

In February 1997, the Commerce Ministry removed restrictions on 162 items for imports. Of them, 69 items were moved from special Import Licence (SIL) to free imports. Among these items are escalators and moving walkways, cable cars, fire alarms, cameras of all kinds, industrial vacuum cleaners and various kinds of glassware. Besides this, 93 items were moved from industrial to SIL list which include photographic firms rubber stoppers, aluminium beverage cans, car, air-conditioning machines, cosmetic perfumes, picture tubes and a wide range of office machines.

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(ii) **Encouragement of foreign investment:** The government has taken a number of measures to encourage foreign investment. The main measures taken in this regard are:

(a) Approval would be given for direct investment up to 51 per cent foreign equity in high priority industries as per Industrial Policy of 1991. Such clearances will be given if foreign equity covers the foreign exchange requirements for imported capital goods.

In December 1996, the cabinet gave its assent to a new list of industries whereby joint ventures with up to 74 per cent foreign equity would be cleared automatically. The basic purpose of this move is to facilitate direct foreign investment in India.

(b) To provide to international markets, majority foreign equity holding up to 51 per cent equity would be allowed for trading companies primarily engaged in export activities.

(iii) **Encouragement to foreign technology agreement:** The Industrial Policy of 1991 undertook the following measures:

(a) Automatic permission will be given for foreign technology agreements in high priority industries up to a lumpsum payment of ₹ 1 crore, 5 per cent royalty for domestic sales and 8 per cent for exports subject to total payments of 8 per cent sales over a 10-year period from the date of the agreement or 7 years from the commencement of production.

(b) In respect of other industries, automatic permission would be given if no free foreign exchange is required for any payment.

(c) No permission will be necessary for hiring of foreign technicians and foreign testing of indigenously developed technologies.

### 9.3.3 NEP Effect on Globalization

Privatization is the process of involving the private sector in the ownership or operation of a state-owned or public sector undertaking. It can take three forms:

(i) Ownership measures, (ii) Organizational measures and (iii) Operational measures.

(i) **Ownership Measures:** The degree of privatization is judged by the extent of ownership transferred from the public enterprise to the private sector.

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Ownership may be transferred to an individual, cooperative or corporate sector. This can have three forms:

- (a) Total denationalization implies 100 per cent transfer of ownership of a public enterprise to private sector.
  - (b) Joint venture implies partial transfer of a public enterprise to the private sector. It may have several variants—25 per cent transfer to private sector in a joint venture implies that majority ownership and control remains with the public sector. Fifty one per cent transfer of ownership to the private sector shifts the balance in favour of the private sector, though the public sector retains a substantial stake in the undertaking. 74 per cent transfer of ownership to the private sector implies a dominant share being transferred to private sector. In such a situation, the private sector is in a better position to change the character of the enterprise.
  - (c) *Liquidation* implies sale of assets to a person who may use them for the same purpose or some other purpose. This solely depends on the preference of the buyer.
  - (d) *Workers' Cooperative* is a special form of denationalisation. In this form, ownership of the enterprise is transferred to workers who may form a cooperative to run the enterprise. In such a situation, appropriate provision of bank loans is made to enable workers to buy the share of the enterprise. The burden of running the enterprise rests on the workers in a workers' cooperation. The workers become entitled to ownership dividends besides getting wages for their services.
- (ii) **Organizational Measures:** These include a variety of measures to limit state control. They include—
- (a) *A holding company structure* may be designed in which the government limits its control to top level major decisions and leaves a sufficient degree of autonomy for the operating companies in their day-to-day operations. A big company like the Steel Authority of India may acquire a holding company status, thereby transferring a number of functions to its smaller units. In this way, a decentralized pattern of management emerges.
  - (b) *Leasing:* In this arrangement, the government agrees to transfer the use of assets of a public enterprise to a private bidder for a specified period, say five years. While entering into a lease, the bidder is required to give an assurance of the quantum of profits that would be made available to the state. This is a kind of tenure ownership. The government reserves the right to review the lease to the same person or to grant the lease to another bidder depending upon the circumstances of the case.
  - (c) *Restructuring:* It is of two types—Financial Restructuring and Basic Restructuring.



(iii) **Operational Measures:** The efficiency of public sector enterprises depends upon the organizational structure. Unless this structure grants a sufficient degree of autonomy to the operators of the enterprise or develops a system of incentives it cannot raise its efficiency and productivity. These measures include (a) grant of autonomy to public enterprises in decision-making, (b) provision of incentives for workers and executives consistent with increase in efficiency and productivity, (c) freedom to acquire certain inputs from the markets with a view to reducing costs, (d) development of proper criteria for investment planning and (e) permission to public enterprises to raise resources from the capital market to execute plans of diversifications. The basic purpose of operational measures is to infuse the spirit of private enterprise in public enterprises so that government control is effectively reduced and private initiative is promoted.

Privatization in a narrow sense indicates transfer of ownership of a public sector undertaking to private sector, either wholly or partially. But in another sense, it implies the opening up of the private sector areas which were hitherto reserved for the public sector. Such deliberate encouragement of investment to the private sector in the economy, while emphasising to a lesser degree the expansion of the public sector, will increase the overall share of the private sector in the economy. The basic purpose is to limit the areas of the public sector and to extend the areas of private sector operation.

**Aims of Liberalization, Globalization and Privatization:** Liberalization, globalization and privatization are all means to achieve certain ends of the society just as nationalization and regulatory frameworks were intended to achieve certain goals. These are—

1. To achieve a high rate of growth of national and per capita income.
2. To achieve full employment.
3. To achieve self-reliance.
4. To reduce inequality of income and wealth.
5. To reduce the number of people living below the poverty line.
6. To develop a pattern of society based on equality and absence of exploitation.

#### 9.3.4 Positive and Negative Effects of NEP

The factors and forces of business environment have lot of influence over the business. The common influence and impact of such changes in business and industry are explained below:

1. **Increasing Competition:** After the new policy, Indian companies had to face all round competition which means competition from the internal market and the competition from the MNCs. The companies which could adopt latest technology and which were having large number of resources could

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only survive and face the competition. Many companies could not face the competition and had to leave the market.

For example, Weston Company which was a leader in T. V. market with more than 38% share in T.V. market lost its control over the market because of all round competition from MNCs. By 1995-96, the company almost became unknown in the T.V market.

- 2. More Demanding Customers:** Prior to new economic policy there were very few industries or production units. As a result there was shortage of product in every sector. Because of this shortage the market was producer-oriented, i.e., producers became key persons in the market. But after new economic policy many more businessmen joined the production line and various foreign companies also established their production units in India.

As a result there was surplus of products in every sector. This shift from shortage to surplus brought another shift in the market, i.e., producer market to buyer market. The market became customer- oriented and many new schemes were made by companies to attract the customer. Nowadays products are produced/manufactured keeping in mind the demands of the customer.

- 3. Rapidly Changing Technological Environment:** Before or prior to new economic policy there was a small internal competition only. But after the new economic policy the world class competition started and to stand this global competition the companies need to adopt the world class technology.

To adopt and implement the world class technology the investment in R & D department has to increase. Many pharmaceutical companies increased their investment in R and D department from 2% to 12% and companies started spending a large amount for training the employees.

- 4. Necessity for Change:** Prior to 1991 business enterprises could follow stable policies for a long period of time but after 1991 the business enterprises have to modify their policies and operations from time to time.

- 5. Need for Developing Human Resources:** Before 1991 Indian enterprises were managed by inadequately trained personnel's. New market conditions require people with higher competence skill and training. Hence Indian companies felt the need to develop their human skills.

- 6. Market Orientation:** Earlier firms were following selling concept, i.e., produce first and then go to market but now companies follow marketing concept, i.e., planning production on the basis of market research, need and want of customer.

- 7. Loss of Budgetary Support to Public Sector:** Prior to 1991 all the losses of Public sector were used to be made good by government by sanctioning special funds from budgets. But today the public sectors have to survive and grow by utilising their resources efficiently otherwise these enterprises have to face disinvestment. On the whole the policies of Liberalisation,

Globalisation and Privatisation have brought positive impacts on Indian business and industry. They have become more customer focus and have started giving importance to customer satisfaction.

- 8. Export a Matter of Survival:** The Indian businessman was facing global competition and the new trade policy made the external trade very liberal. As a result to earn more foreign exchange many Indian companies joined the export business and got lot of success in that. Many companies increased their turnover more than double by starting export division. For example, the Reliance Company, Videocon, MRF, Ceat Tires, etc. got a great hold in the export market.

Now, let's look at the impact of the NEP on the individual categories of Liberalisation, Privatisation and Globalisation:

### **Liberalisation**

#### ***Advantages***

Increase in foreign investment → Increase in Production → Technological advancement → Increase in GDP growth rate

Disadvantages → Increase in Unemployment → Decrease in Tax Receipt

### **Privatisation**

POSITIVE EFFECTS → Private companies cut cost and be more efficient → Increased competition → More Responsive to customer complaints

NEGATIVE EFFECTS → Public service → Job loses → Privatisation is expensive  
IMPACTS OF PRIVATISATION

### **Globalisation**

Positive Effects Expansion of market → Development of infrastructure → Higher living standards → International cooperation

NEGATIVE EFFECTS → Cut throat competitions → Rise in Monopoly → Take over of Domestic Firms → Increase in Inequalities

#### **Check Your Progress**

3. What was the main aim of liberalization?
4. What does globalization intend to do?

## **9.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS**

1. The first industrial policy statement was issued in the Government's Industrial Policy Resolution of April 1948.

## **NOTES**

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2. The two objectives of the 1956 industrial policy are; to accelerate economic growth and industrial development of the country, and to expand the public sector.
3. The main aim of liberalization was to dismantle the excessive regulatory framework which acted as a shackle on freedom of enterprise.
4. Globalization intends to integrate the Indian economy with the world economy.

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## 9.5 SUMMARY

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- The first industrial policy statement was issued in the Government's Industrial Policy Resolution of April 1948. *The resolution contemplated a mixed economy. There was a sphere reserved for private enterprise and another for public ownership.*
- The Industrial Policy of 1948 envisaged a mixed economy. Mixed economy is the outcome of compromise between two diametrically opposite schools of thought—one which champions the cause of *laissez faire* capitalism and another which supports the cause of socialization of all means of production.
- Jawaharlal Nehru laid the foundations of modern India. The aims and objectives set out for the nation by Nehru on the eve of independence were rapid agricultural and industrial development of the country, rapid expansion of opportunities for gainful employment, progressive reduction of social and economic disparities, removal of poverty and attainment of self-reliance.
- The 1956 policy resolution had as its objective the achievement of a socialist pattern of society.
- Economic Reforms in India were started by Prime Minister Rajiv Gandhi. He said, 'the public sector has entered into too many areas where it should not be. We shall open the economy to the private sector in several areas hitherto restricted to it.'
- The aim of the new economic policy was to save the entrepreneur from unnecessary harassment of seeking permission from the bureaucracy to start an undertaking.
- The major purpose of liberalization was to free large private corporate sector from bureaucratic controls. It therefore, started dismantling the regime of industrial licensing and control.
- Privatization is the process of involving the private sector in the ownership or operation of a state-owned or public-sector undertaking. It can take three forms: (i) Ownership measures, (ii) Organizational measures and (iii) Operational measures.

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## 9.6 KEY WORDS

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- **Denationalisation:** It refers to changing something from state to private ownership or control.
- **Cooperative:** It refers to a farm, business, or other organization which is owned and run jointly by its members, who share the profits or benefits.
- **Budget:** It is an estimate of income and expenditure for a set period of time.

## NOTES

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## 9.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

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### Short-Answer Questions

1. Briefly explain the Industrial Policy of July 1980.
2. What do you understand by the crisis of June 1991?
3. Write a note on initiatives taken under NEP.
4. Discuss the positive and negative effects of NEP.

### Long-Answer Questions

1. Give a detailed description of the Industrial Policy of 1948.
2. Discuss the elements in the industrial policy of Rajiv Gandhi's government.
3. Assess the New Industrial Policy, 1991. Explain its objectives.
4. How did NEP impact liberalization? Elucidate.

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## 9.8 FURTHER READINGS

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# UNIT 10 PRIVATIZATION AND GLOBALIZATION

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## NOTES

### Structure

- 10.0 Introduction
- 10.1 Objectives
- 10.2 Privatization: Meaning and Features
  - 10.2.1 Nature and Objectives of Privatization
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## 10.0 INTRODUCTION

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In this unit, you will study privatization and globalization in detail. Privatization is the process of transferring an enterprise or industry from the public sector to the private sector. By definition, globalization is the process by which businesses or other organizations develop international influence or start operating on an international scale.

This unit discusses the nature and objectives of both privatization and globalization.

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## 10.1 OBJECTIVES

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

- Define privatization and globalization
- Discuss the objectives of disinvestment
- Assess privatization in India
- Interpret problems with privatization and globalization
- Describe future of globalisation

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## 10.2 PRIVATIZATION: MEANING AND FEATURES

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Privatization is the process of involving the private sector in the ownership or operation of a state-owned or public sector undertaking. It can take three forms: (i) Ownership measures, (ii) Organizational measures and (iii) Operational measures.

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(i) **Ownership measures:** The degree of privatization is judged by the extent of ownership transferred from the public enterprise to the private sector. Ownership may be transferred to an individual, cooperative or corporate sector. This can have three forms:

- (a) Total denationalization implies 100 per cent transfer of ownership of a public enterprise to private sector.
- (b) Joint venture implies partial transfer of a public enterprise to the private sector. It may have several variants—25 per cent transfer to private sector in a joint venture implies that majority ownership and control remains with the public sector. Fifty-one per cent transfer of ownership to the private sector shifts the balance in favour of the private sector, though the public sector retains a substantial stake in the undertaking. 74 per cent transfer of ownership to the private sector implies a dominant share being transferred to private sector. In such a situation, the private sector is in a better position to change the character of the enterprise.
- (c) Liquidation implies sale of assets to a person who may use them for the same purpose or some other purpose. This solely depends on the preference of the buyer.
- (d) Workers' cooperative is a special form of denationalization. In this form, ownership of the enterprise is transferred to workers who may form a cooperative to run the enterprise. In such a situation, appropriate provision of bank loans is made to enable workers to buy the share of the enterprise. The burden of running the enterprise rests on the workers in a workers' cooperation. The workers become entitled to ownership dividends, besides getting wages for their services.

(ii) **Organizational measures:** These include a variety of measures to limit state control:

- (a) A holding company structure may be designed in which the Government limits its control to top level major decisions and leaves a sufficient degree of autonomy for the operating companies in their day-to-day operations. A big company like the Steel Authority of India may acquire a holding company status, thereby transferring a number of functions to its smaller units. In this way, a decentralized pattern of management emerges.

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(b) **Leasing:** In this arrangement, the Government agrees to transfer the use of assets of a public enterprise to a private bidder for a specified period, say five years. While entering into a lease, the bidder is required to give an assurance of the quantum of profits that would be made available to the State. This is a kind of tenure ownership. The Government reserves the right to review the lease to the same person or to grant the lease to another bidder depending upon the circumstances of the case.

(c) **Restructuring:** It is of two types—financial restructuring and basic restructuring.

(i) Financial restructuring implies the writing-off of accumulated losses and rationalization of capital composition in respect of debt equity ratio. The main purpose of this restructuring is to improve the financial health of the enterprise.

(ii) Basic restructuring is said to occur when the public enterprise decides to shed some of its activities to be taken up by ancillaries or small-scale units.

(iii) **Operational measures:** The efficiency of public sector enterprises depends upon the organizational structure. Unless this structure grants a sufficient degree of autonomy to the operators of the enterprise or develops a system of incentives, it cannot raise its efficiency and productivity. These measures include (a) grant of autonomy to public enterprises in decision making, (b) provision of incentives for workers and executives consistent with increase in efficiency and productivity, (c) freedom to acquire certain inputs from the markets with a view to reducing costs, (d) development of proper criteria for investment planning and (e) permission to public enterprises to raise resources from the capital market to execute plans of diversifications. The basic purpose of operational measures is to infuse the spirit of private enterprise in public enterprises, so that Government control is effectively reduced and private initiative is promoted.

Privatization in a narrow sense indicates transfer of ownership of a public sector undertaking to private sector, either wholly or partially. But in another sense, it implies the opening up of the private sector areas which were hitherto reserved for the public sector. Such deliberate encouragement of investment to the private sector in the economy, while emphasising to a lesser degree, the expansion of the public sector, will increase the overall share of the private sector in the economy. The basic purpose is to limit the areas of the public sector and to extend the areas of private sector operation.

### 10.2.1 Nature and Objectives of Privatization

Privatization is only a modern name assigned to the concept of laissez faire advocated by Adam Smith and other classical economists. But in the environment



of mixed economy, it has a new significance. The world economists have adopted it as a tool of new economic prosperity. It is expected that the new liberal era of industrialization will open a new chapter in the field of productivity, efficiency, cost consciousness, competitiveness and management. The participation of the private sector in the development process is not an option, it is an essential requirement of development.

Earlier, private enterprises which had financial difficulties were taken over by the government in most of the countries. Now, the policy has completely changed. Public enterprises which had financial difficulties are transferred to a private agency.

Government policy in India as in other countries is undergoing a sea change both on account of shifts on ideological account as well as basic economic considerations. Moreover, international lending agencies have increasingly brought in the privatization of public enterprises as a condition for their project lending in several countries. It is evident from the World Bank report which has supported the privatization of the public sector steel industry and World Bank experts have suggested that privatization is essential to attain productivity and efficiency.

After four decades of experiments with nationalization in many countries of the world, a new worldwide experiment has started during the 1980s in the form of privatization. Many countries are moving away from nationalization out of sheer economic compulsions, viz., the widespread failure of the public sector enterprises, higher pressure on government budgets, particularly due to the subsidizing of the public sector white elephants and various other macro-economic problems. The public sector has lost its dynamism and according to some, it is now more a drag on development than an engine of growth.

It can be said that if a failing private enterprise should go out of business or close down the organization, the same principle should be followed in case of public sector. But this is not always the case as the sick PSUs are allowed to operate with budgetary support.

Contradictory as it may seem, privatization is perfectly compatible with Marx's postulate of withering of the State. It really envisages the shifting of ownership of the means of production from the elite to the masses.

### **Objectives of privatization**

The objectives of privatization are:

- Improvement of the economic-performance of assets.
- Depoliticization of economic decisions.
- Reduction in public outlays, taxes and borrowing requirements.
- Promotion of popular capitalism through wider ownership of assets.
- Promotion of equity.

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### 10.2.2 Objectives of Disinvestment and the Indian Scenario

One basic rationale for privatization is the notion that private ownership leads to better use of resources and their more efficient allocation. Throughout the world, the preference for market economy received a boost after it was realized that the State could no longer meet the growing demands of the economy and the State shareholding inevitably had to come down. The 'State in business' argument thus lost out and so did the presumption that direct and comprehensive control over the economic life of citizen from the Central Government can deliver results better than those of a more liberal system that directly responds according to the market driven forces. Another reason for adoption for privatization policy around the globe has been the inability of the Governments to raise high taxes, pursue deficit/inflationary financing and the development of money markets and private entrepreneurship. Further, technology and WTO commitments have made the world a global village and unless industries, including PSEs do not quickly restructure, they would not be able to survive. Public enterprises, because of the nature of their ownership, can restructure slowly and hence the logic of privatization gets stronger. Besides, techniques are now available to control public monopolies by regulation/competition, and investment of public money to ensure protection of consumer interests is no longer a convincing argument.

**Objectives:** Following objectives were stated in July 1991 while propounding the disinvestment policy:

1. To meet the budgetary needs.
2. To improve overall economic efficiency.
3. To reduce fiscal deficit.
4. To diversify the ownership of PSU for enhancing efficiency of individual enterprise.
5. To raise funds for technological upgradation, modernization and expansion of PSUs.
6. To raise funds for golden handshake (VRS).

The new industrial policy statement 1991 based on economic reform measures envisaged disinvestment of a part of government holding in the case of select public sector enterprises to provide financial support and improve the performance of public sector enterprises. This became necessary because of the withdrawal of the budgetary support of 60 percent by the government to the loss making units. The Common Minimum Programme of the United Front Government has also emphasized that it would be a democratic disinvestment.

### 10.2.3 Problems with Privatization

Opponents of privatization dispute the claims concerning the alleged lack of incentive for governments to ensure that their public services are well run, on the basis of

the idea that governments are proxy owners answerable to the people. It is argued that a government which runs nationalized enterprises poorly will lose public support and votes, while a government which runs those enterprises well will gain public support and votes. Thus, democratic governments do have an incentive to maximize efficiency in nationalized companies, due to the pressure of future elections.

Opponents of certain privatizations believe that certain public goods and services should remain primarily in the hands of government in order to ensure that everyone in society has access to them (such as law enforcement, basic health care, and basic education). Likewise, private goods and services should remain in the hands of the private sector. There is a positive externality when the government provides public goods and services to society at large, such as defense and disease control. As for natural monopolies they are by their nature not subject to fair competition and better administrated by the state.

The controlling ethical issue in the anti-privatization perspective is the need for responsible stewardship of social-support missions. Market interactions are all guided by self-interest, and successful actors in a healthy market must be committed to charging the maximum price that the market will bear. Privatization opponents believe that this model is not compatible with government missions for social support, whose primary aim is delivering affordability and quality of service to society.

Many privatization opponents also warn against the practice's inherent tendency toward corruption. As many areas which the government could provide are essentially profitless, the only way private companies could, to any degree, operate them would be through contracts or block payments. In these cases, the private firm's performance in a particular project would be removed from their performance, and embezzlement and dangerous cost-cutting measures might be taken to maximize profits.

Furthermore, large corporations may pay public-relations professionals to convince decision-makers that privatization is a sensible idea. Corporations typically have far more resources for expert testimony, advertisements, conferences and other propaganda efforts than anti-privatization advocates.

Some would also point out that privatizing certain functions of government might hamper coordination, and charge firms with specialized and limited capabilities to perform functions which they are not suited for. In rebuilding a war torn nation's infrastructure, for example, a private firm would, in order to provide security, either have to hire security, which would be both necessarily limited and complicate their functions, or coordinate with government, which, due to a lack of command structure shared between firm and government, might be difficult. A government agency, on the other hand, would have the entire military of a nation to draw upon for security, whose chain of command is clearly defined. Opponents would say that this is a false assertion: numerous books refer to poor organization between government departments.

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Although private companies will provide a similar good or service alongside the government, opponents of privatization are careful about completely transferring the provision of public goods, services and assets into private hands for the following reasons:

- **Performance:** A democratically elected government is accountable to the people through a legislature, Congress or Parliament, and is motivated to safeguarding the assets of the nation. The profit motive may be subordinated to social objectives.
- **Increased market efficiency for public goods and services:** A public organization tends to produce more of a public good or service according to the Samuelson condition and Marginal Social Benefit curve. This results in a better positive externality for society. On the other hand, a private firm does not provide sufficient public goods and services, because it provides them on the marginal private benefit curve or private demand curve. A private firm provides less in order to make more profit. Therefore the public goods and services are provided more efficiently for society as a whole by a public organization. (Any market is more efficient for society when marginal social benefits equals marginal social costs,  $MSB=MSC$ .)
- **Improvements:** the government is motivated to performance improvements as well run businesses contribute to the State's revenues.
- **Corruption:** Government ministers and civil servants are bound to uphold the highest ethical standards, and standards of probity are guaranteed through codes of conduct and declarations of interest. However, the selling process could lack transparency, allowing the purchaser and civil servants controlling the sale to gain personally.
- **Accountability:** The public does not have any control or oversight of private companies.
- **Civil-liberty concerns:** A democratically elected government is accountable to the people through a parliament, and can intervene when civil liberties are threatened.
- **Goals:** The government may seek to use state companies as instruments to further social goals for the benefit of the nation as a whole.
- **Capital:** Governments can raise money in the financial markets most cheaply to re-lend to state-owned enterprises.
- **Strategic and sensitive areas:** Governments have chosen to keep certain companies/industries under public control because of their strategic importance or sensitive nature.
- **Cuts in essential services:** If a government-owned company providing an essential service (such as the water supply) to all citizens is privatized, its new owner(s) could lead to the abandoning of the social obligation to those who are less able to pay, or to regions where this service is unprofitable.

- **Natural monopolies:** Privatization will not result in true competition if a natural monopoly exists.
- **Concentration of wealth:** Profits from successful enterprises end up in private, often foreign, hands instead of being available for the common good.
- **Political influence:** Governments may more easily exert pressure on state-owned firms to help implementing government policy.
- **Downsizing:** Private companies often face a conflict between profitability and service levels, and could over-react to short-term events. A state-owned company might have a longer-term view, and thus be less likely to cut back on maintenance or staff costs, training, etc., to stem short-term losses. Many private companies have downsized while making record profits.
- **Profit:** Private companies do not have any goal other than to maximize profits. A private company will serve the needs of those who are most willing (and able) to pay, as opposed to the needs of the majority, and are thus anti-democratic. The more necessary a good is, the lower the price elasticity of demand, as people will attempt to buy it no matter the price. In the case of price elasticity of demand is zero (perfectly inelastic good), demand part of supply and demand theories does not work.
- **Privatization and poverty:** It is acknowledged by many studies that there are winners and losers with privatization. The number of losers—which may add up to the size and severity of poverty—can be unexpectedly large if the method and process of privatization and how it is implemented are seriously flawed (e.g. lack of transparency leading to state-owned assets being appropriated at minuscule amounts by those with political connections, absence of regulatory institutions leading to transfer of monopoly rents from public to private sector, improper design and inadequate control of the privatization process leading to asset stripping).
- **Job loss:** Due to the additional financial burden placed on privatized companies to succeed without any government help, unlike the public companies, jobs could be lost to keep more money in the company.

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### Check Your Progress

1. Name the three forms of privatization.
2. What are the objectives of privatization?

## 10.3 GLOBALIZATION: MEANING AND FEATURES

The emergence of the global economy was the result of private initiative rather than carefully orchestrated national manoeuvres; yet today, it determines the course of national economic policies. The features of the globalized economy are:

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1. Activity takes place on an increasingly supranational scale.
2. Manufacturing is no longer confined to stand-alone factories within state boundaries, but involves sourcing materials/components/sub-assemblies across geographies wherever cost/quality parameters are met.
3. Labour and processes are outsourced from wherever they are most economically available at desired quality levels.
4. Financial operations are conducted around the world as matters of routine.
5. These events indicate the start of a new period of economic theory—a new globalism distinct from the relatively recent post-war period which was dominated by internationalism.
6. After World War II, nations took the lead in initiating economic activity, acting in concert through the creation of an international economic system for trade and payments.
7. There have been successive rounds of multilateral tariff reduction.
8. A new era of globalization now sees corporates taking the lead, establishing their hold in world markets for goods and services.
9. Their activities are widening and deepening the economic interdependence of nations to the extent of creating a borderless economy.
10. This is quite unlike the earlier phase, which was characterized by exchange of goods, services, capital and technology and where FDI was insignificant.
11. Technological change and deregulation has seen transnationals integrate their activities across a borderless world, to reduce costs, while consolidating home markets and taking on global ones.
12. Economic interdependence is increasingly production based, and not trade based.
13. Trade and technology transactions are taking place increasingly between transnationals, not the market.

Thus, globalization refers to:

1. The multiplicity of linkages and interconnections between states and societies which comprise the present world system.
2. It describes the process by which events, decisions, and activities in one part of the world come to have significant consequences for individuals and societies in quite distant parts of the globe.
3. Globalization has two quite distinct phenomena:
  - (i) Scope (or stretching), i.e., widening of the extent and form of cross-border transactions.
  - (ii) Intensity, i.e., deepening of the economic interdependence between the actions of globalizing entities located in one country and those located in other countries.

4. The two most important causes of globalization are:

- (i) The pressure on business enterprises by consumers and competitors alike, to continually innovate and come up with new products while improving existing ones. Escalating R&D costs coupled with shrinking product lifecycles are compelling corporations both to downsize the scope of their value-added activities and to venture further afield in search of wider markets.
- (ii) The renaissance of market-oriented policies pursued by national governments and regional authorities. In the last five years alone, while more than thirty countries have abandoned centralized planning as the main mode of allocating scarce resources, and over eighty countries have liberalized their inward FDI policies, including China and India.

Moreover, the undernoted factors have worked to stimulate cross-border corporate integration, both within TNCs and between independent firms:

1. The privatization of state-owned enterprises
2. Liberalization and deregulation of markets
3. Removal of a levy of structural distortions

### **Globalization of the Indian Economy**

Globalization of the Indian economy implies that:

1. Commodity as well as factor market is functioning under the influence of market forces generated in the world economy.
2. There is a gain in efficiency to compete in world markets.
3. Exports increase; there is an influx of foreign exchange and private foreign capital.
4. Higher growth path with stability.
5. Better balance of payments position relieves tension of default on IBRD loan instalments.
6. Enables movement towards ultimate full convertibility on capital and current accounts.
7. There is a need to become globally competitive by creating stable micro and macroeconomies without any vested interests.

The argument in favour of integrating the Indian economy with the global economy has long been put forward by the IMF and the World Bank as the answer to the failure of hitherto followed economic policies. The slowdown of the world economy after 9/11 and the meltdown of the south-Asian economies showed that the global economy is unlikely to work very well unless there is globalization of both production and consumption. Yet, complete globalization would also mean vulnerability to shocks that are transmitted throughout the global economic system; India was insulated from the fallout of the Baring's Bank collapse and subsequent

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meltdown of the south-Asian economies, because it was not an active member of any trading blocs in the region.

Globalization is viewed as a two-way action plan, envisaging:

1. Free competition
2. High productivity
3. Selling to one market—a global one where all are in open competition
4. This facilitates integration with the global mainstream
5. Sourcing cheapest suppliers, in open global competition
6. Boosting industrial development and employment
7. Better quality, export earnings and economic stability

Independent India inherited an inward-oriented policy and in the early years of planning, an import substitution regime with anti-export bias was considered to be quite appropriate. India's trade regime remained basically inward-looking until export incentives were introduced in the mid-1960s. In the 1970s, many more export incentives were introduced but this did not help export promotion much. The 80s witnessed attempts towards export promotion and trade liberalization under the Sixth and Seventh Plans. Despite the efforts towards liberalization, India's trade regime remained more or less inward-looking.

Owing to greater reliance on the working of the closed economy, Indian economy has generated a high cost inefficient industry which has prohibited the optimum utilization of factors of production. Despite all potentialities, Indian industries are not competing with the global industries with respect to cost and quality. Protection has always given an avenue to develop a high cost industry. Under the shadow of FERA and MRTP Acts, monopoly houses have developed. It is the closeness of the Indian economy that prohibits introduction of the advanced technology of the developed nations. So the globalization of the economy is essentially needed.

It will provide an opportunity for India to become an important production centre of the world. It will also provide an opportunity to the Indian companies to become multinational concerns. At the same time, it can attract foreign investors so as to make India a centre of the world market. India can utilize these avenues very well on account of its competitive edge over other countries due to its large skilled labour.

The strategy adopted since July 1991 for further integration of the Indian economy with the world economy includes exchange rate adjustment to improve competitiveness of exports, reduction in tariffs and a more open policy towards direct foreign investment and technology.

The new economic policy aims at making the Indian economy competitive and much better integrated with the world economy. We are now clearly in a new and different world. India cannot expect large inflow of external funds while there



is an irrational exchange rate policy. India has no alternative but to integrate its economy into the global mainstream to boost its economic growth. As most of the countries in the world are steadily reorienting their economies to the market-friendly forces, it will be suicidal on the part of India to remain in isolation. Competition from abroad would lead to improvement in quality, productivity, efficiency and cost-effectiveness.

For integrating the Indian economy with the world economy not only faster export growth but, also free access to imports is necessary and accordingly import duties have been brought down substantially. High tariffs have created a high cost industrial structure and Indian competitiveness has been affected by this. When many other countries had substantially reduced the tariffs, India's tariff structure also needed to be lowered.

Since globalization requires the creation of suitable environment for free flow of direct foreign investment, the new industrial policy of 1991 permits approval for foreign direct investment up to 51 per cent foreign equity in the case of high priority industries and this obviously opens the door for multinationals in a big way. The foreign investment will bring in new technology and marketing expertise from which the country will benefit. The market-friendly approach of the new economic policy is expected to create a suitable environment for the entry of foreign capital on a large scale.

An open policy towards technology transfer is also an important requirement for globalization of the Indian economy. One obstacle to the much-needed inflow of technology has been the cumbersome approval process involving delays and uncertainties. To overcome this problem, the new industrial policy recommends that automatic approval be given by the government for technology agreements related to high priority industries and similar facility be provided to non-priority industries also if expenditure in foreign exchange is not involved.

The new economic policy which advocates a market-friendly approach and removal of bureaucratic controls is expected to attract foreign capital and technology and also facilitate easy movement of goods through substantial reduction in tariffs and thus pave the way for further integrating the Indian economy with the global economy.

External environment is going to be more dynamic and complex. There will be less social protection for inefficiency. There will be noticeable fights in the marketplace for innovation and competitiveness. Unless we increase our productivity and efficiency, we will not be able to go beyond 'the Hindu rate of growth'.

India's globalization efforts are hindered by the lack of a favourable international environment. At a time when advanced countries, particularly the

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US, are adopting a protectionist policy with Super 301 threat, it is very difficult to accomplish the objective of globalization of the Indian economy.

Also, openness of the economy to the world competition is an invitation to multinationals. The role of multinationals is not salubrious for poor countries.

Moreover, globalization would imply certain consequences which may not be always beneficial to the developing countries. One major implication of globalization is the internationalization of prices. Globalization would also imply the equalization of domestic prices with international prices. This would mean that the firms in the developing economies should enhance their competitive strength. If some of the commodities have relatively lower prices due to subsidization, the policy prescription would be that subsidies should be withdrawn so that the prices would attain parity with prices prevailing in the international markets. In recent times, the fertiliser prices in India had been raised and the subsidies were withdrawn. The aftermath of the withdrawal of subsidies would be a hefty increase in the prices of agricultural commodities. This would mean that Indian prices must rise to US levels. So as a result of globalization, inflationary tendencies would persist as prices are expected to rise by 15 to 20 per cent.

### 10.3.1 Future of Globalization

The future actor of globalization may be understood under the following heads:

- **Technological disruption:** While new digital “technologies” (robotics, digital services, global platforms) are emerging which are beginning to impact productivity, they will not be able to create the same virtuous cycle of rapid economic growth through trade of goods to create a new global growth pole. Unlike in the past, digital technologies are not “dominated” by one or few countries. This marks a major deviation from previous cycles, where countries such as the US and China leveraged their competitive advantages in mass manufacturing and low-cost production, respectively, to emerge as the world’s economic “pole”. Further, the adoption of digital technologies across various industries will result in more localized manufacturing and globalized services, giving rise to very different trade patterns. Additionally, rapid, large-scale replacement of old manufacturing technologies by newer, digital ones is unlikely, given the growing unavailability of enough skilled workers like robot programmers. Rising income inequality and the need to protect jobs could also bring in stringent regulations, slowing the adoption of disruptive technologies.
- **New governance structures:** The stable “rules of the game” set by the Bretton Woods institutions and the Group of Seven nations are now changing, with the Group of 20 states playing an increasingly influential role. This is likely to create new winners and losers. In the previous phases of globalization, there was a fair degree of long-term alignment between

economics and politics. Today, the WTO-governed free trade regime is making way for more bilateral and regional partnerships and possibly mega-regional and sub-regional trade agreements like the Trans-Pacific Partnership (TPP) and Regional Comprehensive Economic Partnership, although the latter has been stalled. There is growing protectionism across both developed and emerging markets. The multilateral financial architecture is getting decentralized, with China and other prominent developing countries teaming up to establish new institutions such as the Asian Infrastructure Investment Bank (AIIB) and New Development Bank (NDB). There is also growing influence of state capitalism on capital allocation worldwide, through multiple levers such as direct acquisition of private companies, investments via sovereign wealth funds, and loans and subsidies for the development of certain domestic industries.

- **The Fourth Wave of Globalization:** These shifts in geopolitics, and the trade and financial architectures point to a growing divergence between economics and politics. This has the potential to create greater uncertainty and volatility, as well as a country-region centricity in decision-making, hindering global integration. The market is losing ground to the state and labour advantage is giving way to digital advantage. These trends are driving the emergence of a new model of globalization.

It is unlikely that export-led trade growth, a core feature of the old model, will continue to be the primary driver of GDP growth going forward. The new model will be different on all three key dimensions

- (i) Growth:** The new model will see a shift away from the “pole” model of economic growth, and vocabulary of developed economies versus EMs, to that of a multipolar world. Countries will have varied growth trajectories, with many EMs becoming less reliant on exports and focusing more on boosting domestic demand. Meanwhile, developed economies and China are likely to grow through greater increases in productivity and de-bottlenecking of the economy through internal structural reforms.
- (ii) Technology:** In the previous phase, global value chains were designed to be cost-optimized and relied on a dominant “technology” of low-cost manufacturing driven by labour cost advantage in emerging economies. In the next phase, these will give way to complex multi-technology value chains that blend digital technology with the earlier low-cost technologies. We will also see greater integration across products and services. Moreover, global platforms (for example, marketplaces like Amazon and Alibaba) are likely to assume increasing importance, as companies rely on these platforms for exchange of goods and services, rather than investing in their own asset-heavy supply chains.

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- (iii) **Governance:** The “rules of the game” will become more complex with the emergence of a multi-institutional governance architecture, wherein regional and local regulations will coexist alongside global rules, balancing national political interests with global multilateral economic agendas.

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## 10.4 ORGANIZATIONS TO FACILITATE GLOBALIZATION

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### 10.4.1 International Bank for Reconstruction and Development (World Bank)

The World Bank was set up at the same time as the IMF in July 1944. The World Bank is concerned with assisting its member countries to achieve sustained economic growth. It functions as an intermediary for the transfer of financial resources from the more developed to the less-developed countries.

**Objectives:** The World Bank was created with the following objectives:

1. To help in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including:
  - (a) the restoration of economies destroyed or disrupted by war,
  - (b) the reconversion of productive resources to peace-time needs, and
  - (c) the encouragement of the development of productive facilities to peace-time needs, and
  - (d) encouragement of development of productive facilities and resources in less-developed countries.
2. To promote private foreign investment by means of:
  - (a) guarantees or participations in loans and other investments made by private investors and
  - (b) to supplement private investment when private capital is not available on reasonable terms.
3. To promote the long range balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging long term international investment thereby assisting in raising productivity, the standard of living and conditions of labour in their territories.
4. To encourage loans made or guaranteed so that the more useful and urgent projects will be dealt with first, and
5. To conduct its operation so as to bring about a smooth transference from a war-time to peace-time economy.

The World Bank's capital is too small to provide for the development need of the entire world. It has therefore set up a number of subsidiary organizations for further finance.

Thus, the Bank was intended to serve as an essential adjunct to the IMF and in particular to ensure a high and stable level of international investment with a view to promoting the maintenance of a high level of international trade and thus of production and employment.

**Functions:** The functions of the World Bank are as follows:

1. *It grants long-term and medium-term loans:* One of the early objectives of the World Bank was to aid reconstruction of war-torn nations, the job is not a matter of history. After an initial period of two years in which the Bank concentrated its loans on Europe's reconstruction needs, the Bank turned its attention to developing countries. Loans are of two types-*Reconstruction Loans* and *Development Loans*.
2. The Bank gives loans to member governments or to private enterprises. In the latter case, the Bank demands a guarantee from the Government, the Central Bank and similar organizations of the region in which the project is to be undertaken. Loans are granted on a basis of sound financial and economic analysis; the project must produce an acceptable rate of return.
3. The Bank gives technical advice to the borrowers and for this purpose engages experts.
4. *Economic and Social Research:* In the field of economic and social research, the World Bank conducts research projects and undertakes smaller research studies. The World Bank Staff working papers are of great interest among professional economists. The bank undertakes annually a comprehensive analysis of economic and social situation in the developing countries with a view to assessing the situation and making the decisions relating to development. The World Development Report (Annual) deals with fundamental problems currently facing the developing countries.
5. The Bank promotes foreign investments by guaranteeing loans made by other organizations. The Bank's duty is to supplement and not to supersede the flow of private risk capital.
6. The World Bank's capital is too small to provide for the development needs of the entire world. It has therefore set up a number of subsidiary organizations for further finance.

#### 10.4.2 The International Monetary Fund (IMF)

The creation of the International Monetary Fund, briefly called IMF, in the post-Second World War period constitutes an important landmark in the history of international monetary cooperation.

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All members of the United Nations Organization excepting the former USSR are members of the IMF.

**Objectives:** The objectives of the IMF are as follows:

1. To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
2. To facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of productive resources of all members as primary objectives of economic policy.
3. To promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.
4. To assist in the establishment of a multilateral system of payments in respect of current transaction between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
5. To give confidence to members by making the Fund's resources available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive to national or international prosperity.
6. In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.

The fundamental objective of the IMF is to facilitate the expansion and balanced growth of international trade by promoting exchange stability and establishing a multilateral system of payments. It is also required to make provision of means to correct short-term maladjustments in member's balance of payments.

In essence, the main purpose of establishing the Fund was to achieve external advantages of gold standard without subjecting nations to its internal disadvantages and at the same time maintain the internal advantages of paper standard while by-passing the external disadvantages of paper standard.

**Functions:** The fund performs five major functions.

- (i) ***It serves as a short-term credit institution:*** If any country faces a temporary balance of payments difficulty, the Fund will come to its aid. It does not however, undertake to supply all the foreign exchange that a country may need. All countries are supposed to have their separate monetary and foreign exchange reserves to meet their normal requirements. The Fund is not intended to supplant them but to provide only a second line of defence in case of emergency. The borrowing country has to pay interest and maintain its quota intact.
- (ii) ***The Fund provides a mechanism for improving short-term balance of payments position:*** To achieve this purpose, its rules provide for orderly adjustment of exchange. No member country can indulge in competitive

exchange depreciation thus introducing the law of the indulgence in international monetary relations. Whenever a country feels that its rate of exchange is out of line with its economy, the rate can be altered but only after due deliberation between the country and the authorities of the fund. Thus there is provision for the careful determination of the initial rate and its orderly adjustment subsequently.

- (iii) ***The Fund provides machinery for international consultations:*** It brings together representatives of the principal countries of the world and affords an excellent opportunity for reconciling their conflicting claims. This constructive approach and measure of international cooperation have had not only a stabilising influence on world economy but they have also led to the expansion and balanced development of world trade and world production. The Fund has thus contributed to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of the member countries.
- (iv) It provides a reservoir of the currencies of the member countries and enables members to borrow one another's currency.
- (v) It promotes orderly adjustment of exchange rates to promote exchange stability.

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### 10.4.3 The UN Conference on Trade and Development

Established in 1964, UNCTAD promotes the development of friendly integration of developing countries into the world economy. UNCTAD has progressively evolved into an authoritative knowledge-based institution whose work aims to help shape current policy debates and thinking in development, with a particular focus on ensuring that domestic policies and international action are mutually supportive in bringing about sustainable development.

The organization works to fulfil this mandate by carrying out three key functions:

- It functions as a forum for intergovernmental deliberations, supported by discussions with experts and exchanges of experience, aimed at consensus building.
- It undertakes research, policy analysis and data collection for the debates of government representatives and exerts.
- It provides technical assistance tailored to the specific requirements of developing countries, with special attention to the needs of the least developed countries and of economies in transition. When appropriate, UNCTAD cooperates with other organizations and donor countries in the delivery of technical assistance.
- The Secretary-General of UNCTAD is Dr. Supachai Panitchpakdi (Thailand) who took office on 1st September, 2005.

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In performing its functions, the secretariat works together with member governments and interacts with organizations of the United Nations system and regional commissions, as well as with governmental institutions, non-governmental organizations, the private sector, including trade and industry associations, research institutes and universities worldwide.

### Check Your Progress

3. State one feature of the globalized economy.
4. What does the UN Conference on Trade and Development UNCTAD promote?

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## 10.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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1. Privatization can take three forms namely Ownership measures, Organizational measures and Operational measures.
2. The objectives of privatization are:
  - Improvement of the economic-performance of assets.
  - Depoliticization of economic decisions.
  - Reduction in public outlays, taxes and borrowing requirements.
  - Promotion of popular capitalism through wider ownership of assets.
  - Promotion of equity.
3. One feature of the globalized economy is that activity takes place on an increasingly supranational scale
4. The UNCTAD promotes the development of friendly integration of developing countries into the world economy.

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## 10.6 SUMMARY

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- Privatization is the process of involving the private sector in the ownership or operation of a state-owned or public-sector undertaking.
- The degree of privatization is judged by the extent of ownership transferred from the public enterprise to the private sector.
- Privatization in a narrow sense indicates transfer of ownership of a public sector undertaking to private sector, either wholly or partially. But in another sense, it implies the opening up of the private sector areas which were hitherto reserved for the public sector.



- Signals of the privatization process in India began with certain loosening of controls in the area of industrial licensing, liberalization of import control policy, reduction in income and corporate tax rates and the long-term fiscal policy since 1985.
- In keeping with the socialistic pattern of functioning, private enterprise had long laboured under the stigma of profiteering at public expense.
- One basic rationale for privatization is the notion that private ownership leads to better use of resources and their more efficient allocation.
- The new industrial policy statement 1991 based on economic reform measures envisaged disinvestment of a part of government holding in the case of select public sector enterprises to provide financial support and improve the performance of public sector enterprises.
- The strategy adopted since July 1991 for further integration of the Indian economy with the world economy includes exchange rate adjustment to improve competitiveness of exports, reduction in tariffs and a more open policy towards direct foreign investment and technology.
- The new economic policy which advocates a market-friendly approach and removal of bureaucratic controls is expected to attract foreign capital and technology and also facilitate easy movement of goods through substantial reduction in tariffs and thus pave the way for further integrating the Indian economy with the global economy.
- Globalization would imply certain consequences which may not be always beneficial to the developing countries. One major implication of globalization is the internationalization of prices.
- The World Bank is concerned with assisting its member countries to achieve sustained economic growth. It functions as an intermediary for the transfer of financial resources from the more developed to the less-developed countries.
- The fundamental objective of the IMF is to facilitate the expansion and balanced growth of international trade by promoting exchange stability and establishing a multilateral system of payments.
- Established in 1964, UNCTAD promotes the development of friendly integration of developing countries into the world economy. UNCTAD has progressively evolved into an authoritative knowledge-based institution whose work aims to help shape current policy debates and thinking in development, with a particular focus on ensuring that domestic policies and international action are mutually supportive in bringing about sustainable development.

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### 10.7 KEY WORDS

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- **Tariff:** It refers to a tax or duty to be paid on a particular class of imports or exports.
- **Acquisition:** It is the process of acquiring a company to build on strengths or weaknesses of the acquiring company.
- **Monopoly:** It is the exclusive possession or control of the supply of or trade in a commodity or service.

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### 10.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

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#### Short-Answer Questions

1. What is privatization? State its features.
2. Write a short note on nature and objective of privatization.
3. What are the objectives of disinvestment and how does it relate to the Indian scenario?
4. Briefly explain the fourth wave of globalization.

#### Long-Answer Questions

1. Discuss in detail the arguments in favour and against privatization.
2. What do you understand by globalization? How has it affected the Indian economy?
3. Explain the Industrial Policy 1991.
4. Discuss the organizations that aim to facilitate globalization.

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### 10.9 FURTHER READINGS

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**BLOCK IV**  
**ENVIRONMENT OF INSTITUTIONS**

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*India, WTO and  
Trading Blocs*

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**UNIT 11 INDIA, WTO AND TRADING  
BLOCS**

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**NOTES**

**Structure**

- 11.0 Introduction
- 11.1 Objectives
- 11.2 Levels of Economic Integration/Trading Blocs
- 11.3 Effects of Economic Integration
  - 11.3.1 Major Regional Trading Blocs
  - 11.3.2 Commodity Agreement
- 11.4 WTO
  - 11.4.1 WTO and India
- 11.5 Answers to Check Your Progress Questions
- 11.6 Summary
- 11.7 Key Words
- 11.8 Self Assessment Questions and Exercises
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**11.0 INTRODUCTION**

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This unit focusses on the World Trade Organization and its relationship with India. As previously discussed how major organizations impact an economy, this unit to highlights such issues while focusing majorly on the Indian economy and the various advantages and disadvantages these relationships have.

The unit also explains major regional trading blocks.

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**11.1 OBJECTIVES**

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

- Discuss the levels of economic integration and trading blocs
- Assess the effects of economic integration
- Describe the major regional trading blocks as well as commodity agreements
- Explain the relationship between the WTO and India

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## 11.2 LEVELS OF ECONOMIC INTEGRATION/ TRADING BLOCS

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In the theory of international trade, free and multilateral trade is the most favoured situation which would maximize world welfare under certain assumptions. But in actual practice, these assumptions do not hold well due to imperfections in international markets. Control on international trade and payments would result in less than optimal conditions. In such a world, a measure of promoting greater welfare through increased trade is regional economic cooperation in the form of trade and payment union or customs union.

This would mean that two or more countries agree to co-operate in such a way as to increase economic and commercial transactions among themselves and promote freer trade and payments. While in bilateral trade agreements, only two countries agree to channelize and promote their trade in a particular direction, in regional economic union or in a common market, a set of countries with a geographic contiguity or common interests would agree to promote trade and payments among themselves by reducing or eliminating tariffs and other barriers among themselves.

A trading bloc is a large free trade area formed by one or more tax, tariff and trade agreements. Typically, a trade pact that defines such a bloc specify formal adjudication bodies, e.g., the North American Free Trade Agreement (NAFTA) trade panels. This may include a more democratic and participative system, such as the European Union (EU) and its parliament. Since the demise of most of the world's empires, a number of international—generally regionally based—economic blocs have been developed to promote trade between member states. Several blocs have stated or implicit political goals—notably the EU. Varieties of economic blocs include free trade areas, customs unions, single markets and economic and monetary unions. One of the first economic blocs was the German Customs Union (Zollverein) formed in 1834 on the basis of the German Confederation, subsequently the German Empire from 1871.

The post-World War II period saw a growing interest in integrating national economies at regional levels, though the efforts have often floundered due to political differences and unforeseen economic hurdles. The motivation for regional economic integration arises out of the realization of the limitations imposed by national frontiers and the expected benefits of a wider market, considering several national economies in terms of increased trade, investment and economic efficiency.

### Forms of Economic Groupings

The forms of economic groupings are diverse, involving different levels of economic integration. Economic literature generally envisages four types of economic groupings: Free Trade Area, Customs Union, Common Market and Economic Union.

- (a) **Free Trade Area:** A Free Trade Area (FTA) consists of a number of countries among whom there is free trade in the sense that customs duties are not leviable at the frontier of trade but, in practice, it is limited to specified products with specified exceptions. Exceptions arise out of typical national needs to protect specific sectors of the economy from international competition. Though tariff barriers on intra trade are removed, each country maintains its separate customs barriers on trading with non-member countries.
- (b) **Customs Union:** Like FTA, there are no internal tariff barriers on intra-union trade. But, member-countries give up their individual tariff schedules and erect a common external tariff barrier for trade with non-union members. A customs union is like a single nation not only in international trade, but also in presenting a common front to the rest of the world with its common external tariff. A customs union is more difficult to achieve than a free trade area because every member must give up its sovereignty in commercial policy matters.
- (c) **Common Market:** A common market is the next stage of economic integration. In addition to the characteristics of a customs union, a common market also allows free movement of labour and capital among member-countries. A common market goes beyond a customs union because it seeks to standardize all Government regulations affecting trade. The European Union (EU) is the most successful experiment of a common market. Other examples of common markets are:
- (i) The Central American Common Market comprising Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua
  - (ii) The Andean Common Market comprising Peru, Venezuela, Colombia, Ecuador and Bolivia
- (d) **Economic Union:** This represents the final stage of economic integration. The member-countries not only allow free trade and movement of capital and labour, but also harmonize their fiscal, monetary and financial policies. Such harmonization is extremely difficult to achieve (i) because of the unequal stages of development of the members, (ii) typical individual country needs and (iii) apprehension of erosion of national sovereignty.

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### 11.3 EFFECTS OF ECONOMIC INTEGRATION

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Regional economic cooperation can take many forms. Nations in a region, for example, can pursue joint endeavours to develop regional infrastructure, human resources and economic development in general. Regional economic integration must include joint, reciprocal reduction of trade barriers, and the fruits of barrier reductions are shared only by the participating nations, even though member states can develop various forms of cooperation other than barrier reductions. If nations

within a region develop economic cooperation without having a free trade agreement or a customs union, we may call it a regional economic cooperative body.

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### 11.3.1 Major Regional Trading Blocs

At present, the world is witnessing various regional economic groups. Standard theory deals with a framework of non-discriminatory tariff, trade and investment policies. But the very essence of a regional grouping is the fact that it discriminates against, non-member countries to its own economic advantages. Each member country of the group follows two sets of policies—one for the member countries and other for the non-members, an example of double standards.

A regional grouping has two or more-member countries while the remaining countries of the world are treated as non-members.

Economic benefits from a regional grouping are directly dependent upon the level of economic development of the member countries and the size of their external sectors.

A few regional groups are explained as follows:

1. The **South Asian Association for Regional Cooperation (SAARC)** was formed in January 2004. Its seven members are Bangladesh, Bhutan, Nepal, Pakistan, Sri Lanka, India and Maldives.

SAARC countries are to institute free trade amongst themselves in ten years, starting from 1 January 2000.

2. The **Organization of Petroleum Exporting (OPEC)** countries is an association of countries which are substantial net exporters of oil and which subscribe to a set of commonly agreed objectives. It is a permanent, intergovernmental organization. Created at the Baghdad Conference on Sept. 10–14, 1960, by five countries – Iran, Iraq, Kuwait, Saudi Arabia and Venezuela, it was joined by eight others: Qatar, Indonesia, Socialist People, Libyan Arab Jamahirija, United Arab Emirates, Algeria, Nigeria, Ecuador and Gabon. Two countries Ecuador and Gabon left OPEC reducing its membership to eleven countries. It started with its headquarters at Geneva and moved to Vienna, Austria in Sept. 1965.

OPEC produces around 40 per cent of total world output and exercises a substantial control over its international price.

3. The **India-Sri Lanka Free Trade Area (ILFTA)** was signed in December 1998. Its objective is primarily to lower import tariffs against each other in a phased manner.
4. The **Association of Southeast Asian Nations (ASEAN)** was created in August 1967 by five countries: Indonesia, Malaysia, Philippines, Singapore and Thailand. Its objectives and aims are to provide peace, freedom and prosperity for its members and described several areas of mutual

cooperation. At the time of signing AFTA, ASEAN membership had increased to six, with the addition of Brunei Darussalam. Four countries – Vietnam, Laos, Myanmar and Cambodia joined later thus raising its membership to ten countries.

5. The **Asia-Pacific Economic Cooperation (APEC)** was established in 1989, though some countries joined it later, the last one being Vietnam. Its current membership includes twenty-one countries comprising both developed and developing countries, viz., China, Australia, Vietnam, Indonesia, South Korea, Malaysia, Japan, Philippines, Indonesia, Russia, New Zealand, Hongkong, Singapore, USA, etc. APEC operates on non-binding commitments. Its membership does not entail any treaty obligations. All decisions are based on negotiations and commitments by member countries on a voluntary basis.
6. The **European Union**: European Union occupies a special position in the country of regional economic blocs. It is one of the most successful regional blocs and accounts for a large proportion of world trade and output. It is an example of member countries successfully overcoming mutual differences for the sake of their collective good. In the process, it has created even supra-national institutions with decision-making powers for member economies to the extent the process is seen as beneficial for the entire community.

European Union is a comprehensive association of some European countries and goes far beyond a conventional customs union. It aims at full integration of the economies of member countries with a common currency, a common central bank, coordinated fiscal and industry policies and other supranational institutions to effectively monitor and administer the Union. It is successively achieving complete integration of the markets for goods and services, labour, capital and other productive resources.

The European Union has fifteen members, e.g., Sweden, Denmark, Finland, France, Germany, Italy, Spain, Portugal, Greece etc. A significant achievement of EU is the launching of a single currency, the euro, on 1 January 1999 to replace national currencies of the member countries.

The **North American Free Trade Agreement (NAFTA)**: While USA was pressing for bringing into existence the World Trade Organization on the grounds that the world needed a rule-based free international trade regime and that hitherto left out trade and non-trade issues should be brought under its purview, it was negotiating a free trade area for the North American countries. The North American Free Trade Agreement came into force on 1 January 1994.

NAFTA was signed by the Government of USA, United Mexican States and Canada. Other countries are permitted to join it by subscribing to its aims, objectives, principles and other terms and conditions. The basic

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objective of NAFTA was to bring into existence a free trade area between the member countries. It is to be noted that a major portion of trade between US and Canada was already sufficiently free and the new agreement was expected to only complete the process of having fully free trade between two neighbours. USA is one of the biggest economies of the world and the other members of NAFTA were expected to gain substantially by the new agreement.

### **General Agreement on Trade and Tariff (GATT)**

An attempt to create an international organization to look after matters of trade and commercial policy were made as early as 1947. Although a charter for an International Trade Organization was drafted at the Havana Conference, it was never ratified due to differences between those who wanted a free multilateral trading system and those who placed emphasis on a full employment policy on a national basis. However, the American proposal for a general agreement on tariffs and trade was agreed upon, and many nations signed. So emerged the General Agreement on Tariffs and Trade with no formal organization and no elaborate secretariat. It is through increasing liberalization of world trade and through GATT negotiations that the World Trade Organization emerged in 1995.

The two outstanding features of GATT will be the principle of non-discrimination and the principle of reciprocity with the purpose of promoting fair and free international trade among members. To ensure non-discrimination the members of GATT agreed to apply the principle of MFN (Most Favoured Nation) to all import and export duties. This means that each nation shall be treated as well as the most favoured nation. However, GATT did not prohibit economic integration such as the formation of free trade areas or customs unions, provided that the purpose of such integration was to facilitate trade between constituent territories and not to raise barriers to the trade of other parties.

Protection to domestic industries is given only through customs tariffs, thereby prohibiting import quotas and other restrictive trade practices.

The GATT office periodically convened conferences of nations for Multilateral Trade Negotiations called rounds. Several rounds of trade negotiations conducted under the auspices of GATT, resulted in significant reductions in the average level of world trade tariffs.

The last round of multilateral trade negotiations known as the Uruguay Round, which was the eighth round, centred around three main issues:

- (i) Trade Related Intellectual Property Rights (TRIPs)
- (ii) Trade Related Investment Measures (TRIMs) and
- (iii) Trade in Agricultural Commodities

The third world countries have been dissatisfied with GATT negotiations. Liberalization of trade-related intellectual property rights would mean that the less-developed countries would have to compete with the advanced countries or



multinational companies. TRIPs covering copyrights, patents and trademarks is likely to harm the indigenous technology and nascent industries—particularly pharmaceutical and drug industry. GATT covers the service sectors as well under TRIMs. This is likely to affect the employment conditions in the developing countries as they will be swamped by professionals from the advanced industrial countries. Agriculture, is another controversial issue under GATT. While the US insisted on free trade in agriculture withdrawal of state subsidies EEC countries particularly France, which heavily subsidize their agriculture objected. The US threatened to use a law called super 301, under which punitive actions is taken against countries which do not follow a free trade regime.

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### 11.3.2 Commodity Agreement

Commodity agreements are arrangements between producing and consuming countries to stabilise markets and raise average prices. Such agreements are common in many markets, including the market for coffee, tea, and sugar. Meaning: International Commodity Agreements which are inter- governmental arrangements concerning the production of & trade in, certain primary products with a view to stabilizing their prices.

The basic objective is to stimulate a dynamic & steady growth & ensuring reasonable predictability in the real export earnings of the developing countries so as to provide:

- Expanding the resources for economic & social development.
- Consider the interest of the consumers in importing countries
- Considering the remunerative & equitable & stable prices for primary commodities.

### Considering the import purchasing power

Increased imports & consumption & also coordination of production & marketing policies

1. **Quota agreements:** In international trade, a government-imposed limit on the quantity of goods and services that may be exported or imported over a specified period of time. Limits on the amount of a goods produced, imported, exported or offered for sale. International quota agreements seek to prevent a fall in commodity prices by regulating prices. This agreement undertakes to restrict the export or production by a certain percentage of the basic quota decided by the Central Committee or Council. This type of agreement mostly in the case of the commodities like coffee, tea & sugar This agreement avoids accumulation of stocks require no financing & do not call for continuous operating decisions.
2. **Buffer Stock Agreements:** A practice in which a large investor, especially a government, buys large quantities of commodities during periods of high supply and stores them so they do not trade or circulate. The investor then

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sells them when supply is low. This is done to stabilize the price. It is to stabilize the prices by maintaining the demand & supply balance. It is more useful for the commodities like tea, sugar, rubber, copper. This arrangement only for those products which can be stored at relatively low cost without the danger of deterioration & this is one of the limitation of this agreement.

**3 Bilateral or Multilateral Contracts:** Bilateral agreements may be formed as business or personal agreements between individuals or companies. They may also be formed between sovereign countries in the form of trade agreements or agreements in other areas. In either case, a bilateral agreement is a binding contract between the two parties that have agreed to mutually acceptable terms. International sale & purchase contracts may also be entered into by two or more major exporters & importers. Bilateral contract to purchase & sell certain quantities of a commodity at agreed prices. In this agreement, an upper price & a lower price are specified. If the market price, throughout the period of the agreement, remains within these specified limits the agreement becomes inoperative. If the market price rises above the upper limit specified, the exporter country is obliged to sell to the importing country a certain specified quantity of the upper price fixed by the agreement. On the other hand, if the market price falls below the lower limit specified, the importer is obliged to purchase the contracted quantity at the specified lower price.

### Check Your Progress

1. What is a trading bloc?
2. What do you understand by regional grouping?

## 11.4 WTO

The new World Trade Organization (WTO) which replaced the General Agreements in Tariffs and Trade (GATT) came into effect from 1 January 1995, with the backing of at least eighty-five founding members including India. The WTO now comes as the third economic pillar of worldwide dimensions along with the World Bank and the IMF.

As many as seventy-seven of the 125 countries which signed the Uruguay round trade accord in April 1994 at a conference in Marrakesh have officially notified GATT that they would join the WTO.

The new trade body—WTO with power to settle trade disputes between nations and to widen the principle of free trade to sectors such as service and agriculture, covers more areas than GATT, whose rules have been in operation for the last fifty years. The WTO envisages the reduction of tariffs by more than one-third and is concerned with further opening of markets. It is expected that the

world trade would be stimulated strongly in the long run as a result of the coming into being of the new trade body—WTO.

*India, WTO and  
Trading Blocs*

Like GATT, the WTO agreement will regulate the commodities trade, but in addition it will also deal with services across borders like insurance and tourism. The new WTO conditions also protect intellectual property like patents, copyrights and brands. Agriculture and textiles are completely covered by the WTO agreements. The highest WTO body is a ministerial conference which will meet at least once in two years.

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The WTO has been entrusted with the following functions:

1. The WTO would facilitate proper implementation of multinational trade agreements.
2. It will review trade policies undertaken by the member countries.
3. It will act as a forum for the negotiation of disputes among the member countries over trade related problems.
4. The WTO will work in cooperation with the IMF and the World Bank.

### 11.4.1 WTO and India

#### *India's Commitments to WTO*

1. **Tariff lines:** As a member of the WTO, India has bound about 67 per cent of its tariffs lines, whereas prior to the Uruguay Round only 6 per cent of the tariff lines were bound. For non-agricultural goods with a few exceptions, ceiling bindings of 40 per cent ad valorem on finished goods and 25 per cent on intermediate goods, machinery and equipment have been undertaken. The phased reduction to these bound levels is being undertaken over the period March 1995 to the year 2005. In textiles, where reduction will be achieved over a period of ten years, India has reserved the right to revert to duty levels prevailing in 1990, if the integration process, envisaged under the Agreement on Textiles, does not materialize in full. Under the Agreement of Agriculture, India's bound rate ranges from 100 to 300 per cent.
2. **Quantitative restrictions:** Quantitative restrictions on imports maintained on balance of payments grounds were notified to WTO in 1997 for 2714 tariff lines at the eight digit level. In view of the improvements in India's balance of payments, the Committee on Balance of Payments Restrictions had asked India for a phase out for the quantitative restrictions. An agreement between USA and India was reached which envisaged the phasing out of all quantitative restrictions by India by April 2001. In line with this agreement, India removed quantitative restrictions on 714 items in the Exim Policy announced on 31 March 2000 and on the remaining 715 items in the Exim Policy announced March 2001.

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**3. TRIPs (Trade-related Intellectual Property Rights):** The ruling of the two WTO Dispute Settlement Panels following the complaints made by the USA and the European Union that India had failed to meet its commitments under Article 70.8 and Article 70.9 made it obligatory for the Government of India to make appropriate amendments to the Patents Act, 1970 by April 1999. The Patents (Amendment) Act, 1999 was passed by the Parliament in March 1999 to provide for exclusive marketing Rights. In respect of plant varieties, a decision has been taken to put in place a sui generis system as it is perceived to be in our national interest.

As far as copyrights and related rights are concerned, the Copyright Act, 1957, as amended in 1994 takes care of our interest and meets the requirements of the TRIPs Agreement except in the case of terms of protection of performers' rights. A Bill to increase this term to fifty years was passed by the Parliament in December 1999.

**4. TRIMs (Agreement on Trade-related Investment Measures):** Under the TRIMs agreement, developing countries have a transition period of five years upto 31 December 1999 during which they can continue to maintain measures in consistent with the Agreement provided these are duly notified. The Government of India notified two TRIMs viz., that related to local content requirements in the production of certain pharmaceutical products and dividend balancing requirement in the case of investment in twenty-two categories consumer items.

**5. GATS:** Under the General Agreement on Trade in Services (GATS), India has commitments in thirty-three activities. Foreign service providers will enter these activities. According to the Government of India, the choice of the activities has been guided by considerations of national benefit.

**6. Customs Valuation Rules:** India's legislation on Customs Valuation Rules, 1998, has been amended to bring it in conformity with the provisions of the WTO Agreement on implementations of Article GATT of 1994 and the Customs Valuation Agreement.

### **Benefits to India**

1. The World Bank and the GATT secretariat have estimated that the income effects of the implementation of the Uruguay Round package will add between 213 and 274 billion US dollars annually to world income. According to the Government of India, since our country's existing and potential export competitiveness lies in clothing, agriculture, fishery products and processed food, it is logical to believe that India will obtain large gains in these sectors.
2. The phasing out of the MFA (Multi-Fibre Arrangement) by 2005 will benefit India as the exports of textiles and clothing will increase.
3. The third benefit that India expects relates to the improved prospects for agricultural exports as a result of likely increase in the world prices of

agricultural products due to reduction in domestic subsidies and barriers to trade. While on the one hand, earnings from agricultural exports are likely to increase, on the other hand India has ensured that all major programmes for the development of agriculture will be exempted from the disciplines in the Agricultural Agreement. Thus, the operation of the public distribution system will not be affected by the provisions of the Agreement; agricultural subsidies granted by developing countries need not be withdrawn till such time they remain within the prescribed limits specified in the Agreement; and protection necessary for developing the agricultural sector in the underdeveloped countries might be continued. In fact, India hopes that the reduction of subsidies in the USA and the European Community will enable it to increase its earnings from agricultural exports.

4. The Uruguay Round Agreement has strengthened multilateral rules and disciplines. The most important of these relate to antidumping, subsidies and countervailing measures, safeguards and disputes settlement. This is likely to ensure greater security and predictability of the international trading system and thus create a more favourable environment for India in the new world economic order.

### ***Disadvantages to India***

The most important advantage of the new world economic order claimed by its supporters is that it will increase the volume of trade substantially and as a result, India's export earnings will expand considerably. However, the estimates of quantitative gains by India may prove wrong. The gains expected by the Government of India on account of tariff reductions on goods may also not materialize as the number of goods of export increase to India is very small.

The most serious disadvantages to India are likely to flow from the Agreements pertaining to the TRIPs, TRIMs and services.

Protection of intellectual property rights—patents, copyrights, trademarks, etc., has been made more stringent in the Uruguay Round. This has been done to protect the interests of multinational corporations and developed countries as the Agreement on TRIPs is highly weighted in favour of patent-holders. As correctly pointed out by Mukund Dubey, intellectual property rights protection is anti-competition and anti-liberalization and goes against the spirit of opening up the world economy and global integration. It is to be noted that the TRIPs Agreement goes against the Patent Act of India 1970 in almost all-important areas. Under the Indian Patents Act, only process patents can be granted in food chemicals and medicines. TRIPs Agreement provides for granting product patents also in all these areas. TRIPs Agreement provides that the general term of a patent shall be twenty years. The Indian Patents Act provides for a general term of the fourteen years for both product as well as process patents.

## **NOTES**

**NOTES**

**Check Your Progress**

3. Which organization replaced the General Agreements in Tariffs and Trade (GATT)?
4. State one of India's commitment to the WTO.

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**11.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS**

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1. A trading bloc is a large free trade area formed by one or more tax, tariff and trade agreements.
2. A regional grouping has two or more-member countries while the remaining countries of the world are treated as non-members.
3. The new World Trade Organization (WTO) replaced the General Agreements in Tariffs and Trade (GATT) and came into effect from 1 January 1995.
4. As a member of the WTO, India has bound about 67 per cent of its tariffs lines, whereas prior to the Uruguay Round only 6 per cent of the tariff lines were bound.

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**11.6 SUMMARY**

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- In the theory of international trade, free and multilateral trade is the most favoured situation which would maximize world welfare under certain assumptions.
- A trading bloc is a large free trade area formed by one or more tax, tariff and trade agreements. Typically, a trade pact that defines such a bloc specify formal adjudication bodies, e.g., the North American Free Trade Agreement (NAFTA) trade panels.
- A common market is the next stage of economic integration. In addition to the characteristics of a customs union, a common market also allows free movement of labour and capital among member-countries.
- Regional economic integration must include joint, reciprocal reduction of trade barriers, and the fruits of barrier reductions are shared only by the participating nations, even though member states can develop various forms of cooperation other than barrier reductions.
- At present, the world is witnessing various regional economic groups. Standard theory deals with a framework of non-discriminatory tariff, trade and investment policies.

- The South Asian Association for Regional Cooperation (SAARC) was formed in January 2004. Its seven members are Bangladesh, Bhutan, Nepal, Pakistan, Sri Lanka, India and Maldives.
- The two outstanding features of GATT will be the principle of non-discrimination and the principle of reciprocity with the purpose of promoting fair and free international trade among members.
- The third world countries have been dissatisfied with GATT negotiations. Liberalization of trade-related intellectual property rights would mean that the less-developed countries would have to compete with the advanced countries or multinational companies.
- Commodity agreements are arrangements between producing and consuming countries to stabilise markets and raise average prices.
- The new World Trade Organization (WTO) which replaced the General Agreements in Tariffs and Trade (GATT) came into effect from 1 January 1995, with the backing of at least eighty-five founding members including India.
- Like GATT, the WTO agreement will regulate the commodities trade, but in addition it will also deal with services across borders like insurance and tourism.

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### 11.7 KEY WORDS

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- **Commercial:** It refers to something that is concerned with or engaged in commerce.
- **Fiscal:** It refers to something relating to government revenue, especially taxes.
- **Quota:** It refers to a limited quantity of a particular product which under official controls can be produced, exported, or imported.

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### 11.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

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#### Short-Answer Questions

1. Describe the forms of economic groupings.
2. Write short notes on:
  - a) The North American Free Trade Agreement (NAFTA)
  - b) General Agreement on Trade and Tariff (GATT)
3. What do you understand by commodity agreement?

**NOTES**

**Long-Answer Questions**

1. Explain all the major regional trading blocks in detail.
2. How did WTO come into being? What are India's commitments to WTO?
3. Discuss the role of the World Trade Organization in the world economy.

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**11.9 FURTHER READINGS**

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# UNIT 12 CORPORATE SOCIAL RESPONSIBILITY

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### Structure

- 12.0 Introduction
- 12.1 Objectives
- 12.2 Corporate Social Responsibility: Meaning and Definition
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## 12.0 INTRODUCTION

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Corporate Social Responsibility (CSR) is a broad concept. Depending on the company and industry, it can take many forms. CSR activities are a way of strengthening brand value while benefiting the society through various philanthropy, and volunteer efforts. As important as CSR is for the community, it is equally valuable for a company. This unit discusses the concept of CSR in detail.

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## 12.1 OBJECTIVES

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

- Define corporate social responsibility
- Explain the need for social responsibility of business
- Assess the barriers to social responsibility
- Describe the social responsibility of business in India

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## 12.2 CORPORATE SOCIAL RESPONSIBILITY: MEANING AND DEFINITION

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### NOTES

In the heyday of *laissez faire* capitalism of Europe, the basic maxim was maximize profits. Social responsibility had no place in this scheme of things. The business of business is business. Business began merely as an institution for the purpose of making money. So long as a man-made money and kept himself out of jail, he was considered successful. He felt no particular obligation and acknowledged no responsibility to the community. As he was the owner of his business he thought he had a perfect right to do with it exactly what he pleased. Social welfare was not his concern.

But such an attitude does not hold good in the present situation. The recognition of social responsibility has been termed as the emergence of ‘corporate conscience.’

Business is not an end in itself. It is only a means to an end. That end is man himself. Therefore, business has to contribute to man’s happiness, his freedom, his material, moral and spiritual growth.

In the early 1990s, the mission of business firms was exclusively economic. But today, the social involvement of business has increased.

The concept of social responsibility is not new. Although the idea was already considered in the early part of the 20th century, modern discussion on social responsibilities got a major impetus with the book, *Social Responsibilities of the Businessman*’ by Howard Bowen. He suggested what businesses should consider the social implications of their decisions. Corporate social responsibility involves serious consideration of the impact the company’s actions on society.

A newer concept, but still very similar to social responsibility is *social responsiveness* that simply means the ability of a corporation to relate its operations and politics to the social environment in ways that are mutually beneficial to the company and to the society. The main difference between social responsibility and social responsiveness is that the latter implies actions and the ‘how’ of enterprise responses.

A new philosophy of management is emerging that has deep influence in corporate goals and business policy. The major elements that contributed to its evolution are:

1. The business leaders as a whole were becoming increasingly conscious of the fact that the public was an integral part of the general business scheme. Sense of service thus came to qualify and modify the greed for profit.
2. The second element that helped the process of evolution of the new idea was the purchasing power of public. The demand of the public meant nothing unless sufficient purchasing power was placed in their

hands. Industry had come to understand that one of its proper functions was to manufacture and distribute purchasing power as well as to manufacture and distribute merchandise. The most important effect of this changed attitude was a new business policy that demanded a persistent tilt towards higher wages and lower prices.

3. The third consideration in the process is the rise of a new relationship between the public and business, slowly displacing the era of purely private business for private profits. Business has a duty to report to the public, whose money it is constantly asking for, in order to conduct the business.

According to the classical view, if a business was striving to utilize the resources at its disposal as efficiently as possible in producing the requisite goods and services, it was acting in a socially responsible manner. But the modern concept of social responsibility has enlarged itself very much, though no consensus is available as regards to its definition or the extent of its scope.

According to K. R. Andrews, social responsibility may be taken to mean intelligent and objective concern for the welfare of the society that restrains individual and corporate behaviour from ultimately destructive activities. According to Bowen, a businessman has an obligation to pursue those policies to make those decisions or to follow those lines of action that are desirable in terms of objectives and values of our society. Therefore, business must recognize and understand the aspirations of the society and resolve to contribute to its achievements.

According to Keith Davis, social responsibility begins where the law ends. A firm is not being socially responsible if it merely complies with the minimum requirements of law because this is what any good citizen would do. Social responsibility goes one step further. It is a firm's acceptance of a social obligation beyond the requirements of law.

Social responsibility means that organizations have significant influence on the social system and that this influence must be properly considered and balanced in all organizational actions. It simply means that business organizations must function as part of a larger social system because they are, in fact, a part of that system.

### 12.2.1 Principles of CSR

Simple reflections on corporate social responsibility can be initiated by recognizing that much behaviour takes place outside of 'self-interest' and also outside of 'law' which can be addressed in terms of ethics. Also, we are made increasingly aware through (scandalous) events that there are externalities and consequences to corporate decisions and behaviour. In this context, it is helpful to focus on three primary principles of corporate (social) responsibility and each then espouses a strand of CSR quite distinct from others. Each of these would be ethically significant and are often related to other general principles, standards and expectations of business such as sustainability, transparency and accountability which are also

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being recognized as ‘CSR’ principles. So the set of CSR principles is expanding and more broadened. We focus on the three primary principles.

**(i) Stakeholder-driven CSR:** In this type of CSR, it is a response to stakeholder pressures. The response tends to be more reactive to stakeholder pressures, and often degenerates into a public relations exercise for protecting the image and reputation of the company, which is obviously a costly asset and one that can be easily damaged by the ability of stakeholders to voice their concerns in the media more convincingly.

We can state the principle of stakeholder-driven CSR as going beyond the self-interest and engaging in stakeholder dialogue that furthers mutually the interests of stakeholders and of the company, balancing various interests, limiting the perceived harm done through business actions and limiting the effect of (un)ethical business actions. Holding companies accountable and asking them to voluntarily disclose critical information and be transparent becomes difficult.

**(ii) Value-driven CSR:** In this type of CSR, the company has its core values and the CSR is the live expression of those core values, which the corporation expects from all its employees, both as a means of communicating the meaning and purpose of life and also enhancing the quality of life. It is more driven from within by policy and culture of the company.

We can state the principle of value-driven CSR as going beyond the law and giving full expression to its core values, defining what is right for the corporation in terms of the core values and their pursuit. A corporation in this sense would aim at maximizing the ‘intangible’ value of the company for all, which recognizes the core values (ethics of the company) as Prime assets that make up the good corporation.

**(iii) Performance-driven CSR:** In this type of CSR, the company has found a way to integrate business strategy and ethics (CSR) which is more proactive, self-regulative and advantageous both for the company and for the society. It is part of the corporate performance.

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### 12.3 SOCIAL RESPONSIBILITY OF BUSINESS

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Maximize profits was the underlying maxim in the hey-day of *laissez-faire* capitalism of Europe. Social responsibility had no place in its philosophy. *The business of business is business*. Business began merely as an institution for the purpose of making money. So long as a man made money and kept himself out of jail he was considered successful. He felt no particular obligation and acknowledged no responsibility to the community. As he was the owner of his business he thought he had a perfect right to do with it what he pleased. ‘The public be damned’. Social welfare was not his job.

But such attitude does not hold good in the present situation. The recognition of social responsibility has been termed as the emergence of corporate conscience.

Business is not an end in itself. It is only a means to an end. That end is man himself. Therefore, business has to contribute to man's happiness, his freedom, his material, moral and spiritual growth.

### 12.3.1 Nature of Social Responsibility

Social responsibility of business involves consideration of general public interest by businessmen while taking business decisions and actions.

According to Bowen, social responsibility refers to the 'obligations of businessmen to pursue those policies, to make those decisions or to follow those lines of action which are desirable in terms of the objectives and values of our society.'

This entails that businessmen should perform their operations with due consideration of the aspirations of society. They should fulfil the demands of those who have a claim in the operations of business. They must measure the consequences of their decisions and courses of action on the society and ascertain that no undue harm is done to the interests of the society.

### 12.3.2 Need for Social Responsibility of Business

1. *The Iron law of responsibility:* The institution of business exists only because it performs an invaluable service to society. Society gives business its charter to exist and the charter can be amended or revoked at any time if it fails to live up to society's expectations. Therefore, if business intends to retain its existing social role and social power, it must respond to society's needs constructively. This is called the 'iron law of responsibility', which is that in the long run, those who do not use power in a manner which society considers responsible will tend to lose it. Though the long run may be decades or even centuries in some instances, history confirms that society ultimately acts to reduce the power of those who have not used it responsibly.
2. *To fulfill long-term self-interest:* A business organization most sensitive to community needs would in its own self-interest like to have a better community in which to conduct its business. To achieve that, it would implement special programmes for social welfare. As a result of social improvements, crime will decrease. Less money will be required to protect property. Labour recruitment will be easier. Turnover and absenteeism will be substantially reduced. A better society would produce a better environment in which the business may aim at long run profit maximization.
3. *To establish a better public image:* Each business organization must enhance its public image to secure more customers, better employees and higher profits. The public image concept may be extended to the

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accomplishment of various types of social goals. According to this line of argument, social goals are now a top priority with members of the public. So, if a firm wants to project a favourable public image, it will have to show that it supports these social goals.

4. *To avoid government regulation or control:* Regulation and control are costly to business, both in terms of energy and money and restricts its flexibility of decision-making. Failure of businessmen to assume social responsibilities voluntarily invites government intervention and regulation or control of their activities. By their own socially responsible behaviour they can prevent government intervention. Businessmen have learnt that once a government control is established it is seldom removed even though the warranting conditions change. If these are the facts, then the prudent course for business is to understand the limit of its power and to use that power responsibly, giving government no opportunity to intervene.
5. *To avoid misuse of national resources and economic power:* Businessmen command considerable power on the productive resources of a community. They are obliged to use those resources for the common good of society. They should not forget that the power to command national resources has been delegated to them by the society to generate more wealth for its betterment. They must honour social obligations while exercising the delegated economic power. Society will not indefinitely tolerate their misdeeds in wasting away these resources.
6. *To avoid class-conflicts:* Industrial peace is a precondition for the success of business. Trade unions are becoming more and more militant and demand social welfare measures, better wages, better working conditions, etc. Their demand derives its force from the fast changing social environment. Businessmen must win over the confidence of workers and avoid violent class conflicts in their own interest.
7. *To convert resistances into resources:* If the innovative ability of a business is used to solve to social problems, many resistances (problems) can be transformed into resources and the functional capacity of resources may be increased manifold. All problems may not be capable of being handled this way, but many of them would be solved to the ultimate benefit of society. It is recognised that prevention is better than cure. Any delay in dealing with social problems now may leave business managements constantly occupied with extinguishing social fires in future. It is economical and wise to deal with such problems before they snowball and become uncontrollable. Business organizations can do a lot in this regard.
8. The effluence of many factories damages the surrounding environment. They are duty-bound to repair the damage by recognizing their responsibility towards society.

### 12.3.3 Social Responsibility of Business towards Different Groups

According to Earnest Dale, it is the duty of business to provide a fair return to the shareholders, fair working conditions to the employees, fair deal to the suppliers and customers and to make the business an asset to the local community and the nation.

1. *Owners of business:* Management must provide fair, adequate and stable long-run rate of return and steady capital appreciation to the shareholders for their investments. It must also provide to them regular, accurate and up-to-date information about the working of the company. Maximum disclosure about the progress and achievements of the company is very satisfying to the shareholders. It must ensure planned growth, solvency of the business and optimum utilization of the resources of the business.
2. *Employees:* Employees need security of jobs, higher wages, full employment, better conditions of work, opportunities for self-development and promotion. They want to unite and form their trade unions to achieve rights and to seek protection against high-handedness of the management. They also desire their work itself to be rewarding. Management, as a part of its social responsibilities, is expected to provide for their social security, welfare, grievances settlement machinery and sharing of excess profits.

Management should serve as a model employer. A model employer is one who does not exploit his employees. As a model employer, the management should provide stable employment, adequate wages, good and safe working conditions, job satisfaction and opportunities for self-development. Healthy trade union practices may be encouraged. Employees may be considered as partners in business, since their interests in business is not very much different from the interests of the shareholders. They may be allowed to participate in the decision-making process at all levels of management. A feeling of fellowship and a sense of belonging to the company as a whole should be allowed to grow.

3. *Consumers:* In the words of Henry Ford, management must provide those goods and services which the society needs at a price which the society can afford to pay. Management is supposed to provide good quality products to the consumers at reasonable prices. It should develop a liberal and fair attitude towards the consumers. It must maintain regular supply of high quality products and provide services to the consumers. Managers must meet the needs of the consumers of different classes, tastes and with different purchasing powers at the right time, place, price and in right quality. A businessman should act as a friend and guide to the consumer. It is his duty to protect consumers' interest at any cost. He must guard against adulteration, poor quality, lack of service to the consumer, misleading and dishonest advertisements, under-weighting, supply of state goods, etc. He must handle the complaints of the consumers carefully and efficiently.

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The concept of social responsibility of private business may be new to the western world, but in India it is not so. Gandhiji reminded us of these values when he propounded the theory of trusteeship. The rich businessman should recognize that he is the trustee for all the wealth which he has collected from the members of the society. So the entrepreneur has to strike a balance between profit and social good.

The concept of social responsibility of business was first mooted by President Wilson in USA as early as 1913 as a measure of the 'New Democracy'. He gave a new shape to the manners and morals of business through the Chamber of Commerce under the doctrine of self-rule in industry which listed fair trade practices and enforced self-discipline by the business community.

Social issues with which business corporations have been concerned since the 60s may be divided into three categories: The first of these refers to social problems external to the corporation which were not caused by any direct business action. Poverty, drug abuses, decay of the cities are examples of problems in this category. The second category consists of the external impact of regular economic activities. Pollution by production is a case in point. The quality, safety, reliability of goods and services, deception from marketing practices, the social impact of plant closings and plant location belong to this category. The final category of issues occurs within the firm and is tied up with regular economic activities. Equal employment opportunity, occupational health and safety, the quality of work life and industrial democracy belong to this category.

The second and third categories are of increasing importance and are tied up with the regular economic operations of business. Improved social performance demands changes in these operations.

### 12.3.4 Barriers to Social Responsibility

There are certain limitations of social responsibility. The major limitation is that ethical behaviors or charities under social responsibility usually necessitate financial contributions. This creates a limitation, for instance, a survey was once conducted regarding the limits of social responsibility. They found some managers opining that instead of wasting time on social contributions, it was more feasible to market their products and services. Likewise, financial positions of the companies also limit them to take any action for social contribution. Limited company funds also make their contribution low in social responsibility programs. Moreover, some businesses are considered to exist purely for the entertainment of people and they are legal but they are considered unethical; e.g., alcohol business. This also puts a limitation on social responsibility. In other words, there are several policies and regulations in business which limit social responsibility.



### Check Your Progress

1. What is stakeholder-driven CSR?
2. What does social responsibility refer to?

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## 12.4 SOCIAL RESPONSIBILITY OF BUSINESS IN INDIA

In this section, we will briefly study about the social responsibility of business in India.

### 12.4.1 Consumer Rights

The basic idea behind the consumer protection movement is protection of the rights of consumers. It was President Kennedy who declared the consumers' rights for the first time in his message to the American Congress in March 1962. They were the right to information, the right to choose and the right to be heard. Later, International Organization of Consumers' Union added four more rights, viz., the right to redress, the right to consumer education, the right to healthy environment and the right to basic needs. These rights were incorporated in the United Nation's Charter of Human Rights. The Government of India later recognised these rights.

### 12.4.2 Social Audit in India

SCBA is carried out in detail in India. All developmental agencies do SCBA while funding major private projects. State governments also carry out SCBA when luring and approving new mega projects for the state. For example, development banks like ICICI, IDBII and IFCI used a modified L-M approach for appraising projects costing more than five crore rupees.

SCBA is available for several projects in India, including the Delhi Metro Project and the Watershed Development Project in Karnataka.

### 12.4.3 Corporate Governance

For the past two decades there have been a series of corporate governance reforms proposed and some implemented in India. The wave of corporate governance reforms has focused on a number of critical issues that would link India with the rest of the world. But deeply entrenched management conventions still continue to have their sway. There have been eight Corporate governance committees and their reports are available indicating its increased importance and reflecting a common public concern.

- (i) July 2003: Report of the Committee on Regulation of Private Companies and Partnership (Naresh Chandra Committee-II).

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- (ii) 8 February 2003: Report of the SEBI Committee on Corporate Governance
- (iii) 23 December 2002: Report of the Naresh Chandra Committee on Corporate Audit and Governance.
- (iv) April 2002: Report of the Consultative Group of Directors of Banks/Financial Institutions
- (v) 24 March 2001: Report of the Advisory Group on Corporate Governance: Standing Committee on International Financial Standards and Codes
- (vi) 20 November 2000: Report of the Task Force on Corporate Excellence through Governance
- (vii) 7 May 1999: Report of the SEBI Committee on Corporate Governance (Chairman: Kumar Mangalam Birla).
- (viii) April 1998: Desirable Corporate Governance: A Code

### **12.4.4 Naresh Chandra Committee on Corporate Audit and Governance**

By an order of the Government of India dated 21 August 2002, a high-level committee was constituted under the chairmanship of Naresh Chandra to examine auditor company relationships and to regulate the role of auditors.

The background event that triggered this was the Enron scandal and the role of the Auditor Arthur Andersen in it. Arthur Andersen had been operating in India also. The USA government in response to this scandal immediately enacted the Sarbanes Oxley Act (SOX) of 2002, with the aim to deter any recurrence of such scams which eroded the confidence of the public in corporations, corporate governance, in auditors and in regulatory bodies of the government. So this response of the US government must have been the motivation for Indian regulators and authorities to act quickly to protect Indian investors and business by enacting certain measures. The report almost entirely deals with the auditor company relationship and regulatory changes. One central theme was auditing the auditors' and independent directors' role, remuneration and training. However, the implementation of the recommendations has been as expected left to voluntary compliance. It devoted a chapter each on the auditor-company relationship, auditing the auditors, and independent directors. There were other less important recommendations too.

### **12.4.5 Kumar Mangalam Birla Committee on Corporate Governance**

In 1999, SEBI or the Securities Exchange Board of India set up a committee on corporate governance, under the chairmanship of Kumar Mangalam Birla, who was also member of the SEBI board. The main purpose was to raise the standard of corporate governance and to promote better governance standards. It made some mandatory recommendations and some non-mandatory ones. It made the compliance with its recommendations as part of the listing requirements (by revising clause 49 of the listing agreement). The companies had to make proper disclosures

on corporate governance. This made it mandatory to add in the annual report the following: Board of directors, audit committee, remuneration committee, board procedure, management discussion and analysis, shareholder information, and corporate governance report. Companies were expected to comply.

#### 12.4.6 Narayana Murthy Committee on Corporate Governance

In 2003, the Securities and Exchange Board of India (SEBI) appointed a committee under the chairmanship of NR Narayana Murthy on corporate governance. They discussed previous committee – Kumarmagalam Birla and Naresh Chandra – recommendations on corporate governance.

The committee reviewed the recommendations of the Naresh Chandra Committee over the disclosure of contingent liabilities, CEO/CFO certification, definition of independent directors and independence of audit committees.

#### 12.4.7 Reserve Bank of India (RBI) Advisory Group on Corporate Governance

The standing committee on international financial standards and codes issued its advisory report on 24 March 2001. Its aim was to strengthen the Companies Act, the role of independent directors and governance in public sector units and banks. In its approach, it searched for universal standards in corporate governance, and dealt with issues of convergence of standards, issues of international standards and India, and aimed for good governance mechanisms in India. In its search for good governance mechanisms, it based itself mainly on the OECD principles.

#### Check Your Progress

3. What has Milton Friedman argued?
4. When was the Kumar Mangalam Birla Committee on Corporate Governance?

### 12.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. In stakeholder-driven CSR, it is a response to stakeholder pressures.
2. According to Bowen, social responsibility refers to the ‘obligations of businessmen to pursue those policies, to make those decisions or to follow those lines of action which are desirable in terms of the objectives and values of our society.’
3. Milton Friedman and others have argued that a corporation’s purpose is to maximize returns to its shareholders, and that since only people can have social responsibilities, corporations are only responsible to their shareholders and not to society as a whole.

### NOTES

4. In 1999, SEBI or the Securities Exchange Board of India set up a committee on corporate governance, under the chairmanship of Kumar Mangalam Birla, who was also member of the SEBI board.

## NOTES

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### 12.6 SUMMARY

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- The concept of social responsibility is not new. Although the idea was already considered in the early part of the 20th century, modern discussion on social responsibilities got a major impetus with the book, *Social Responsibilities of the Businessman* by Howard Bowen.
- Corporate social responsibility involves serious consideration of the impact the company's actions on society.
- A newer concept, but still very similar to social responsibility is *social responsiveness* that simply means the ability of a corporation to relate its operations and politics to the social environment in ways that are mutually beneficial to the company and to the society.
- Social responsibility means that organizations have significant influence on the social system and that this influence must be properly considered and balanced in all organizational actions.
- There are many barriers to social responsibilities for businesses. Critics of Corporate Social Responsibility (CSR) as well as proponents debate a number of concerns related to it.
- There are certain limitations of social responsibility. The major limitation is that ethical behaviors or charities under social responsibility usually necessitate financial contributions.
- The basic idea behind the consumer protection movement is protection of the rights of consumers.
- In 1999, SEBI or the Securities Exchange Board of India set up a committee on corporate governance, under the chairmanship of Kumar Mangalam Birla, who was also member of the SEBI board.
- The main purpose of the Birla committee was to raise the standard of corporate governance and to promote better governance standards.

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### 12.7 KEY WORDS

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- **Shareholder:** It refers to an owner of shares in a company.
- **Corporate Social Responsibility:** It is a type of international business self-regulation.
- **Corporate governance:** It is the system of rules and practices by which a firm is directed and controlled.

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## 12.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

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### Short-Answer Questions

1. Define corporate social responsibility. What are its principles?
2. Define social responsibility of business?
3. What is the need for social responsibility of business?

### Long-Answer Questions

1. Compare corporate social responsibility and corporate citizenship.
2. Explain the causes of growing awareness for social responsibility.
3. Discuss the barriers to social responsibility.
4. Describe social responsibility in India's context.
5. Give a detailed description of Indian corporate governance.

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## 12.9 FURTHER READINGS

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# UNIT 13 PUBLIC, PRIVATE, JOINT AND COOPERATIVE SECTORS

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### Structure

- 13.0 Introduction
- 13.1 Objectives
- 13.2 Public Sector
  - 13.2.1 Organization of Public Sector Enterprises
- 13.3 Private Sector
- 13.4 Joint Sectors and Formation of Joint Sector Enterprises
- 13.5 Cooperative Sectors
- 13.6 Answers to Check Your Progress Questions
- 13.7 Summary
- 13.8 Key Words
- 13.9 Self Assessment Questions and Exercises
- 13.10 Further Readings

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## 13.0 INTRODUCTION

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Economic activities, such as the production and distribution of goods and services, take place broadly in four sectors. These are public sector, private sector, joint sector, and cooperative sector. Each sector has been emphasised differently in different countries in different periods of their economic history. This unit discusses these four sectors in detail.

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## 13.1 OBJECTIVES

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

- Discuss the organization of public sector enterprises
- Describe the features of private sector
- Explain the formation of joint sector enterprises
- Examine the cooperative sector

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## 13.2 PUBLIC SECTOR

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Public sector or public enterprises include all governmental activities including public, industrial and commercial enterprises. Public enterprise occupies a strategic and crucial position in the Indian economy. It is no exaggeration to say that the

economy would sink or swim depending upon the efficiency with which these enterprises operate.

Public enterprises are expected to be the principal agents for rapid economic and social transformation by developing infrastructure and the core sector and by closing the gaps in the industrial structure. Its dominant position in the financial field is intended to control and guide the private sector, wherever necessary. Lastly, the economic growth through public enterprise will ensure social justice.

In developing countries, public enterprises are largely a necessity and not a matter of choice. In India, though the Congress government was clearly committed to expanding the public sector, it did not go into areas where private enterprise was operating. Nationalization of the existing enterprises has been generally resorted to where the public interest was involved or where it was imperative to put the industry on sound footing and regulation and control were not found sufficiently effective. The vast majority of public enterprises is in areas which were hitherto untouched or unexplored by the private sector.

In the Industrial Policy Statement of 1956 it was emphasized that public enterprise was designed to control the 'commanding heights' of the economy. But in recent years, the trends toward increasing liberalization are very much in evidence in India and one gets the impression that private sector is designed to play an important role in the economy in the coming era.

Public sector in the industrial field has expanded rapidly since Independence. In 1951, there were only five non-departmental public undertakings with an investment of ₹ 29 crore. On 31 March 2004, the number of public enterprises had risen to 230 with the total capital employed therein amounting to ₹ 586,140 crore.

The public enterprises comprise:

- (i) Public utilities, e.g., the Railways, Posts and Telegraphs and Irrigation projects.
- (ii) Departmental undertakings of the Government, Central as well as State, e.g., Post and Telegraphs, Integral Coach Factory, etc.
- (iii) Other industrial undertakings which derive their finance from the Government of India in the form of equity capital and loan, e.g., Durgapur Steel Plant, Hindustan Fertilizers, etc.

Public sector units generally are of four kinds:

- (i) National monopolies like railways that have downward sloping unit cost curves. These are hard to assess, being monopolies.
- (ii) Entrepreneurial ventures that, at the start and for many years thereafter, are monopolies or near monopolies. These are generally large units with sophisticated technologies and long gestation periods that produce basic products. Many of the Indian public sector manufacturing units are of this type.

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(iii) Sick units in the private sector that have been taken over to maintain employment etc.

(iv) Units taken over or formed to acquire the 'commanding heights' or for other ideological reasons.

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The State Trading Corporation is a case in point.

### 13.2.1 Organization of Public Sector Enterprises

The entry of the public sector in a big way in the economic sphere is a post-independence development. Prior to 1947, public sector investment was limited to the railways, the post and telegraphs department, the ordinance factories and a few state-managed factories like the quinine factories and salt factories. It was the Industrial Policy Resolution of the Government of India in 1948 which brought the public sector into the limelight. It declares that a dynamic national policy must be directed to a continuous increase in production by all possible means, side-by-side with measures to secure its equitable distribution. The problem of State participation in industry and the conditions in which private enterprise should be allowed to operate must be judged in this context. Since then the expansion of the public sector has been very rapid.

The idea that in the economic development of the country the State enterprises would play a predominant role took root with the adoption of a socialist pattern of society in the second Plan.

The growth of public enterprises in India has taken place in two ways: (a) by nationalizing existing enterprises and (b) by starting new enterprises. The State Bank of India, LIC, the Air India and nationalization of 20 banks etc. are included in the first category, while the Hindustan Steel Ltd and the Fertilizer Corporation of India. fall in the second category.

The enormous growth of public sector investments has taken place against a political and ideological background which is peculiar to Indian political development.

#### Rationale for the Public Sector

1. **Socialist Pattern of Society:** The public sector was meant to socialize the means of mass production and benefit the masses, as is typically the case in a socialistic pattern of society. The commanding heights of the economy – the core sector comprising investment, production, distribution and consumption – were State owned, so as to promote national development as opposed to considerations of private profit. In such a situation, the so-called public sector needs to expand rapidly, cover areas where the private sector is unwilling or unable to participate, and play a dominant role in shaping the economy. Some of these areas are power, communication, mass transportation, information and broadcasting, mines and defence production. Initially, the public sector took the lead in developing



the basic and capital goods industries, laying the foundations for national growth unhindered by narrow considerations of profit as would arguably be seen in a laissez faire economy dominated by private enterprise, where motives of personal profit would presumably supersede national priorities. In time, however, some of these monolithic establishments exhausted their early dynamism and metamorphosed into complacent, inefficient, cash-strapped, overstaffed, over unionized islands of mediocrity that generated aught but huge losses—dinosaurs that had run out of time and relevance.

2. **Socio-economic Objectives:** Reduction of inequalities of wealth and income is the most important socio-economic objective, going hand in hand with the need to eliminate poverty and establish an egalitarian society by redistributing wealth and earning potential equitably. Another important objective of a socialistic system is to help the underprivileged, realize their dormant potential by liberating them from economic serfdom and to give them all opportunity to attain social justice. Although rarely declared in so many words, the giant public sector organizations were also meant to serve this purpose by providing upliftment to these neglected sectors, by means of reserving a certain percentage of jobs for weaker sections of society including the physically handicapped. Nationalized banks rendered yeoman service by extending concessional loans under the ‘Differential Rates of Interest’ scheme, that allowed cheap finance to reach District Consultative Committee sponsored beneficiaries drawn from such sections of the local populace—something a purely profit-driven banking system would never dream of undertaking.
3. **Balanced Regional Development:** One of the major goals of planning is to try and correct regional disparities by spreading the benefits of economic development as evenly as possible across the country. It is vital for humane as well as for security reasons to ensure that the fruits of prosperity percolate throughout the nation, for civil unrest is usually born of discontent with a system of wealth distribution that serves but to defeat the very purpose of adopting a socialistic type of governance. This is particularly true of the sensitive north and north-eastern states, many of which are economically underdeveloped, and hence, vulnerable to ideologies incompatible with our peaceful, non-violent, democratic system of governance run on socialist principles. Industrial development of these areas is a top priority; Bhilai, Rourkela and Durgapur are well-known examples, but more such success stories are needed, and quickly.
4. **Need for Rapid Economic Development:** The need of the hour is rapid economic development. The private sector has neither the desire nor the resources to undertake the massive programme of industrialization. Hence, dependence on the private sector will only slow down the economic development. Expansion of public enterprise will speed up the rate of economic growth.

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5. **Pattern of Resource Allocation:** The main reason for the expansion of the public sector lies in the pattern of resource allocation decided upon under the plans. In the first Plan, the major emphasis was on agriculture, but in the second Plan the emphasis was shifted to basic and capital goods industries. During the first plan period, the private sector was dominant in the field of industrial activities. But, with changed emphasis it was inevitable that the public sector must grow not only absolutely, but also relatively to the private sector.
6. **Building Infrastructure:** Infrastructure provides certain basic facilities for rapid economic growth. In the economic infrastructure, there are facilities like power, irrigation, transport and communication, banking and training. Social infrastructure includes education, health, sanitation, drinking water facilities, etc. The development of infrastructure is not possible through efforts of private individuals since its benefits go to society as a whole and not to individuals. It is, therefore, mainly the responsibility of the State. The infrastructure has accounted for 95.1 per cent of the public outlays in the first Plan and nearly 75 per cent in the subsequent plans.

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### 13.3 PRIVATE SECTOR

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It is pertinent to discuss the role and future of the private sector against the background of socialist pattern of society which is the declared objective of the government policy in India. The pattern of socialism that we have envisaged is different from that pursued by many western countries. Unlike China, India has chosen an economic system that is basically capitalist in character, but it combines this system with a significant degree of state influence, the latter implemented through various types of controls and a state planning system.

Jawaharlal Nehru who shaped the destiny of the country for nearly two decades, was not in favour of socialism for its own sake. He was not in favour of nationalization of private undertakings until it could be proved that some definite social purpose would be achieved by such nationalization, a purpose which cannot be secured under private management. The acceptance of the philosophy of socialist pattern of society by the government had led to a feeling that private sector in the country has a dark future. The Third Five-Year Plan, however, clearly stated that the socialist pattern of society envisaged in India's Plans does not imply that all economic initiative must rest with the state. Indeed, it assigns to private enterprise an important role in national development, provided it attunes itself to the new philosophy of democratic socialism and operates in unison with the public sector.

In the private sector, the enterprise is owned by private person. In the sphere of private sector, there is the corporate sector with such organizations as public limited companies and private limited companies. Outside the corporate sector, there are many forms of ownership like single entrepreneur and partnership and trade as also cottage industries. Private sector can be divided into two parts:

- (i) The organized sector
- (ii) The unorganized sector

In the unorganized private sector it is difficult to enforce policy interventions.

The private sector plays an important supporting role in India's mixed economy. Seen in 1948 as complementary to the catalytic, dynamic and fast expanding public sector, the private sector was nonetheless accorded due recognition as playing a useful partnership role in rounding out the economy, it was not intended to nationalize it straight away, but to regulate and direct it properly, and facilitate and encourage its development through provision of infrastructure along with financial institutions, that would all serve to promote and assist it to serve social objectives.

It is pertinent to mention that the private sector not only survived this slightly patronizing approach as well as the hardships of the 'license Raj' but went to achieve heights of glory and achievement. Meanwhile, several public sector units stultified and decayed, to the point that they had to go the BIFR way or be disposed of (under the policy of divestment or 'disinvestment'). The main reasons as to why the private sector turned the tables on its bigger, stronger stablemate are:

1. Entrepreneurial talent is its greatest asset, while most of the public sector units did not have a mindset that promoted cost or profitability consciousness as opposed to western countries, where private enterprise has played such an important role in economic development that Joseph Schumpeter has described it as the initiator and moving force behind industrialization.
2. Private entrepreneurs are driven by profit and survival needs to constantly innovate, reduce costs and improve both products and bottomlines, in response to stakeholders' demands.
3. In India, the role of the private sector – even after five decades of planning – translates to 75 per cent of the economy, while the State-aided public sector is a distant straggler with a mere 25 per cent share.
4. The private sector in India is vast; agriculture – the most important productive activity – is the largest employer. It employs 66.5 per cent of the working population and contributes around 30 per cent of the net domestic product, though much of it is mere subsistence farming for a vast multitude of destitute marginal farmers and agricultural labourers. Nevertheless, it is practically exclusively in private hands.
5. Moreover, trading activities are mostly concentrated in private hands; the few public sector organizations engaged in trading, like the State Trading Corporation, withered away after their monopoly was demolished by liberalization
6. Recent trends in private sector engagement in large retail and real estate developments, including the involvement of the two Reliance Group companies, presages a new thrust by the private sector into the service

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industry—an evolutionary step that signals that the Indian economy is approaching the next stage of development already well under way in the developed countries.

Trading activities are mostly concentrated in private hands. This is because of the general belief that the trading community renders useful services and its returns are justifiable.

Private sector in industry can be conveniently classified into three groups:

- (i) Unorganized industrial units
- (ii) Small-scale industrial units
- (iii) Large-scale industrial units

In 1988–89, large units having capital investment of more than ₹ 35 lakh formed only 6.3 per cent of the total industrial units in the country. But, these units accounted for 60 per cent of the gross output and 80.1 per cent of the total value added in the factory sector. Thus, these large-scale industrial units form the backbone of the private sector in India.

Most of the consumer goods' industries are generally left to private enterprise. The consumer goods industries are left to private enterprise as this sector has already established itself in some major consumer goods industries like cotton textiles, jute, edible oils, etc. These industries require small capital and yield quick returns. As such, these are fit for the private sector. These industries are also regulated with a view to control investment in different industries.

While the large-scale private industries are restricted and regulated, the small sector is encouraged to expand in the old field and enter into new spheres. Quite a large number of products, more than 800, are reserved for this sector. These industries are encouraged for being labour-absorbing industries as also those that can be easily dispersed over space.

The general pattern of development of the corporate form in India is similar to that in the western countries. The methods of growth have been through diversification, integration, acquisition and merger. Crossing international borders in joint ventures to other countries is also in progress. Most of the growth in the corporate sector has been through foreign collaboration in technology and sometimes capital also and rarely through innovation by means of internal research and developing technology.

The hereditary succession is still very powerful, though a professional managerial class is slowly evolving. Some authorities even equate private sector to the 'family sector' in view of the widespread prevalence of family management in large companies.

Despite numerous constraints, there has been an expansion of private sector activities. Under the new Industrial Policy of 1991, emphasis was shifted from public to private sector.

It should be noted that there has been growing concentration of economic power in the hands of big business houses. This economic power has secured control over political power. Owing to the commanding position of big businesses in the total industrial sector, they can exercise considerable influence over government policies. The report of the Dutta Committee showed that twenty big business houses secured a disproportionately large share in the number of licenses issued. During the last twenty-five years, through the process of concentration of wealth and economic power, they have strengthened themselves with the result that the two top business houses (Tatas and Birlas) have amassed huge total assets.

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### Check Your Progress

1. What activities does public sector include?
2. How did public enterprises grow in India?

## 13.4 JOINT SECTORS AND FORMATION OF JOINT SECTOR ENTERPRISES

Although the Joint Sector concept was conceived by the authors of the Industrial Policy Resolution, 1956 was really the brainchild of the Industrial Licensing Policy Enquiry Committee, popularly known as the Dutta Committee. Besides the public and the private sectors, there was a need for a new sector—a joint sector—for the harmonious industrial development of the economy. The joint sector is envisaged as something in between the public and the private sector and in which the state could actively participate in management, control and decision-making. It is claimed that the joint sector scheme has the advantages of both the public and the private sectors and at the same time avoids the evils of both sectors, and thus, fulfils the basic socio-economic objectives of the country. Moreover, it offers an avenue of growth when all other gates to growth seem to have been closed. The concept of a joint sector is basically an extension of the idea of mixed economy in which the public and private sector units are separate and function independently, but are nevertheless part of a national plan. It is a compromise between total nationalization and complete private autonomy. In the joint sector, the relationship between the representatives of the private and public sectors is much closer as they have to work together within the same unit. The joint sector was recommended for units where a large proportion of the cost of a new project was to be met by public financial institutions either directly or through their support.

There are three different concepts of joint sector: First, financial institutions can exercise the right to convert debt into equity and appoint directors on company boards. Second, the government may appoint directors on company boards through the exercise of powers granted by the Monopolies and Restrictive Trade Practices Act to check malpractices. This need not involve share participation and must not be confused with the joint sector. The third form is the real joint sector where the

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government directly, or through its agencies, is a co-shareholder in an enterprise. The government, in this case, plays a promotional and entrepreneurial role and is an active majority partner.

**Features of the Joint Sector:** In a memorandum submitted to the government, JRD Tata suggested a slightly different definition of the joint sector. 'A joint sector enterprise is intended to be a form of partnership between the private sector and the Government in which the State participation of capital will not be less than 26 per cent, the day-to-day management will normally be in the hands of the private sector partner, and control and supervision will be exercised by a board of directors on which government is adequately represented'.

The Dutta Committee advocated conversion of some of the private sector units into joint sector enterprises as an important means of curbing the concentration of economic power in certain private groups. A number of new industrial projects had been established in the private sector with the help of funds provided by public financial institutions, but the latter had not asked for a voice in the management. It was strange that huge private industrial empires should be built with funds provided by public institutions without knowing how the money was actually spent. The Dutta Committee asked the government to enunciate a new industrial policy whereby this anomaly could be rectified.

There was a change in the industrial policy without there being a change in the 1956 Policy Resolution. The government announced the new industrial policy in February 1970. The joint sector concept as suggested by the Dutta Committee, was accepted in principle. It was laid down that while sanctioning loans or subscribing to debentures, public financial institutions should in future have the option to convert them into equity within a specified period of time. Specific guidelines had been laid down. In case the aggregate loans granted were below ₹ 25 lakh, the financial institutions are not to insert any convertibility clause in the agreement. If the loans granted were between ₹ 25 lakh and ₹ 50 lakh, it is optional for the financial institutions to insert a convertibility clause in the agreement. Once convertibility was agreed to, the undertaking is required to appoint representatives of the lending institutions as directors on company board.

It is not difficult to understand the logic behind the joint sector. As had been emphasized by the then Prime Minister, the old concepts of exclusive private ownership and private profit do not fit in with today's social values and priorities. An open society requires an open corporate structure; the joint sector provides this openness without taking away the advantages of private enterprise and initiative. The joint sector is a departure from exclusive private ownership, but it should be welcomed in preference to outright nationalization.

The joint sector experiment has been viewed with misgivings by many industrialists. It has been assailed as 'nationalisation by the backdoor'. But others have welcomed it on the ground that it is preferable to wholesale nationalization of existing private undertakings. There is one serious objection to the joint sector.

The concept is based on mutual trust and confidence, yet the idea originated because the private sector could not be trusted enough to grow on its own. Thus, conceived in mistrust, the marriage might be a disastrous failure.

The joint sector was evolved to check the concentration of economic power of private groups. But, some think it is not necessary to check the concentration of economic power as the existing Monopolies and Restrictive Trade Practices Act was adequate for the purpose.

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### 13.5 COOPERATIVE SECTORS

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The cooperative sector has emerged as an important sector in our economic environment. Cooperatives, inspired by the principle of self-help, are of great importance for the poor people of India. Cooperatives consist of persons of small means. Unable to face cut-throat market competition, these people get together and organize themselves into cooperatives. Thus poor individuals, through cooperatives, acquire strength to perform tasks which they would not be able to do otherwise.

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 registration of credit societies—was passed. Later in 1912, the Cooperative Societies Act also provided for registration of non-credit societies as well as federations of cooperatives. Since then the cooperative movement has made noticeable progress, especially in agricultural credit, marketing and processing of agricultural produce, supply of farm inputs and distribution of consumer goods. An idea of the growth of cooperative movement in India can be had from the fact that there were as many as 3.50 lakh cooperative societies of all types with the total membership of about 16 crores and total working capital of about ₹ 62,500 crore as on 30 June 1990. Another distinguishing feature of the cooperative scene is that it is largely village-based. The government's emphasis on institutionalization of distribution of inputs to farmers and marketing of their agricultural produce through cooperatives owned by them has helped in strengthening cooperative sector in the rural areas.

By June 1989, there were 93,000 Primary Agricultural Credit Societies operating in the rural areas. Membership of these societies comprised 9.20 crore persons. Cooperatives occupy an important place in the field of village and small industries and handloom weaving. As on 30 June 1989, there were 53,786 industrial cooperatives with a membership of 43.76 lakh. The National Federation of Industrial Cooperatives was set up in 1966 with a view to assisting the marketing of products of the member societies.

The total number of cooperative spinning mills installed was 10,948 in the growers' sector and 61 in the weavers' sector with a capacity of about 29.13 lakh spindles which was about 11 per cent of total spindlage in the country.

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Functional cooperatives for programmes like dairy, fishery and poultry mainly extended help to the weaker sections. As such cooperatives provide increased employment and income opportunities to different sections like small and marginal farmers and fishermen. The National Cooperative Development Corporation (NCDC) also gives financial assistance to various types of cooperatives.

Cooperative societies is a state subject under the Constitution. However, such cooperative societies having their objects not confined to one State, come under the jurisdiction of Central Government. The Multi-State Cooperative Societies Act, 1984 came into operation from 16 September 1985. At present, there are 182 Multi-State Cooperative Societies in the country.

A major development after Independence has been the emergence of the National Cooperative Federations which added a new dimension to the cooperative infrastructure. With the National Cooperative Union of India at the apex, other National Level Cooperative Federations established in the country are: National Agricultural Cooperative Marketing Federation, National Federation of State Cooperative Banks, National Federation of Cooperative Sugar Factories, National Cooperative Agriculture and Rural Development Banks' Federation, National Cooperative Consumers' Federation, National Federation of Industrial Cooperatives, All India Federation of Cooperative Spinning Mills, National Cooperative Housing Federation, National Cooperative Dairy Federation, National Federation of Urban Cooperative Banks and Credit Societies, National Federation of Fishermen's Cooperatives, National Federation of Labour Cooperatives and National Cooperative Tobacco Grower's Federation.

### Check Your Progress

3. State one concept of a joint sector.
4. Name any one National Level Cooperative Federation established in India.

## 13.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Public sector or public enterprises include all governmental activities including public, industrial and commercial enterprises.
2. The growth of public enterprises in India has taken place in two ways: (a) by nationalizing existing enterprises and (b) by starting new enterprises.
3. One concept of a joint sector is that financial institutions can exercise the right to convert debt into equity and appoint directors on company boards.
4. One National Level Cooperative Federation established in India is the National Cooperative Union of India.



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## 13.7 SUMMARY

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- Public sector or public enterprises include all governmental activities including public, industrial and commercial enterprises.
- Public enterprises are expected to be the principal agents for rapid economic and social transformation by developing infrastructure and the core sector and by closing the gaps in the industrial structure.
- In the Industrial Policy Statement of 1956, it was emphasized that public enterprise was designed to control the 'commanding heights' of the economy.
- But in recent years, the trends toward increasing liberalization are very much in evidence in India and one gets the impression that private sector is designed to play an important role in the economy in the coming era.
- It is pertinent to discuss the role and future of the private sector against the background of socialist pattern of society which is the declared objective of the government policy in India.
- In the private sector, the enterprise is owned by private person. In the sphere of private sector, there is the corporate sector with such organizations as public limited companies and private limited companies.
- The radical shift in government policy has brought the concept of the joint sector into sharp focus.
- Although the Joint Sector concept was conceived by the authors of the Industrial Policy Resolution, 1956 was really the brainchild of the Industrial Licensing Policy Enquiry Committee, popularly known as the Dutta Committee.
- The cooperative sector has emerged as an important sector in our economic environment. Cooperatives, inspired by the principle of self-help, are of great importance for the poor people of India.
- A major development after Independence has been the emergence of the National Cooperative Federations which added a new dimension to the cooperative infrastructure.

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## 13.8 KEY WORDS

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- **Nationalization:** It refers to the transfer of a major branch of industry or commerce from private to state ownership or control.
- **Entrepreneurship:** It is the activity of setting up a business or businesses, taking on financial risks in the hope of profit.
- **Socio-economic:** It is relating to or concerned with the interaction of social and economic factors.

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## 13.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

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### NOTES

#### Short-Answer Questions

1. Describe the concept of public-sector.
2. Write a short note on formation of public sector enterprises.

#### Long-Answer Questions

1. What forms a private sector? What are its divisions?
2. How do private sectors function in India?
3. Describe the concept of joint sectors. What led to the formation of joint sector enterprises?
4. Explain the emergence of the cooperative sector.

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## 13.10 FURTHER READINGS

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# UNIT 14 INDIAN ECONOMY AT A GLANCE

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## NOTES

### Structure

- 14.0 Introduction
- 14.1 Objectives
- 14.2 India as a Developing Economy
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- 14.4 Answers to Check Your Progress Questions
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## 14.0 INTRODUCTION

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With 1.2 billion people and the world's fifth-largest economy, India's recent growth and development has been one of the most significant achievements of our times. From independence till 1991, India followed a socialist pattern of economy. Since then, India has embraced globalization policies. Yet India remains a mixed economy.

This unit elaborates on the concept of mixed economy and discusses Indian economy in detail.

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## 14.1 OBJECTIVES

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

- Assess India as a developing economy
- Describe the characteristics of developing economy
- Explain emerging economy
- Discuss India as a mixed economy

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## 14.2 INDIA AS A DEVELOPING ECONOMY

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Over seven decades since Independence, the country has brought about a landmark agricultural revolution that has transformed the nation from chronic dependence on grain imports into a global agricultural powerhouse that is now a net exporter of food. Life expectancy has more than doubled, literacy rates have quadrupled, health conditions have improved, and a sizeable middle class has emerged. India

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is now home to globally recognized companies in pharmaceuticals and steel and information and space technologies, and a growing voice on the international stage that is more in keeping with its enormous size and potential.

Historic changes are unfolding, unleashing a host of new opportunities to forge a 21st century nation. India will soon have the largest and youngest workforce the world has ever seen. At the same time, the country is in the midst of a massive wave of urbanization as some 10 million people move to towns and cities each year in search of jobs and opportunity. It is the largest rural-urban migration of this century.

The historic changes unfolding have placed the country at a unique juncture. How India develops its significant human potential and lays down new models for the growth of its burgeoning towns and cities will largely determine the shape of the future for the country and its people in the years to come.

Massive investments will be needed to create the jobs, housing, and infrastructure to meet soaring aspirations and make towns and cities more livable and green. Generating growth that lifts all boats will be key, for more than 400 million of India's people—or one-third of the world's poor—still live in poverty. And, many of those who have recently escaped poverty (53 million people between 2005-10 alone) are still highly vulnerable to falling back into it. In fact, due to population growth, the absolute number of poor people in some of India's poorest states actually increased during the last decade.

Inequity in all dimensions, including region, caste and gender, will need to be addressed. Poverty rates in India's poorest states are three to four times higher than those in the more advanced states. While India's average annual per capita income was \$1,410 in 2011—placing it among the poorest of the world's middle-income countries—it was just \$436 in Uttar Pradesh (which has more people than Brazil) and only \$294 in Bihar, one of India's poorest states. Disadvantaged groups will need to be brought into the mainstream to reap the benefits of economic growth, and women—who 'hold up half the sky'—empowered to take their rightful place in the socioeconomic fabric of the country.

Fostering greater levels of education and skills will be critical to promote prosperity in a rapidly globalizing world. However, while primary education has largely been universalized, learning outcomes remain low. Less than 10 per cent of the working-age population has completed a secondary education, and too many secondary graduates do not have the knowledge and skills to compete in today's changing job market.

Improving health care will be equally important. Although India's health indicators have improved, maternal and child mortality rates remain high and, in some states, are comparable to those in the world's poorest countries. Of particular concern is the nutrition of India's children whose well-being will determine the extent of India's much-awaited demographic dividend; at present, an overwhelming 40 percent (217 million) of the world's malnourished children are in India.

The country's infrastructure needs are massive. One in three rural people lack access to an all-weather road, and only one in five national highways is four-lane. Ports and airports have inadequate capacity, and trains move very slowly. An estimated 300 million people are not connected to the national electrical grid, and those who are face frequent disruptions. And, the manufacturing sector—vital for job creation—remains small and underdeveloped.

Nonetheless, a number of India's states are pioneering bold new initiatives to tackle many of India's long-standing challenges and are making great strides towards inclusive growth. Their successes are leading the way forward for the rest of the country, indicating what can be achieved if the poorer states were to learn from their more prosperous counterparts.

India now has that rare window of opportunity to improve the quality of life for its 1.2 billion citizens and lay the foundations for a truly prosperous future—a future that will impact the country and its people for generations to come.

### **Characteristics of Developing Economies**

The term underdevelopment refers to that state of an economy where levels of living of masses are extremely low due to very low levels of per capita income resulting from low levels of productivity and high growth rates of population. According to the United Nations' definition, an underdeveloped country is one which has a real per capita income that is lower in relation to the real per capita income of the USA, Canada, Australia and Western Europe. This approach to underdevelopment highlights their potential for development and their capability to make better use of their resources to catch up with the more advanced countries.

### **Main Characteristics of Developing Economies**

Developing economies are those which have low per capita income, low quality of life, low level of living, high incidence of miseries, elongated period of demographic transition, (from high birth rate and high death rate regime to low birth rate and low death rate regime), high growth rate of population, low incidence of infrastructure location per square kilometre, high rates of sterile inflation, structural maladjustment of sectorial and regional development, high incidence of depressed ethnic groups, high debt burden, unfavourable terms of trade in international commerce and generally a corrupt and oppressive administrative-political system. The following are the main characteristics of developing economies:

#### **(i) Lower Per Capita Income**

Developing economies have lower per capita income as compared to developed economies. It is per capita income of a country which determines whether a country is rich or poor, i.e., developed or underdeveloped/developing. According to the World Bank estimates, in 2013 the average GNP per capita of the high-income economies was \$ 39,312 whereas it was \$ 664 in low income underdeveloped countries.

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**Table 14.1** Per Capita GNP in Some Developed and Developing Countries in the Year 2013

(in U.S. Dollars)

NOTES	Developed Economies	GNP Per Capita	Developing Economies	GNP Per Capita
	High Income Economies	39,312	Low Income Economies	664
			Medium Income Economies	4,721
	America	53,670	Brazil	11,690
	Japan	46,140	Malaysia	10,400
	Germany	46,100	China	6,560
	France	42,250	Thailand	5,370
	England	39,110	Indonesia	3,580
	Italy	34,400	India	1,570
	South Korea	25,920	Pakistan	1,380
	Greece	22,530	Bangladesh	900
			Ethiopia	470

Source: World Bank, *World Development Indicators 2014, Table 1.1.*

It is, however, pertinent to mention that all Third World countries are not equally underdeveloped in terms of GNP per capita, Algeria, Argentina, Brazil, Republic of Korea, Malaysia, Mexico, Turkey, Venezuela and Thailand are far more affluent than most of the South and East Asian countries such as India, Nepal, Pakistan, Bangladesh, Myanmar, and Indonesia. Depending upon the degree of underdevelopment, the development potentials in these countries differ significantly. Thus, one cannot deny that there are substantial income inequalities as among the developed and the underdeveloped countries and within the underdeveloped countries themselves.

**(ii) Low Rate of Capital Formation**

The insufficient amount of physical capital in existence is also a characteristic feature of all developing economies that they are often called simply ‘capital-poor’ economies. The existence of capital deficiency is reflected in two ways—first, the amount of capital per head available is low; and second, the current rate of capital formation is also low.

**(iii) Excessive Dependence on Agriculture**

In underdeveloped countries, however, two-thirds or more of the people live in rural areas and their main occupation is agriculture. There are four times as many people occupied in agriculture and allied activities in some underdeveloped countries

as there are in advanced countries. In low income countries like India, Kenya, Bangladesh and Vietnam, more than 60 per cent of the population is engaged in agriculture while the percentages for the United States, Canada, and West Germany are 2, 5 and 4 respectively. This heavy concentration in agriculture is a symptom of poverty. Agriculture, as the main occupation, is mostly unproductive. It is carried on in an old fashion with obsolete and out-dated methods of production. The average land holdings are as low as 1 to 3 hectares which usually support 10 to 15 people per hectare. As a result, the yield from land is precariously low and the peasants continue to live at a bare subsistence level.

This excessive dependence on agriculture is due to the fact that non-agricultural occupations have not grown at a rate commensurate with the increase in population owing, *inter alia*, to lack of sufficient investment outside agriculture.

#### **(iv) Demographic Features**

Underdeveloped/developing countries differ greatly in demographic position and trends. Diversity exists in the size, density, age-structure and the rate of growth of population. But there appears to be one common feature, a rapidly increasing population which adds to a substantial number to the total population every year. This rate has been rising still more in recent years, thanks to the advances in medical sciences which have greatly reduced the mortality rate due to epidemics and diseases. While the death-rate has thus fallen phenomenally, birth rate does not yet show such significant decline, so that the natural survival rate has become much larger. With their low per capita incomes and low rates of capital formation, it becomes difficult for such countries to support this additional number. And when output increases due to improved technology and capital formation, it is swallowed up by the living standards of the masses.

#### **(v) Unemployment and Disguised Unemployment**

The rapid rate of population growth throws more and more people on land to eke out their living from agriculture, since alternative occupations do not simultaneously develop at that rapid rate and thus are not there to absorb the increasing numbers seeking gainful employment. The resultant pressure of population on land thus gives rise to what has been called 'disguised unemployment'. It means that there are more persons engaged in agriculture than are actually needed so that the addition of such persons does not add to land's productivity; or putting it alternatively, given the technique and organization, even if some of the persons are withdrawn from land, no fall in production will follow from such development.

#### **(vi) Technological Backwardness**

In underdeveloped countries over a wide range of industrial activity, production techniques are backward. Often, lack of Research and Development (R&D) is blamed for the technological backwardness in these countries. Their technological backwardness is also reflected, first, in high average cost of production despite

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low money wages; second, in high labour-output and capital-output ratios as a rule, and on the average, given constant factor prices thus reflecting a generally low productivity of labour and capital; third, in the predominance of unskilled and untrained workers; and last, in the large amount of capital equipment required to produce a national output. Deficiency of capital hinders the process of scrapping off the old techniques and the installation of modern techniques. Illiteracy and the absence of skilled labour are the other major hurdles in the spread of techniques in the backward economy. Thus it may be pointed out that technological backwardness is not only the cause of economic backwardness but it is also the result of it.

### **(vii) Foreign Trade Orientation**

Underdeveloped economies are generally foreign trade-oriented. This orientation is reflected in exports of primary products and imports of consumer goods and machinery. The percentage share of fuels, minerals, metals, and other primary products in the merchandise exports of the majority of LDCs is normally high. This too much dependence on exports of primary products leads to serious repercussions on their economies. First, the economy concentrates mainly on the production of primary exports to the comparative neglect of the other sectors of the economy. Second, the economy becomes particularly susceptible to fluctuations in the international prices of the export commodities. A depression abroad brings down their demand and prices. As a result, the entire economy is adversely affected. Lastly, too much dependence on a few export commodities to the utter neglect of other consumption goods has made these economies highly on imports.

### **(viii) Under-Utilization of Natural Resources**

The natural resources in an underdeveloped economy are either unutilized or under-utilised. Generally speaking, underdeveloped countries are not deficient in land, water, minerals, forest or power resources though they may be yet untapped. In other words, these constitute only potential resources. The main problem in their case is that such resources have not been fully and properly utilized due to various difficulties, such as their inaccessibility, shortage of capital, primitive techniques, and the small extent of the market. The natural resources of India remain still largely underdeveloped. Vast Indian forest and mineral wealth remain unexplored. India has not been able to develop until recently more than 5 per cent of her water power potential.

### **(ix) Wide Income Inequalities**

Compared to developed countries, income inequalities are larger in underdeveloped countries. Data published in the *World Development Report 2014* suggest that income disparities are far greater in the less developed countries than in the developed countries. For example: If we compare the share of national income accruing to the poorest 10 per cent of a country's population with that of the richest 10 per cent as a rough measure of income inequalities, we note that a great



number of underdeveloped countries, For example: Kenya, Nigeria, Zambia, Colombo, Malaysia, Brazil, Mexico, Venezuela, Thailand and Argentina have considerable degree of income disparity, while developed industrial market economies such as Finland, Australia, Netherland, Sweden, Germany, France and Japan have relatively less inequalities.

### **(x) Dualistic Economy**

Almost all underdeveloped countries have a dualistic economy. One is the market economy; the other is the subsistence economy. One is in and near the towns; the other is in the rural areas. One is developed, the other is less developed. Centered in the towns, the market economy is ultra-modern with all the amenities of life, viz., the radio, the car, the bus, the train, the telephone, the picture house, the schools and colleges. The subsistence economy is backward and is mainly agriculture-oriented.

Dualism is also characterised by the existence of an advanced industrial system and an indigenous backward agricultural system. The industrial sector uses capital-intensive techniques and produces variety of capital goods and durable consumer goods. The rural sector is engaged in producing agricultural commodities with traditional techniques. Both perpetuate unemployment and disguised unemployment. There is also financial dualism consisting of the unorganised money market charging very high interest rates on loans and the unorganised money market with low interest rates and abundant credit facilities. This aggravates economic dualism between the traditional sector and the modern industrial sector.

### **14.2.1 India as an Emerging Economy**

India's economic advancement in the past 70 years is one of the most fascinating success stories. Faced with multiple woes, ranging from near absence of infrastructure to almost everything needed for economic enhancement, India's odyssey towards economic independence was dotted with challenges. It was the determination of our founding fathers who did not give up and build the country brick by brick. The concept of Five-Year-Plan was a great beginning in the right direction, with an emphasis on eradication of poverty and woes of farmers.

There were multiple problems which had crept into the system over the years in the system and the ease of doing business was never encouraging. Foreign reserves were never assuring, while the flow of foreign direct investments (FDI) was minimal. As a result, the demand for the opening up economy began gaining momentum when Rajiv Gandhi was the country's Prime Minister. Due to political turmoil there was not much happening till PV Narasimha Rao became the country's Prime Minister and he opened the gate for foreign investors by liberalising norms, thus beginning the era of economic liberalisation. The pace of foreign as well as domestic investment remained sluggish during 1996 to 1999 due to political instability and Kargil War.

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However, Indian economy bounced back post-Kargil War, thanks to the visionary leadership of the then Prime Minister Atal Bihari Vajpayee. In fact, the ‘feel good factor’ of liberalisation became explicit and the flow of investment and disinvestment of PSUs to fund major infrastructure projects including roads and power plants picked up momentum. Since then Indian economy has not looked back. In fact, even during the global economic crisis in 2008, Indian economy showed resurgence and maintained an upward growth rate, emerging as a bright spot for the world investors.

Now under the leadership of Prime Minister Narendra Modi, India has become the fastest growing economy in the world, leaving behind China. A series of reforms initiated by Prime Minister Modi has significantly increased the ease of doing business in the country. That is why India is today one of the most sought after investment destination of world’s leading firms.

Prime Minister Modi’s demonetisation decision has created a solid ground for the formalization of Indian economy. Indian economy has suffered a lot due to its over dependence on informal or unorganised sector, which could be a major source of employment but in the process end up causing huge losses to the economy by way of tax evasion and violation of labour laws, which have negative bearing on the final output of workforce. Similarly, the landmark Goods and Services Tax (GST) is all set to give a new boost to the country’s economy. It will have long term positive impact on investment and growth. According to the International Monetary Fund (IMF), “this tax reform and the elimination of targeted subsidies are needed to widen the revenue base and expand the fiscal envelope to support investment in infrastructure, education, and healthcare.”

Targeted Delivery of Financial and Other Subsidies (Benefits and Services) Act 2016, rationalisation of subsidies, enactment of Insolvency and Bankruptcy Code 2016 and operationalisation of National Company Law Tribunal (NCLT) and National Company Law Appellate Tribunal (NCLAT) for new corporate insolvency framework are some other measures which will add lot of resilience to the country’s economy.

The World Bank has predicted India’s growth at 7.7 per cent during 2017-18, which reinforces the fact that fundamentals of Indian economy remain quite strong and are capable of absorbing the aftershocks of policy ‘disruptions’. India has all the potential to grow at a much higher pace if the Centre takes care of industrial and manufacturing sectors. IMF too has underlined the need for removing long-standing structural bottlenecks so that market efficiency improves. Indian economy had grown at 7.6 per cent in 2015-16. According to the World Bank, India’s gross domestic product (GDP) could grow at 7.7 per cent in 2017, supported by “expectations of a rebound in agriculture, civil service pay reforms supporting consumption, increasingly positive contributions from exports and a recovery of private investment in the medium term.” India’s recent growth rate of more than 7 percent annually has been the strongest among G-20 countries.

The latest OECD Economic Survey of India 2017 finds that the acceleration of structural reforms and the move toward a rule-based macroeconomic policy framework are sustaining the country's longstanding rapid economic expansion. Liberalising norms for a wide range of FDIs will lead to a kind of surge in job and employment creation. Barring the small negative list, Prime Minister Modi has ensured that all sectors get FDIs through the automatic approval route. According to an estimate, net FDI inflows during April-December 2016-17 increased to US \$ 31.18 billion from US \$ 27.22 billion during the last corresponding period. India's foreign exchange reserves stood at US \$ 367.93 billion on March 24, 2017 with the current account deficit (CAD) at sustainable level of 1.3 percent and 1.1 percent in 2014-15 and 2015-16.

If we go by other economic indicators, there are many more things to cheer about.

As per the Economic Survey 2018, with Gross Domestic Product (GDP) growth averaging 7.5 per cent between 2014-15 and 2016-17, India can be rated as among the best performing economies in the world on this parameter. Although growth is expected to decline to 6.5 per cent in 2017-18, bringing the 4-year average to 7.3 per cent, the broad story of India's GDP growth to be significantly higher than most economies of the world does not alter. The growth is around 4 percentage points higher than global growth average of last 3 years and nearly 3 percentage points more than the average growth achieved by emerging market & developing economies (EMDE).

As per the Union Budget 2018-19, Government says that it is firmly on course to achieve high growth of 8% plus as manufacturing, services and exports are back on good growth path. While GDP growth at 6.3% in the second quarter of 2017-18 signalled turnaround of the economy, growth in the second half is likely to remain between 7.2% to 7.5%. The Union Minister for Finance and Corporate Affairs Shri Arun Jaitley while presenting the General Budget 2018-19 in Parliament today said that Indian society, polity and economy had shown remarkable resilience in adjusting with the structural reforms. IMF, in its latest Update, has forecast that India will grow at 7.4% next year in the backdrop of services resuming high growth rates of 8% plus, exports expected to grow at 15% in 2017-18 and manufacturing back on good growth path.

With an "ambitious government undertaking comprehensive reforms", India has "enormous growth potential" compared to other emerging economies, the World Bank said in Jan 2018, as it projected country's growth rate to 7.3 per cent in 2018 and 7.5 for the next two years.

India, despite initial setbacks from demonetisation and Goods and Services Tax (GST), is estimated to have grown at 6.7 per cent in 2017, according to the 2018 Global Economics Prospect released by the World Bank.

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### Check Your Progress

1. What does unemployment refer to?
2. What are developing economies?

## 14.3 INDIA AS A MIXED ECONOMY

The economy of India is said to be the twelfth largest in the world on the basis of market exchange rates. India's mixed economy is a blend of the features of a capitalist market economy as well as a socialist command economy. The public sector comprises areas which are either extremely important or not sufficiently profitable to be left to the market. Examples of such areas are the postal system and the railways. Post-independence, banks have undergone nationalization and of late, privatization also.

From the 1950s to the 1980s, India adopted socialism. It was characterized by public ownership, a lot of regulation and protectionism. All this put together, slowed down the pace of growth and even encouraged corruption.

After 1991, following liberalization, the Indian economy has become more market-based. This has definitely increased the pace of growth.

Approximately 60 per cent of the population is involved in agriculture, 28 per cent of the employment is seen in the service sector and approximately 21 per cent in the industrial sector. The country has a huge labour force with approximately half a billion workers; 17 per cent of GDP comes from the agricultural sector whereas the industrial and service sectors account for 29 per cent and 54 per cent respectively. India's main industries comprise chemicals, steel, food processing, textiles, transportation equipment, mining, cement, petroleum, machinery and IT-related software and services.

Post-independence, the country chose to operate as a planned economy. The attempt was to allocate the national resources in an effective and equitable manner and to bring about balanced economic development. The Planning Commission, with the Prime Minister as its head, is responsible for formulating and directing the Five-Year Plans.

### India as a Mixed Economy

Ours is a mixed economy in which both the public and the private enterprises would work side by side. It is a compromise between private capitalism and state socialism. Private enterprise is actuated by the profit motive which may be looked upon as an index of efficiency while public enterprise serves a social end. Therefore, we may say that a mixed economy is a combination of efficiency with social objective. The onus lies on the public sector to initiate development steps to accelerate the rate of economic growth. The private sector might, or might not, participate in such measures. However, it is the duty of the public sector to give

shape to the entire pattern of investments in the economy whether the investments are made directly or whether they are made by the private sector.

In a mixed economy, the private, public, joint sectors and the like, all have some say in the major decisions that influence the functioning of an economy.

In a mixed economy, the entire economic system is divided into three parts:

- (i) Sectors which are exclusively controlled and managed by the private enterprise subject to the general control and regulation by the State;
- (ii) Sectors which are exclusively controlled and managed by the State; and
- (iii) Sectors which are jointly managed and controlled by the state and private enterprise. The three systems are discussed hereunder:

**1. Private sector:** There is a vast private sector in India dealing with both production and distribution of goods and services. The private ownership has taken many forms—single proprietorship, partnership, joint stock companies and cooperatives. The private sector produces and distributes a major proportion of the total product of the country. This is quite clear from the fact that it contributes to the GDP to as much as 75 per cent. Almost the entire agriculture is in private hands. The private sector industries are based on self-interest and profit motive. Individual initiative is given full scope and the system of private property is respected. Individual freedom and competition are allowed to co-exist. At the same time, it is not free capitalism but controlled capitalism because free enterprise and profit motive are all controlled in the interest of society.

**2. Public sector:** The Industrial Policy Resolution of 1948 of the Government of India contemplated a mixed economy. There was a sphere reserved for private enterprise and another for public ownership. The government was of the opinion that the state could expand its economic activities thereby increasing its contribution to the national wealth. In the 1956 Industrial Policy, industries were categorized into three categories. The first category included industries whose future growth and development would be the sole responsibility of the state. There are seventeen industries in this category and all new units in these industries would be established by the state. The second category included industries that would be primarily owned by the state but the private sector may be permitted to supplement the effort of the state. There are twelve industries in this category that are less in importance than those in the first category. The third category included all the remaining industries and their future growth and development would, in general, be the responsibility of the private sector. However, the state would have the power to intervene in this category as well.

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**Check Your Progress**

3. What is the size of Indian economy?
4. Define mixed economy.

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**14.4 ANSWERS TO CHECK YOUR PROGRESS  
QUESTIONS**

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1. The term underdevelopment refers to that state of an economy where levels of living of masses are extremely low due to very low levels of per capita income resulting from low levels of productivity and high growth rates of population.
2. Developing economies have lower per capita income as compared to developed economies.
3. The economy of India is said to be the twelfth largest in the world on the basis of market exchange rates.
4. In a mixed economy, the private, public, joint sectors and the like, all have some say in the major decisions that influence the functioning of an economy.

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**14.5 SUMMARY**

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- Over the six and half decades since Independence, India has brought about a landmark agricultural revolution that has transformed the nation from chronic dependence on grain imports into a global agricultural powerhouse that is now a net exporter of food.
- The historic changes unfolding has placed the country at a unique juncture. How India develops its significant human potential and lays down new models for the growth of its burgeoning towns and cities will largely determine the shape of the future for the country and its people in the years to come.
- Fostering greater levels of education and skills will be critical to promote prosperity in a rapidly globalizing world.
- The country's infrastructure needs are massive. One in three rural people lack access to an all-weather road, and only one in five national highways is four-lane.
- The term underdevelopment refers to that state of an economy where levels of living of masses are extremely low due to very low levels of per capita income resulting from low levels of productivity and high growth rates of population.

- Developing economies have lower per capita income as compared to developed economies.
- According to Colin Clark and Kuznets, economic development consists in the progressive enlargement of the proportion of tertiary occupations.
- Almost all underdeveloped countries have a dualistic economy. One is the market economy; the other is the subsistence economy. One is in and near the towns; the other is in the rural areas.
- The concept of Five-Year-Plan was a great beginning in the right direction, with an emphasis on eradication of poverty and woes of farmers.
- The World Bank has predicted India's growth at 7.7 per cent during 2017-18, which reinforces the fact that fundamentals of Indian economy remain quite strong and are capable of absorbing the aftershocks of policy 'disruptions'.
- The latest OECD Economic Survey of India 2017 finds that the acceleration of structural reforms and the move toward a rule-based macroeconomic policy framework are sustaining the country's longstanding rapid economic expansion.
- The economy of India is said to be the twelfth largest in the world on the basis of market exchange rates. India's mixed economy is a blend of the features of a capitalist market economy as well as a socialist command economy.

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### 14.6 KEY WORDS

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- **Migration:** It is the movement by people from one place to another with the intentions of settling, permanently or temporarily in a new location.
- **Inequity:** It means lack of fairness or justice.
- **Capitalist:** It refers to a person who uses their wealth to invest in trade and industry for profit in accordance with the principles of capitalism.

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### 14.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

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#### Short-Answer Questions

1. Write a short note on low rate of capital formation in under-developed countries.
2. Differentiate between unemployment and disguised unemployment.
3. What is a dualistic economy?

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**Long-Answer Questions**

1. What are the main characteristics of developing economies? Discuss India as a developing economy.
2. Assess India as an emerging economy.
3. What do you understand by a mixed economy? How is India a mixed economy?

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**14.8 FURTHER READINGS**

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