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BACHELOR OF COMMERCE

BCOM 206

BUSINESS ENVIRONMENT

Guru Jambheshwar University of Science & Technology, Hisar – 125001

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Course: Business Environment	Author: Dr. Aparna Bhatia
Course Code: BCOM 206	Vetter: Prof. Pardeep Kumar Gupta
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1.0 LEARNING OBJECTIVES

After going through this lesson you should be able to know

- the concept of business
- the concept of business environment
- nature of business environment
- significance of business environment

1.1 INTRODUCTION

The dictionary meaning of 'business' suggests that business is an occupation or a trade involving buying and selling of goods for the purpose of earning profits. Business is a commercial and an economic activity with a profit motive. Obviously, loss making businesses do not sustain or survive. But with the progression of economy towards gloablisation, the traditional concept of business has undergone a sea-change. These days the concept, "business of a business is to do business only" has become outdated. Rather business has social responsibility of human welfare and public good. From being an economic institution, it has become a social institution with a mutual and interdependent association with the society.

Business is a vital institution of society. It supplies goods and services to the society, helps in generation of employment opportunities, gathers factors of production, remunerates the factors of production, offers better quality life and improved standard of living and hence contributes to the overall economic growth of a country. Hence, business plays a very important role in the society. The concept of business can better be explained with the help of following definition-

"Business refers to an enterprising entity or organization that carries out professional activities. They can be commercial, industrial, or others. For-profit business entities do business to earn a profit, while non-profit ones do it for a charitable mission. Business ownership includes partnerships, sole proprietorships, corporations, etc. Businesses can be small-scale or large-scale". (Economic Times, 20th February, 2023)

"A Business is nothing more than a person or group of persons properly organized to produce or distribute goods or services. The study of business is the study of activities involved in the production or distribution of goods and services-buying, selling, financing, personnel and the like".

A business is a "Complex field of commerce and industry in which goods and services are created and distributed in the hope of profit within a framework of laws and regulations". (K. Ashwathapa)

Since business involves complexity of operations hence it is very important to investigate and identify the various factors that affect business. There is multiplicity of factors and forces impacting a business. All these factors make 'environment' of business. Hence in order to understand business and its operations it is important to understand the environment of the business. Environment refers to all "external forces which have a bearing on the functioning of business".

Features of business

1	**Deals in goods and services**
2	**Economic activity**
3	**Creates form, place and time utilities**
4	**Dealing in 'Stock in trade'**
5	**Continuous and repetitive transactions**
6	**Profit Motive**
7	**Different from trade**
8	**Forms of business**
9	**Size of business**
10	**It includes Non- Profit Organizations**

1. **Deals in Goods and Services: G**oods and services are the major components of business. It is in fact the reason for the existence of the business. Different goods produced by a business may include consumers' goods or producer goods. Consumer goods are those that are meant for direct human consumption, such as wheat, clothes, shampoos etc. Producers' goods are the capital goods that help in the production and manufacturing of consumer goods, such as Plant and Machinery, tools and equipments etc. Services include facilities like banking, information services, consultancy services, insurance services and also includes public services like electricity, gas, water, transportation, warehousing, etc
2. **Economic activity:** Business is a commercial activity with an economic motive. It always involves exchange of goods and services for a consideration. If it is without consideration it is termed as charity and not business. Thus when goods and services are produced for personal consumption it is not business. Similarly, when goods are produced for the purpose of gifting it is not business. There must be exchange of value in terms of money or money's worth for a transaction to be called

business. For example, when a person teaches his or her own children at home it is a personal activity but when the same person teaches in a school or college for a consideration it is called business.

3. **Creation of form, time and place utilities:** Business results in creation of three types of utilities- form, time and place utilities. When there is conversion of raw material into finished product it is called form utility. When the goods are supplied at the required time by storing and preserving them appropriately, it is called time utilities and when the goods are transported from the place of production to the place of consumption it leads to creation of place utilities. Thus, business creates utilities for the society.
4. **Dealing in 'Stock in trade':** The transactions of a business must revolve around its stock in trade. This means that goods should be produced or purchased or sold for the purpose of resale and not self consumption. If a person buys a house and sells later it is a personal transaction but if a person is a dealer in real estate, it is his business.
5. **Continuous and repetitive transactions-** The goods dealt with in a business must be purchased and sold continuously and repetitively. If a person sells a car once at a profit, it is not business. Such transaction of dealing in cars should be a continuous and routine affair for the person to fall in the definition of business.
6. **Profit Motive:** "Business of a business is to do business". In simple words the primary purpose of any business is to earn more than the amount invested therein. No business can run in losses. It is a commercial and economic activity to gain and earn profits. If a businessman is not able to earn profits it cannot sustain in the long run and shall soon be closed.
7. **Different from trade-** The scope of business is much wider than trade. Trade simply refers to 'purchase and sale of goods' but business is wide enough to encompass all activities of production, transportation, distribution, storage etc. It also includes activities relating to financing, banking, insurance and other allied services. In the words of F.C. Hooper, "The whole complex field of commerce and industry, the basic industries, processing and manufacturing industries, the network of ancillary services : distribution, banking, insurance, transport and so on, which serve and inter-penetrate the world of business as a whole, are business activities."

8.Forms of business- A business can take up three forms- sole proprietorship, partnership and joint stock Company. When a business is run by a single individual with unlimited liability and limited capital, it is called sole proprietorship. When two or more people joins hands and agree to share the profits/ losses of a business is called partnership. When the money is raised from the public with limited liability of shareholders contributing towards it, it is called company form of organization.

9.Size of business- A business may be a small size, medium size or a large size business. In small businesses the number of employees is much less as compared to the large scale businesses. Small businesses usually operate in a single industry unlike a large business operating in multiple industries with diversified portfolios.

10. Business also includes Non-Profit Organizations- Business includes all organizations which are opened for the purpose of catering to the various needs and welfare of the society. This does not mean that these organizations do not earn profits but these organizations do not distribute their profits as dividend to its members. Examples of NPOs include clubs, charitable hospitals, public libraries etc.

Business does not operate in isolation. It is affected by multiple forces prevalent in environment. A business must constantly gauge these environmental forces and the impact of these forces that either favor or disfavor a business. A business needs to identify the opportunities and threats posed by the environmental factors and adapt accordingly for its sustenance and survival.

1.2 MEANING OF BUSINESS ENVIRONMENT

Business environment refers to the various factors in the internal and external environment of a business subject to which a business operates. It is "the aggregate of all forces, factors and institutions which are external to and beyond the control of an individual business enterprise but which exercise a significant influence on the functioning and growth of individual enterprises." But in the contemporary times, but for the external factors, internal factors also form the part of business environment. Some factors have a direct bearing on business activities relative to other which affect a business indirectly. But business environment in totality includes all components which affect a business and its effectiveness.

Definitions of Business Environment

Some of the definitions of business environment given by popular authors are as follows-

According to Bayard O. Wheeler -

Business environment refers to "the total of all things external to firms and industries which affect their organization and operation".

According to Arthur M. Weimer-

"Business environment encompasses the 'climate' or set of conditions, economic, social, political or institutional in which business operations are conducted". **According to Glueck and Jauch-**

"The environment includes factors outside the firm which can lead to opportunities for or threats to the firm. Although there are many factors, the most important of the sectors are socio-economic, technological, supplier, competitors, and government."

According to Barry M. Richman and Melvgn Copen-

"Environment consists of factors that are largely if not totally, external and beyond the control of individual enterprises and their managements. These are essentially the 'givers' within which firms and their management must operate in a specific country and they vary, often greatly, from country to country".

According to Keith Davis-

"Business environment is the aggregate of all conditions, events and influences that surround and affect the business."

From the above definitions it can be extracted that-

- Business environment encompasses both the external and internal factors of the environment.
- It also includes the influence of external factors as the social, cultural, economic, legal, political and international environment.
- It includes the influence of internal factors as customers, suppliers, shareholders, competitors etc with the business.

- The environment in which a business operates is highly dynamic and business has to continuously adjust and manage the same.
- The environmental forces affecting a business vary with place, region and country.

To conclude business interacts with its environment. It can neither escape it nor ignore it.

1.3 NATURE OF BUSINESS ENVIRONMENT

The nature of business environment is explained as follows-

1	**Dynamic**
2	**Unpredictable**
3	**Risky**
4	**Complex**
5	**Multi- faceted**
6	**Aggregate of internal and external factors**
7	**General and Specific factor**
8	**Consequential**
9	**Adaptability**
10	**Influence business effectiveness**

1. **Dynamic-** The nature of business environment is that it does not remain constant. It keeps on changing both at the micro level as well as at the macro level. There can be changes in customer taste, preferences and behavior. There can also be changes in the political and governmental factors. For instance many a times the government restrains or liberalizes its policies. There are unending technological changes in the current era. For instance' landline telephones have been replaced by mobiles, cable television is replaced by OTT (Over the Top) concept. Hence business has to keep monitoring such dynamic environment and reshape its strategies in order to compete and survive in the market.

2. **Unpredictable-** The environment is not only dynamic. It is unpredictable also. It cannot be assessed with certainty whether a particular change would be in favor of a business or against a business. For instance, change in fashion and taste of customers cannot be predicted with accuracy. Similarly, nobody could predict the government move of demonetization of Indian currency on Novemeber8, 2016. Hence the forces in the environment could be highly uncertain. Business should learn to adapt and counter them in their favor.
3. **Risky-** Certain changes in the environment could be risky for the business especially when a business does not have sufficient resources and expertise to manage the same. For instance, in the era of digitization a business must have strong IT facilities along with e-savvy manpower. In case of dearth of these modern resources and technology, the environment shall pose threats and risks to the business.
4. **Complex-** Understanding the forces of business environment is not a simple task. These forces do not act in isolation but have an interactive effect. For instance on one hand the central bank of country lowers bank rate in the country and on the other hand the government fixed quota for imports. Both the factors influence and restrict each other.
5. **Multi- faceted-** Business environment offer different threats and opportunities to different industries and businesses. For instance restricting the imports may be bad for a multinational company but it may be good for a domestic or an indigenous company. Similarly, adoption of LPG reforms in India in 1991 was in favor of private and foreign players in the market but it posed threat to the public companies. Hence, the same policy could favor one type of business and disfavor another business.
6. **Aggregate of internal and external factors-** Business environment does not include only the outside forces as the political, governmental or the economic forces. The environment is equally comprised of immediate components of the business like its customers, suppliers, investors, environmentalists, media, competitors etc.
7. **General and Specific factor-** There are some factors in the environment that affect all the businesses. These are referred to as the general factors. For instance inflation affects all the businesses. But there are certain factors which affect a particular business only. These are

referred to as the specific factors. For instance, change in technology and shift from 2G to 5G would largely have an impact on the telecommunication industry rather than the textile industry.

8. **Consequential-** Since business environment is dynamic and varies with time the current decisions taken have an effect in future. Hence, the past, present and future must be analyzed carefully before taking strategic decisions.
9. **Adaptability**- There is no escape from the forces of the environment. Largely these components are beyond the direct control of a business. Rather instead of opposing these factors, the business has to adapt itself in the light of changes in the environment.
10. **Influence business effectiveness**- At the end the components of business environment determine the success or failure of the business. These forces act like springboards that throw the unaccommodating firms out of the competitive market. For instance many companies had to withdraw their products from the market as Hindustan Motors had stopped the production of Ambassador.

1.4 SIGNIFICANCE OF BUSINESS ENVIRONMENT

Business operates in an environment. There is high dependence of business in the environment. In fact environment is the habitat of a business. It interacts, adjusts and grooms in its environment. Environment comprises of both the external as well as the internal factors. External factors are not in the control of a business, though it can manage the internal factors partially. Hence assessment of business environment if highly significant because of the following reasons-

1	**Identification of threats and opportunities**
2	**Conduct of SWOT analysis**
3	**Assessment of First mover VS late mover advantage**
4	**Enhanced adaptability to the environment**
5	**Helpful in meeting future challenges**
6	**Helpful in framing strategies**
7	**Monitoring dynamism in the environment**

8	Learning and up gradation

1. **Identification of threats and opportunities**- Once the business environment is scanned a firm is able to comprehend the threats and opportunities in the external environment. For instance, during the times of COVID pandemic businesses got ceased but there were some entrepreneurs who found an opportunity in pharmaceutical business, insurance business and even IT business. Many people started online business on retail, education, medicines etc. OTT platforms became the favored platform for Television viewers and Netflix, Amazon, Zee5, Hotstar etc. capitalized this business environment by tracing an opportunity out of the threatening environment.
2. **Conduct of SWOT analysis**- Scrutiny of the business environment helps firm to establish a fit between their strengths and weakness which are internal with the external opportunities and threats. A firm that is strong internally in terms of its resources, structure and culture finds an opportunity even out of the threats. For instance TATA group has acquired 100% stake in the debt-ridden Air India from the Government by winning the bid on 27th January 2022. Ratan Tata with his vision and the resources established the fit between external and internal environment to conquer the Indian skies.
3. **Assessment of First mover vs late mover advantage**- Business environment guides firms to be/ not to be the pioneer in the market. The first mover is able to grasp the larger share of the market, become the market leader and establish a brand name. But, the first mover also incurs huge cost, deals with the unpredictable market, risks resources and counters obstacles of the newness. Late movers capitalize on the familiarity generated by the first movers. They tend to incur less cost on introduction and inception of the product/ service. But late movers need to differentiate and compete with an already established firm with good reputation and goodwill. For instance, HP has been the pioneer in laptops and earned the advantage of first movers but DELL following HP grabs a substantial market share with its customized services. Airtel was the first mover to launch 4G while Vodafone followed it.
4. **Enhanced adaptability to the environment**- Business environment scanning helps firm to adapt to the dynamic environment. It helps in developing a proactive approach rather than a

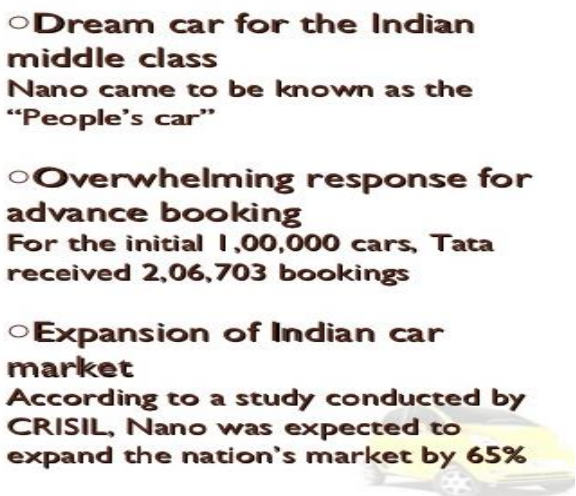
reactive one. It helps firms in foreseeing and developing a vision. There is less fear of change once the environment is assessed.

5. **Helpful in meeting future challenges-** Firms are able to foresee and create a roadmap for future challenges. For instance, Ministry of Corporate Affairs mandated expenditure on social activities under Companies Act, 2013 from 1st April, 2014. But assessing the statutory change companies in India started deploying money for social welfare prior to the mandatory date.
6. **Helpful in framing strategies-** A business is able to assess if it should go in for competitive strategies like low cost and differentiation or cooperative strategies like joint ventures, alliances and partnerships. For instance Cadbury India (Bournvita) and GlaxoSmithKline Consumer Healthcare Ltd and HUL (Horlicks) follow competitive strategies while Intel and HP follow cooperative strategies.
7. **Monitoring dynamism in the environment-** The environment is never stable or constant. Assessment of business environment helps firms to monitor the dynamism of the environment. There are changes in tastes and preferences of people. Technology is becoming obsolete very fast. Artificial intelligence is the buzzword of the modern world. Speed is the prominent factor of success. Hence analysis of business environment helps firms to capture these changes and adapt with the same.
8. **Learning and up gradation-** A firm is able to invest in research and development once it assesses the business environment. Innovation is the key to success these days. Consequently, firms go in for differentiation and novel ideas. For instance- Honda Activa launched a scooter with a button start, Samsonite gave wheels to heavy luggage, Relaince jio gave cheap and high-speed networking.

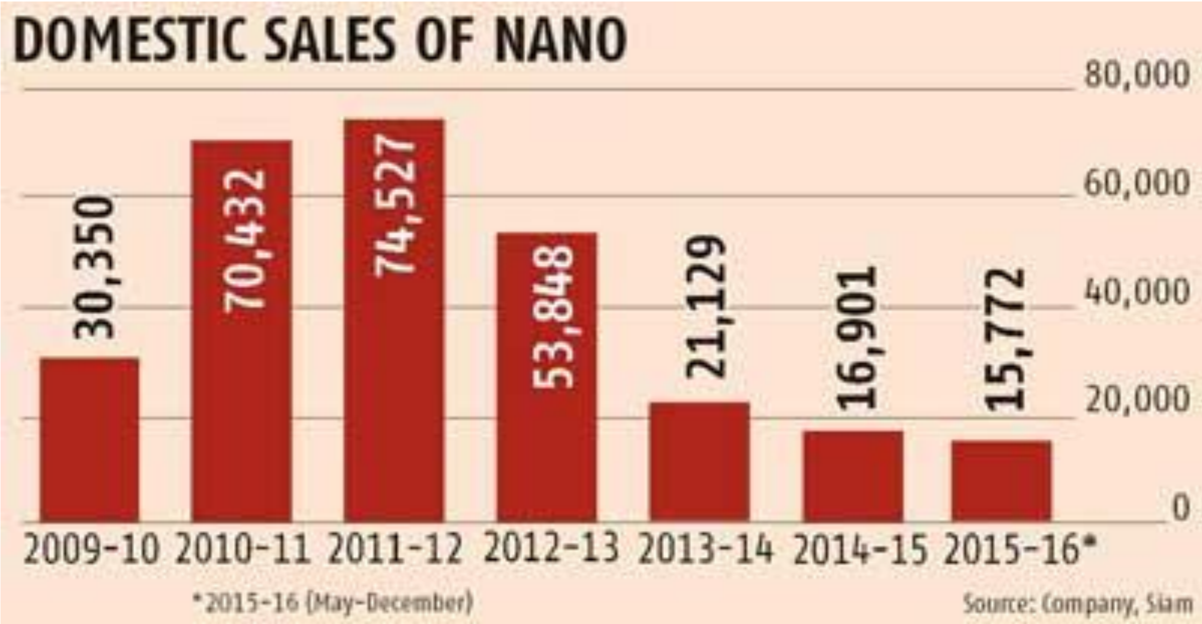
The internal as well as external environment must be gauged by the business in order to be successful in the market. Inaccuracy in gauging the environment results in failure. A recent case study published by Mukherjee, J. (2021). Tata Nano: Case of Repositioning: Case Analysis. Vikalpa, 46(3), 188–190 is given below which describes Tata Nano’s failure in the market due to incorrect assessment about the market environment.

INTRODUCTION

“This case tracks Tata Nano, one of the favourite projects of Ratan Tata, Chairman of the $100 Billion Tata Group of India. Conceptualized initially as the *people’s car* by Tata Motors, it was unveiled in the prestigious Delhi Auto Expo in 2008. It was the first ₹100,000 car globally, showcasing India’s design, manufacturing and technological ability. It was launched in 2009 to upgrade the aspirational middle-class two-wheeler customers to a safer transportation option of a car. The immediate response from the media and the market was tremendous, and the company collected advance deposits from interested customers.



Amid some media reports of engine fires, the initial sales spike ebbed quite rapidly. By 2010, it dropped significantly below the normal expectations of the company. In the next four years, the company made multiple attempts to address the product features and brand imagery to stem the declining sales. Such initiatives included redefining the target market, the value proposition, positioning and consumer communications. However, by 2015, the situation was even more challenging, and the management pondered on what all possibly went wrong and decided the way forward for Tata Nano.



EVOLUTION OF THE TATA NANO BRAND

Immediately after the launch, some analysts pointed to the perception of *cheap car* or *poor man's car* as a problem area for the Nano brand. In 2010, amid falling sales, the company attempted to correct this by a high decibel mass media campaign, portraying Nano as an aspirational car for the lower middle-class families, which offered 'comfort at an affordable price'.

The company deliberated and attempted to rework the product and brand to the elusive target audience. The top management articulated the company's challenges and realizations during their various media interviews. Karl Slym, Managing Director of Tata Motors, said, '[s]cooter drivers weren't attracted because others don't think I'm buying a car, they think I'm buying something between a two-wheeler and a car. Anyone who had a car didn't want to buy it, because it was supposed to be a two-wheeler replacement'. Ratan Tata commented, '[i]t became termed as the cheapest car by the public and, I am sorry to say, by ourselves, not by me, but the company when it was marketing it. I think that is unfortunate'. Despite persistent and significant efforts, the sales continued to decline steadily.

The most audacious attempt to revitalize the brand and target the vibrant youth of India was in the 2013 launch of Nano Twist. An improved model with electric power steering, alloy wheels, swanky interiors, spoilers with graphic designs was made available with multiple personalization kits. The price tag of ₹236,000 brought Nano closer to market leader Maruti's Alto 800, priced at ₹245,000. Its failure to boost sales almost relegated Nano to history books as a marketing failure in 2015.

MANAGERIAL INFERENCES THAT MAY BE DERIVED

In essence, the company was trying to make a car for the average family man who was a two-wheeler buyer. They were trying to solve their functional needs of a safer and more comfortable ride with an aspirational product category, which was beyond the customer's financial capability. Thus, the company wanted to offer something aspirational that was affordable at the same time. Therefore, the affordable, aspirational product was an inherent contradiction in Tata Nano's core value proposition to the target market. This contradiction possibly led to many compromises made in every stage of product development and marketing. The company, to its credit, accepted the challenge and worked relentlessly to come up with a viable product design, manufacturing it to meet the necessary specifications and continuously evolving its marketing programmes to win the acceptance of the market. The possible reasons for the failures are detailed in the following.

The Problem of the Target Market

Tata Group was in passenger cars and commercial vehicles for many decades. It had a good understanding of the transportation needs of the market. However, they had no direct experience of their initial target segment of two-wheeler customers. The basic assumption was that Tata Nano solved their functional need of safe transportation and aspiration of becoming a car owner, which was possibly correct. However, in practice, Nano was functionally a transportation solution, but the car for this customer segment had to meet their aspirational requirement. The idea of a cheap car doused the aspirational element of the Nano appeal completely. What is important to note that, for this customer, even ₹100,000 was still a very big price tag, which they could not afford to meet only their safe transportation need.

By 2015, the company had made many attempts to move away from this target segment and focused on the youth with a costlier, feature-packed offer. It is ample testimony that their initial choice of the target market was not working out. The problem was different now, which prevented acceptance in the redefined target market. The core product did not offer the required functional benefits, and the past brand image of ‘cheap car’ took the sheen away from the stylish and cool image which the brand desperately wanted to project.

The net takeaway would be that aspiration of a consumer is possibly not moderated by their current possession or financial constraints. When the two-wheeler consumer was considering buying an aspirational car, their expectation is not benchmarked against a two-wheeler but a car.

The Problem with the Product

The product brief would have given the details of the target consumer and their expectation based on their current product usage, along with a target price. Since this was meant to be a low priced product, the development team would have resorted to value engineering and focused on the product’s core benefits, delivering the basic product and some elements of the expected product. Consequently, Tata Nano initially lacked the features available in the augmented and potential product, which their intended consumers expected. Hence, the price was still quite high for the potential consumer compared to what they were using (two-wheeler); but the product was far lesser than what were their current references available in the market (four-wheelers). Thus, an expectation mismatch and Tata Nano possibly did not appeal to a sufficient number of two-wheeler owners.

The incidences of engine fires reported in the media did even more damage, possibly raising question marks on the core benefit and basic product of Tata Nano. More importantly, the fire was a serious safety concern, which was diametrically opposite of the safety being promised by a Tata Nano over the two-wheeler. Thus, the credibility of the main product proposition was at stake.

The Problem with Pricing

Nano offered better features than existing two-wheelers, while it offered a better price compared to other four-wheelers. Similarly, Nano offered lesser features than existing four-wheelers while offering higher prices than two-wheelers. In a high price, high involvement product category, this diluted the wow factor for the consumer. The consistently low sales figures indicated that the unbelievably low price point was not attractive enough to convince a large section of the target consumers to shell out their hard-earned ₹100,000.

Positioning Problem

Nano was a basic, economical car, which offered much better safety and comfort than a two-wheeler, at a price point, which the existing two-wheeler owners could arrange to possess their first car. Possibly, the broad thought behind the Tata Nano project was quite good. However, communicating it as a great offer to the two-wheeler consumers was a big challenge. From the consumer’s frame of reference, either the product was better than a two-wheeler. Still, it was significantly costlier, or Nano was a very basic car that was quite economical.

If they used a motorcycle or a scooter as a reference, the jump in price was steep; hence, Nano used cars’ reference price for comparison. This was consistent because the vehicle was an aspirational product for the target consumer. However, the challenge was that the comparison was with available cars in the market, which were costlier, but had features and benefits that were much better than what Nano offered. So the product was perceived as a poor man’s car, which completely diluted the very important aspirational appeal of Nano.

The company needed to incorporate the aspiration angle to the positioning, inducing the two-wheeler consumers to own a car. But these complicated things further and created undesirable confusion and doubt in the minds of the target segment. Thus, the positioning challenge was that Tata Nano had two contradictory reference points for consumers. The company could not reconcile the two contradictory positions. The attempts at repositioning, if at all, only ended up further muddling up the positioning.

CONCLUSION

Overall, the future of the Nano brand was in serious question. Neither the product met the aspirational needs of the target consumers nor the brand had a clear reference point to establish its value proposition. It is difficult to give up a project that had seen a significant investment in resources, and peoples hard work and emotions were involved. But, given the circumstances, that is possibly the best way forward for Tata Nano".

Source- Mukherjee, J. (2021). Tata Nano: Case of Repositioning: Case Analysis. *Vikalpa, 46*(3), 188–190.

1.5. CHECK YOUR PROGRESS

Choose the correct option-

1. Business Environment comprises of-

A. External forces of the environment

B. Internal forces of the environment

C. Both A and B

D. Neither A nor B

2. Business environment is usually-

A. Static

B. Safe

C. Predictable

D. Dynamic

3. ___________business environment is same for all firms.

A. General

B. Specific

C. Micro

D. All of the above

4. Specific environment is ____________ for different firms.

A. Same

B. Different

C. Constant

D. Safe

5. Scanning the business environment-

A. Builds vision

B. Helps to become the first mover

C. Frame strategies

D. All of the above

1.6. SUMMARY

Business does not operate in isolation. It is affected by multiple forces prevalent in environment. A business must constantly gauge these environmental forces and the impact of these forces that either favor or disfavor a business. A business needs to identify the opportunities and threats posed by the environmental factors and adapt accordingly for its sustenance and survival. Business environment refers to the various factors in the internal and external environment of a business subject to which a business operates. It is "the aggregate of all forces, factors and institutions which are external to and beyond the control of an individual business enterprise but which exercise a significant influence on the functioning and growth of individual enterprises." To sum up, "Business environment is the aggregate of all conditions, events and influences that surround and affect the business."

The nature of business environment is that it does not remain constant. It keeps on changing both at the micro level as well as at the micro level. The environment is not only dynamic. It is unpredictable also. It cannot be assessed with certainty whether a particular change would be in favor of a business or against a business. Certain changes in the environment could be risky for the business especially when a business does not have sufficient resources and expertise to manage the same. Understanding the forces of business environment is not a simple task. These forces do not act in isolation but have an interactive effect. Business environment offer different threats and opportunities to different industries and businesses. Business environment does not include only the outside forces as the political, governmental or the economic forces. The environment is equally comprised of immediate components of the business like its customers, suppliers, investors, environmentalists, media, competitors etc.

There are some factors in the environment that affect all the businesses. These are referred to as the general factors. But there are certain factors which affect a particular business only. These are referred to as the specific factors. There is no escape from the forces of the environment. At the end the components of business environment determine the success or failure of the business

Business environment helps in identification of threats and opportunities. Scrutiny of the business environment helps firm to establish a fit between their strengths and weakness which are internal with the external opportunities and threats. It helps in assessment of First mover VS late mover advantage. Business environment scanning helps firm to adapt to the dynamic environment. Firms are able to foresee and create a roadmap for future challenges. A business is able to assess if it should go in for competitive strategies like low cost and differentiation or cooperative strategies like joint ventures, alliances and partnerships. It helps in Identification of threats and opportunities. Scrutiny of the business environment helps firm to establish a fit between their strengths and weakness which are internal with the external opportunities and threats. Assessment of business environment helps firms to monitor the dynamism of the environment. A firm is able to invest in research and development once it assesses the business environment.

1.7. KEY WORDS

1. **Business Environment**- Business environment refers to the various factors in the internal and external environment of a business subject to which a business operates. It is "the aggregate of all forces, factors and institutions which are external to and beyond the control of an individual business enterprise but which exercise a significant influence on the functioning and growth of individual enterprises".
2. **OT**T- It refers to Over the Top Media Services which offers media services to the viewers via the internet. This has replaced the cable operators and bypassed even the broadcasters and satellite television providers.
3. **SWOT analysis**- SWOT is an acronym where S stands for Strengths, W for Weaknesses, O for Opportunities and T for Threats. Strengths and weaknesses are internal to the firm and within the control of a firm; while threats and opportunities are external and beyond the control of the

firm. Hence, SWOT analysis helps in establishing a fit between the strengths and weaknesses & threat and opportunities.

4. **First mover advantage**- This refers to the benefits that a company earns because it is the first to launch a product/ service in a market place. The benefit is in the shape of large market share, goodwill, reputation and brand name.
5. **General VS Specific environment**- The components of environment which affects all units in different industries in a similar manner form the general environment while the components of environment which affects different units in different industries in varied ways is referred to as the specific environment.

1.8. SELF ASSESSMENT TEST

1. Define Business Environment. Give its characteristics.
2. What is business environment? Discuss its need and significance.
3. Explain the nature of business environment.
4. How is assessment of business environment helpful in facing competition?
5. How is SWOT analysis related to scanning the business environment?
6. Write notes on-
   i. Concept of business environment
   ii. Features of business environment
   iii. Purpose of business environment

1.9. ANSWERS TO CHECK YOUR PROGRESS

1. Both A and B
2. Dynamic
3. General
4. Different
5. All of the above

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Course: Business Environment	Author: Dr. Aparna Bhatia
Course Code: BCOM 206	Vetter: Prof. Pardeep Kumar Gupta
LESSON: 02 Factors Affecting Business	

STRUCTURE:

2.0 Learning Objectives

2.1 Introduction

2.2 Types of Business Environment

2.3 Impact of environmental factors on business and strategic decisions

2.4 Check your progress

2.5 Summary

2.6 Keywords

2.7 Self- Assessment Test

2.8 Answers to check your progress

2.9 References/Suggested Readings

2.0. LEARNING OBJECTIVES

After going through this lesson, you should be able to know

- the components of business environment
- political, legal, socio-cultural, economic and global environment
- Impact of environmental factors on business and strategic decisions

2.1. INTRODUCTION

Business environment refers to the various factors in the internal and external environment of a business subject to which a business operates. It is “the aggregate of all forces, factors and institutions which are external to and beyond the control of an individual business enterprise but which exercise a significant influence on the functioning and growth of individual enterprises.” But in the contemporary times, but for the external factors, internal factors also form the part of business environment. Hence, business environment in totality includes all components which affect a business and its effectiveness.

The environment of a business is a massive and hefty terminology. Business is first and foremost affected by its resources, people, culture, values, and belief systems. It is also affected by its immediate environments in terms of its customers, suppliers, investors, the government, competitors and other stakeholders. Over viewing from a higher platform the business is influenced by the economic, social, cultural, political, legal and the global environment as well. Thus, there are multiplicity of components in the environment that affect the business and its strategic decision making.

2.2. TYPES OF BUSINESS ENVIRONMENT

The environment of business is split into Internal Environment and the External Environment. Internal Environment is that environment which is in control of the management. The components of internal environment can be modified and altered in the light of changes in the external environment. External environment is that environment which is beyond the control of the management. The components of internal environment need to be altered and modified in order to adjust with the dynamic external environment. The external environment is further categorized as the Micro Environment and the Macro Environment. Micro Environment is the company specific environment. It is the immediate environment which affects a particular company. The components of micro environment affect different companies differently. These usually include the customers, suppliers, intermediaries, competitors etc. The macro environment affects all firms in a general way. It is not company specific. These include the remote factors over which a company has no control. It comprises of the economic, political, legal, global environment etc.

The categorization of environment can be explained as follows-

TYPES OF BUSINESS ENVIRONMENT

Internal Environment	External Environment		
	Micro Environment	Macro Environment	
		Economic Environment	Non- Economic Environment
• Resources	• Customers	• Economic Systems	• Political and Legal Environment
• Structure	• Suppliers	• Economic Structure	• Social-Cultural Environment
• Culture	• Competitors	• Economic Policies	• Demographic Environment
	• Marketing intermediaries	• Economic Planning	• Technological Environment
	• Workers and trade union	• Other Economic Factors	• Natural Environment
	• Public		• Global Environment

Source- Author’s calculations

The types of business environment is discussed as follows-

Internal Environment

The factors of internal environment are firm specific. They are under the control of the management. These factors can be changed and altered by the management. They determine the strengths and weaknesses of a business. The internal factors are discussed as follows-

1. **Resources-** There are two types of resources: Tangible and Intangible.

Tangible assets are physical things, for instance Land, buildings, machinery, equipment and capital. These are physical resources which can easily be purchased from the market. These are important resources but these do not offer much competitive advantage in the long run as the rivals can soon acquire the identical assets.

Intangible assets are non- physical resources that can still be owned by the company. These include, brand reputation, trademarks, intellectual property etc. since these cannot be replicated these offer sustained competitive advantage to the company.

The resources must be heterogeneous, that is these must be different in different companies. The resources should be immobile, that is these do not move from company to company, for instance reputation cannot travel from one company to another.

2. **Structure**- Structure refers to the hierarchal arrangement of employees in an organization. It depicts the flow of authority and responsibility in an organization. There needs to be a strong fit between the strategy and structure. As the business grows and expands, the structure too becomes decentralized. Structure is of three types-
    A. Simple structure: It has no functional or product categories. It is a line structure. This is appropriate for small entrepreneur. Employees are generalists and not specialists. In terms of stage of development this is stage I of company.
    B. Functional structure: Business functions like marketing, finance, Human Resource etc. are introduced in this structure. Employees are specialists and not generalists. This is suitable for medium sized organization. This is stage II of the company.
    C. Divisional structure: A large corporation with many product lines in several related industries follows this structure. Employees tend to be functional specialists organized according to product/market divisions. This is stage III of the company.
3. **Culture**- Culture refers to the beliefs, expectations, and values learned shared by members of an organization. Such value system is transmitted from one generation of workers to the next generation. It reflects the mission the firm and gives sense of identity to the firm. It shapes the behavior of people. The culture includes dominant orientation of a company, like R&D at HP,

innovation at Google, product quality at BMW etc. The culture reflects the values of a company and is a very important component of firm's internal environment.

External Environment

The factors of external environment are not under the control of the management. These factors cannot be changed and altered by the management. They determine the threats and opportunities of a business. The external factors are further classified as Micro factors and Macro factors.

Micro Factors

These factors are present in the immediate environment of a company. These are more company specific. In the words of Phillip Kotler, "The micro environment consists of the factors in the company's immediate environment that affects the performance of the company. These include the suppliers, marketing intermediaries, competitors, customers and the public." The components of micro environment are explained as follows-

1. **Customers**- Customers are the kings of the market. Business rests on a satisfied customer. They are the ones who make or mar a business. Customers may include the retailers, wholesalers, industrialists, government etc. A business must assess the needs of its customer and satisfy the same to survive in the market.
2. **Suppliers-** These are the providers of raw material and other allied services. A business must have trusted suppliers in order to ensure smooth and continuous working of the business. Suppliers must give regular supplies. They should provide broken lots, offer good credit terms and provision for immediate supplies as well.
3. **Competitors**- Competitors also keep the businesses on tenterhooks. Money has opportunity cost and competitors bring substitutes in the market. Hence businesses must gauge the strategies of their competitors to maintain their market share.
4. **Marketing intermediaries**- These are the middlemen who help in marketing and selling and distribution activities and carry the goods till the ultimate consumer. These may include

marketing agencies, media firms, advertising agencies, transportation agencies etc. These also include the financial intermediaries as the financial institutions, banks, insurance companies and the stock market.

5. **Workers and trade unions**- The employees of the organization are the back bone of any organization. These are the animate resources that bring other inanimate resources into action. Hence, the business must keep its employees satisfied and motivated. They should be given both the financial and non-financial incentives. Similarly, unity amongst workers should be honored by the management. Trade unions should be respected and encouraged. Efforts should be made to have healthy union-management relations.
6. **Public**- In the words of Phillip Kotler, "Public is any group that has an actual or potential interest in or impact on a company's ability to achieve its objective". The remaining stakeholders as the media agencies, environmentalists, Non- Governmental Organizations (NGOs) are included in this category. These stakeholders are indirect customers as well as potential customers. Their interest must not be hampered by the business while conducting its operations.

Macro Factors

These factors are the remote factors and form the general environment of a company. These are the general factors affecting all organizations. These cannot be controlled by the management. In the words of Hill and Jones, "The macro environment consists of the broader economic, social, demographic, political, legal and technological setting within which the industry and the company are placed." Elbing defines it as, "the indirect action environment as it may not have an immediate direct effect on the operations but nevertheless have influence". The components of macro environment are explained as follows-

I. Economic Environment-

Economic environment refers to all the economic forces that affect the operations of a business working in that environment. It includes several factors as the systems of an economy, its taxation policies, demand and supply equilibriums, conditions of business cycles, inflation, banking and monetary policy etc. The components of economic environment are explained as follows-

1. **Economic Systems-** An economic system is a "means by which societies or governments organize and distribute available resources, services, and goods across a geographic region or country. Economic systems regulate the factors of production, including land, capital, labor, and physical resources. An economic system encompasses many institutions, agencies, entities, decision-making processes, and patterns of consumption that comprise the economic structure of a given community". The type of economic system in an economy influences the working of business. An economy may have three types of economic systems-

i. **Capitalist economy**- In a capitalist economy there is least interference by the Government. The production is controlled and owned by private individuals for the purpose of earning profits. The products are allocated among people on the basis of their purchasing power. What they require is not important but what they can purchase is the criteria of production and distribution under a capitalist economy. In brief the forces of demand and supply dominate the consumption and distribution. For instance, as in USA and UK.

ii. **Socialist economy**- In a socialist economy the Government controls and manages the production and distribution of the goods and service in an economy. It is believed that Government best knows the needs of the people. This system is based on the needs of people and not what people can buy. For instance, as in Denmark, New Zealand.

iii. **Mixed economy** – It has features of both the capitalist and the socialist economy. Here means of production are controlled both by the state as well as the private players. The central planning in the country and the demand and supply forces both have a role in a mixed economy. For instance, as in India.

The differences between the three economic systems are explained in the following Table1.

Table 1- Differences between Capitalist, Socialist and Mixed Economy

Parameters	Capitalist economy	Socialist economy	Mixed economy
Ownership of property	Private ownership	Public ownership	Both public and private ownerships
Price determination	Prices are determined by the market forces of demand and supply.	Prices are determined by the central planning authority.	Prices are determined by the central planning authority, and demand and supply.
Motive of production	Profit motive	Social welfare	Profit motive in the private sector and welfare motive in the public sector
Role of government	No role	Complete role	Full role in the public sector and limited role in the private sector
Competition	Exists	No competition	Exists only in the private sector
Distribution of income	Very unequal	Quite equal	Considerable inequalities exist

Source- byjus.com

2. **Economic Sectors**- An economy is divided into four sectors namely, the Primary, Secondary, Tertiary Sector and the Quaternary Sector .

Sectors of the Economy	
Primary (raw materials)	Extraction of raw materials
	Farming/fishing
Secondary (finished goods)	Manufacturing
	Utilities - electricity, gas
	Construction
Tertiary (service sector)	Retail
	Financial services
	Communication
	Hospitality and leisure
	Real estate
	Information technology
Quaternary	Education
	Public sector
	Research and development

Source-economichelp.org

There is interdependence among the three sectors which makes the economy run smoothly. Material is gathered by the Primary Sector which is manufactured in the Secondary Sector and distributed by the Tertiary Sector. The quaternary sector is the intellectual sector of the economy. It includes education, research and development, technological up gradation etc. It enables the entrepreneurs to innovate better manufacturing processes and improve the quality of services offered in the economy. As the economy progresses the role of subsequent sectors become more relevant and prominent.

3. **Economic Policies**- The success of any economic system is affected by the economic policies in a country. These include the fiscal policy, foreign exchange policy, EXIM policy, monetary policy etc. Every business operates within the framework of the economic policies prevailing in the country. These policies are explained as follows-

   i. Fiscal policy- This is the taxation policy of the country. This deals with the receipts and expenditures of the government. It helps the Government to achieve socio-economic objectives and redistribute the resources from the rich to the poor. Fiscal policy plays a major role in allocation of resources across various regions, sector and industries. Government also gives various tax incentives to encourage the growth of certain businesses and also renders disincentives for certain sectors.

   ii. Monetary Policy- This policy helps the Government to control money supply in the country. Through this policy the Government ensures credit circulation in the economy, controls inflation and also generates employment. The various tools used by the government include the Cash Reserve Ratio, the Statutory Liquidity Ratio, the Bank rate, Open Market Operations, Repo rate and the Reverse Repo Rate etc.

   iii. Industrial Policy- It defines the scope and role of various sectors in an economy like the Private Sector, Public Sector and the Joint Sector. It also portrays guidelines for the large, medium, small and the tiny industries. It helps government to evaluate the progress of manufacturing sector that influence the economic development of a country.

iv. **EXIM Policy**- This is the export-import policy of the country. It issues guidelines and regulations for the exports and imports in an economy.The main focus of the government is to encourage exports. The EXIM policy influences the economic development in a country. The exports generate foreign exchange in the economy which is used for poverty alleviation etc. Countries receive foreign investment. There is expansion of market and increase in the national income of the country. Consequently it brings price stability, generates employment, removes monopolies and leads to growth of an economy.

v. **Foreign Exchange Policy**- The foreign exchange policy defines the exchange rates which correct the Balance of Payment disequilibrium in an economy. It then regulates the foreign exchange market and influences exports, imports, investments and the stock markets which have an effect on the economic development of a country as a whole.

4. **Economic Planning**- "Economic Planning is essentially a way of organizing and utilizing resources to maximum advantage in terms of social ends." Following are the features of economic planning-

i. **It involves economic organization-** it consists of activities related to production, consumption, distribution, exchange, and finance in order to achieve economic and social goals.

ii. **Ascertainment of priorities-** Various economic and social target are defined in the process of economic planning and target are set for the achievement of these.

iii. **Central Planning**- There is a central planning authority that undertakes various activities of economic planning. This authority is known as the planning commission. All the decisions are taken by this authority.

iv. **Certain Period**- The process of economic planning used to be for 5 years under the Five Year Plan. The last 5year plan was the 12th Plan from 2012-17. Now this has been replaced by NITI Aayog in 2015. The NITI AAYOG has three documents- 3 year Action Agenda, 7 Year Medium Term Strategy Paper and 15 Year Vision Document.

5. **Other Economic Factors**- Other economic factors include

Infrastructural facilities in the economy,

Power and communication facilities,

Money and Capital Market,

Development level of Banks, Insurance and other financial services

Prime interest rates

Per capita income

Inflation rates

Trends in the growth of the gross national product

Unemployment rates

Globalization of the economy

Outsourcing

Unemployment levels

Membership of associations as EU, WTO

Monetary policy

Free Trade Agreements, fixation of quotas etc.

II. Political and Legal Environment- Political and Legal environment refers to the "influence of the Government, the law and the regulatory system on business environment. Legal factors go hand in hand with the political factors." The political system runs with three bodies-

- the Legislature- this body makes the laws. The Parliament frames various laws, rules and regulations.
- the Executive – this body get the laws implemented. The Government is the executor.
- the Judiciary- this body sees if the law is broken. It ensures that the legislature and the executive functions within the boundaries of the constitution.

Various components of political environment include the following-

i. **Political ideology**- This refers to the vision of the parties and the government towards the accomplishment of social and economic objectives.

ii. **Political stability**- This refers to the fact that the Government should remain stable for a substantial period of time. Stability depends on the election system, law and order situation, terrorism and civil wars etc. India's political stability has fairly improved over years as shown in the following figure-

India	Political stability index (-2.5 weak; 2.5 strong)
Latest value	-0.62
Reference	2021
Measure	points
Source	The World Bank

Source- theglobaleconomy.com

iii. **Image of a country**- The image of a country is a very important component of political environment. Recently India has been given the Presidency of G 20 Summit. This is going to have a strong positive impact on the business environment in India.

iv. **Relations with neighboring countries**- A country should have good relations with its neighboring countries. Countries have interdependence on each other in terms of resources and expertise. For instance, inspite of the disturbances between Russia and Ukraine, India has good relations with Russia who is the major oil exported for India currently.

Legal environment of a country is derived from its political environment in the form of various laws as follows-

The Companies Act, 2013

Consumer Protection Laws

Antitrust Laws

Environment protection laws

Global warming legislation

Immigration laws

Tax Programs

Foreign trade regulations

Minimum Wage Legislation

Pollution and Pricing Policies

III. **Social-Cultural Environment-** Social and Cultural factors refer to the value and belief systems, attitudes and opinion and lifestyles of the population of a country. These are developed over years from Cultural conditioning, Ethnic conditioning, Ecological conditioning, Demographic makeup, Religion, Education etc. A change in society brings a change in business environment. For instance, working women concept brought in the concept of micro waves, day care centers, ready to eat foods etc., Late time working cultures developed chains like Café Coffee Day (CCD), High birth control rates has affected the business of baby product companies, High life expectancy has increased the demand for pension schemes, life insurance policies, health insurance and medical insurance schemes etc. Socio- cultural change includes the following-

- Life style changes
- Career expectations
- Consumer activism
- Rate of family formation
- Growth rate of population
- Age distribution of population
- Regional shifts of population
- Life expectancy
- Birth rates
- Pension plans
- Health care
- Level of education

IV. Demographic Environment-This refers to the characteristics of population of an economy. The demographics affect the demand pattern in the economy. For instance if size of old population is large there shall be more demand for insurance policies, old age homes, medicines, hospitals etc. It includes the following-

Size of population

Growth rate of population

Age

Income levels

Gender ratio

Literacy rates

Life expectancy

Mortality rates

Rural-urban distribution of population

V. Technological Environment- In order to avoid obsolescence and bring innovation, a firm must be aware of technological changes that might influence its industry. Technological innovations lead to –

1. New product development
2. Improvement in the existing product
3. Improvement in manufacturing and marketing techniques.

Technological forecasting should be undertaken in order to develop technological vision. For instance, move towards digitization and e-commerce. Technological factors may include the following-

Computerization, digitization, nanotechnology, biotechnology etc.

Portable information devices and electronic networking (computer+ internet; Telephone +Television)

Alternative energy sources (wind, hydro electric, solar biomass etc.)

Virtual personal assistants

Genetically altered organism

Smart mobile robots

Precision farming

VI. **Natural Environment-** Natural Environment refers to the physical environment and provides resources to the business. Natural environment includes the following-

Natural resources

Climatic conditions

Plant locations

Transportation facilities

Pollution

All businesses depend upon the natural environment for instance, Textile industry is dependent on agriculture, Mining industry depends on natural deposits, Oil industry depends on oil reservoirs etc. The launch of innovative products as lead free paints, filtered cigarettes, recyclable cars/mobiles etc are few examples that suggest that businesses are developing consideration for the natural environment.

VII. **Global Environment-** LPG reforms, that is, Liberalization, Privatization and Globalization has made the environment global. The world has become a small village with high interaction and dependence of countries on one another. It has rightly been said that "when USA sneezes, India catches cold", thereby suggesting the mutual association amongst countries. Global environment includes the following factors-

Economic conditions around the world

International financial systems

International treaties and trade agreements

International laws

International taxation

International wars and other disturbances

Widespread of multinationals

2.3. IMPACT OF ENVIRONMENTAL FACTORS ON BUSINESS AND STRATEGIC DECISIONS

Environmental factors impact the operations of businesses and their strategic decisions in the following ways-

1. **Environmental Factors bring innovation in business**- Any change in the dynamic environment demands innovation from the business. Changed environment paves way for new product development. For instance, Amalgmated Bean Company Ltd (ABC Ltd.) a coffee manufacturing company went in for forward integration and opened chains of Café Coffee Day (CCD) due to cultural change of excursions and entertainments among youth.
2. **Environmental factors have made businesses go virtual**- It is an era of digitization and automation. In earlier times businesses used to focus on the selection of most appropriate location and site for the establishment of their retail stores. But with the technological as well as the demographical changes in the population of the country, businesses have replace the brick and mortar concept and shifted to virtual platforms. Amazon, Flipkart, Myntra are the various online business stalwarts. The COVID pandemic too forced businesses to go online. Even a sphere like education and medical profession opted for virtual platforms to counter the adversities of the pandemic.
3. **Environmental factors shape the mission and vision of companies**- Mission refers to the unique purpose for which the business exists. Forces of the environment motivate companies to become distinct and unique and come up with differentiated products. For instance mission of Uniliver Ltd. is , "To add vitality to life. We meet everyday needs for nutrition, hygiene, and personal care with brands that help people feel good, look good and get more of life". Resultantly the company has developed wide range of cosmetics, toiletries, home care and health care products. A vision is a "clear, comprehensive 'photograph' of an organization at some point in the future. It provides direction because it describes what the organization needs to be like, to be successful within the future". Environmental forces give roadmaps of future to

companies. Vison of Uniliver Ltd. states that, "Uniliver is unique with a proud history and a bright future. We have ambitious plans for sustainable growth and an intense sense of social purpose".

4. **Environmental forces bring structural changes in the business**- A business beings its journey from a sole proprietary firm and becomes a partnership firm and then a joint stock company. Environmental forces help business to grow and expand. Amazon began its journey as an online library and is now a multi-product company.
5. **Environmental forces help in defining marketing strategies**- Over a period of time marketing strategies have undergone a change. Companies have taken the help of social media to market their product. Advertising models are taking the place of door to door and personal selling. So it is not only production that requires innovation even the system of marketing demands new techniques.
6. **Environmental forces help to undertake SWOT analysis**- In the light of the environmental factors business is able to identify its strengths and weaknesses vis a vis the threats and opportunities offered by the market. For instance, a change in government policy, taxation structure, budget announcement etc may have either positive or negative impact on a business. Business should look for its strengths to counter the macro environment and emerge as a winner in the market.
7. **Decision regarding closure of business**- Environmental scanning can also suggest divestment strategies to a business. Forces can indicate that particular product lines should be given up or the business should be closed. If the forces in the environment seem hostile to a business and it is not able to adjust or manage itself against the competitive forces as hostile government policies, cut throat competition at the national and international level, unattractiveness in a particular industry etc. it can take the decision of quitting the business.
8. **Choice of business level strategies**- Environmental forces guides management to take up either competitive strategies or cooperative strategies. Competitive strategies include cost leadership and differentiation strategies while cooperative strategies include strategic alliances, partnerships, mutual consortiums and joint ventures. Depending upon the availability of

resources, skills and capabilities business can opt for such strategies in the light of environmental factors.

Poor assessment of micro and macro environmental factors result in strategic blunders

The case of Xerox versus Apple makes it evident that how poor assessment of environmental factors can lead to bad strategic decision making as happened with Xerox Corporation Ltd.

Xerox Corporation Ltd. is an American multinational document management corporation that produces and sells a range of color and black-and-white printers, multifunction systems, photocopiers, digital production printing presses, and related consulting services and supplies. Researchers at Xerox and its Palo Alto Research Center (PARC) invented several important elements of personal computing, such as the desktop metaphor GUI, the computer mouse and desktop computing.

In early 1970s Xerox developed world changing computer technology including the mouse and the graphical user interface. One of the devices was called XEROX ALTO, a desktop personal computer that XEROX never bothered to market.

A decade later, several Apple employees including Steve Jobs, visited Xerox PARC Research Center. They proposed to exchange Xerox Alto in exchange of $1 million in Apples privately held stock. In 2008 Apples stock was $3.5 billion and Xerox Alto helped Apple build a company worth $110 billion in 2008. The features were taken on by Apple and, later, Microsoft In late 1980s Xerox sued apple for using their technology, but the case was dismissed.

Size of blunder = $110 - $3.5 = $106.5 Billions

(Reported in Forbes March, 2008 in “The 10 Biggest Blunders ever in Business)

2.4. CHECK YOUR PROGRESS

Choose the correct option-

1. Which of the following is not included in internal environment-
    a) Culture
    b) Inflation
    c) Physical assets
    d) Goodwill
2. Which of the following component is included in micro environment-
    a) Media agency
    b) Supplier
    c) NGO
    d) All of the above
3. Which of the following is included in macro environment-
    a) Tangible assets
    b) Bank rates
    c) Employees
    d) None of the above
4. Demonetization in the country is part of-
    a) Social Environment
    b) Cultural Environment
    c) Political/legal Environment
    d) Global Environment
5. High literacy in the country is a part of-
    a) Demographic Environment
    b) Political/legal Environment
    c) Global Environment
    d) Economic Environment

2.5. SUMMARY

Business environment refers to the various factors in the internal and external environment of a business subject to which a business operates. It is “the aggregate of all forces, factors and institutions which are external to and beyond the control of an individual business enterprise but which exercise a significant influence on the functioning and growth of individual enterprises.” But in the contemporary times, but for the external factors, internal factors also form the part of business environment. Hence, business environment in totality includes all components which affect a business and its effectiveness.

The environment of business is split into Internal Environment and the External Environment. Internal Environment is that environment which is in control of the management. The components of internal environment can be modified and altered in the light of changes in the external environment. These include the resources, structure and culture of a company. External environment is that environment which is beyond the control of the management. The components of internal environment need to be altered and modified in order to adjust with the dynamic external environment. The external environment is further categorized as the Micro Environment and the Macro Environment. Micro Environment is the company specific environment. It is the immediate environment which affects a particular company. The components of micro environment affect different companies differently. These usually include the customers, suppliers, intermediaries, competitors etc. The macro environment affects all firms in a general way. It is not company specific. These include the remote factors over which a company has no control. It comprises of the economic, political, legal, socio-cultural and the global environment.

Assessing the environmental forces is very important for business. it influences various strategic decisions of firm. Environmental factors bring innovation in business. These help businesses go virtual, shape the mission and vision of companies, help in bringing structural changes in the business, defining marketing strategies, undertake SWOT analysis, deciding about closure of business and choosing the right business level strategies.

2.6. KEY WORDS

Business Environment- Business environment refers to the various factors in the internal and external environment of a business subject to which a business operates.

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Indirect Action Environment- This refers to the macro environment. "It may not have an immediate direct effect on the operations of a business but nevertheless have influence".

2.7. SELF ASSESSMENT TEST

1. Define Business Environment. Explain the components of business environment.
2. Discuss in detail the factors affecting a business.
3. Explain the types of environment in which a business operates.
4. What is internal environment? What are its components? How do these influence business decisions?

5. What is external environment? What are its components? How do these influence business decisions?
6. Differentiate between micro and macro environment affecting business?
7. What is the impact of environmental forces on strategic decisions of a business.
8. Write notes on-
   - iv. Internal versus external environment
   - v. Economic environment of a business
   - vi. Socio-Cultural environment of a business
   - vii. Global environment of a business

2.8. ANSWERS TO CHECK YOUR PROGRESS

1. Inflation
2. All of the above
3. Bank rate
4. Political/legal environment
5. Demographic Environment

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Course: Business Environment	Author: Dr. Aparna Bhatia
Course Code: BCOM 206	Vetter: Prof. Pardeep Kumar Gupta
LESSON: 03	
Globalization of Business Environment	

Structure:

3.0. LEARNING OBJECTIVES

After going through this lesson you should be able to know

- the concept and phenomenon of globalization
- The rationale of globalization.
- Factors that motivate firms to opt for the strategy of globalization.

- Different channels and modes of international entry.
- Some prerequisites that need to be satisfied for going global

3.1. INTRODUCTION AND MEANING OF GLOBALIZATION

Since times immemorial countries have been trading with each other. India had trade relations with European countries since decades. But today the quantum and volume of trade has increased manifold and hence the relevance of the topic 'globalization' has increased. The phenomenon of globalization picked greater momentum after the liberation of Indian economy in 1991 when foreign and private players were allowed to enter the Indian market. Since then there has been no looking back. The number of multinational corporations entering India and Indian multinationals transiting abroad are showing skyrocketing figures.

In fact in the contemporary times countries cannot think of a non-globalized world. There is high interdependence of resources, skills, knowledge and markets. Global market has become a network of countries with every country connected to the other country. The influx of technology has even expedited the phenomenon. With a click of mouse foreign markets can be accessed; money can be invested in foreign stock exchanges, currency can be transferred in foreign banks, virtual meetings can be conducted at a single platform with members from several countries.

Globalization offers many advantages to the developing nations. It has brought in foreign investment and boosted the economic growth of emerging nations. Globalization has given access to new technologies, innovations and superior ideas and expertise. Globalization has generated employment in countries. It has increased the per capital income of people. It has given access to international markets which were in fact untapped earlier. But on the gloomy side, globalization has introduced unhealthy competition amongst nations. It has resulted in disproportionate economic growth. Globalization has even raised many environmental and sustainability concerns.

Globalization refers to the development of extensive worldwide patterns of economic relationships between the nations. It is the process of "integration of economic, cultural, political and social systems across geographical boundaries throughout the world". It refers to the "increasing assimilation of economies around the world through trade and financial flows". It is described by "the growing interdependence of the world's economies, cultures, and populations, brought about by cross-border trade in goods and services, technology, and flows of investment, people, and information". 'International trade' and 'Internationalization' are used as synonyms for globalization. To sum up, "Globalization refers to the spread of the flow of financial products, goods, technology, information, and jobs across national borders and cultures. In economic terms, it describes an interdependence of nations around the globe fostered through free trade". The modern world has common problems in terms of population explosion, pollution, civil wars and terrorism etc. The phenomenon of globalization has given a global perspective to these problems.

Definitions of Globalization

Some of the definitions of globalization given by popular authors are as follows-

According to International Monetary Fund-

Globalization refers to "the growing economic interdependence of countries worldwide through increasing volume and variety of cross-border transactions in goods and services, free international capital flows, and more rapid and widespread diffusion of technology".

According to International Forum of Globalization-

Globalization is defined as "the present worldwide drive towards a globalized economic system dominated by supranational corporate trade and banking institutions that are not accountable to democratic processes or national governments".

According to WTO-

"Globalization can be defined as "the increased interconnectedness and interdependence of peoples and countries. It is generally understood to include two inter-related elements: the opening of international borders to increasingly fast flows of goods, services, finance, people and ideas; and the changes in institutions and policies at national and international levels that facilitate or promote such flows".

According to **Committee for Development Policy-**

Globalization is "the increasing interdependence of world economies as a result of the growing scale of cross-border trade of commodities and services, the flow of international capital and the wide and rapid spread of technologies. It reflects the continuing expansion and mutual integration of market frontiers and the rapid growing significance of information in all types of productive activities and marketization are the two major driving forces for economic globalization."

According to **Thomas Friedman-**

Globalization is "the inexorable integration of markets, nation states and technologies to a degree never witnessed before—in a way that is enabling individuals, corporations, and nation states to reach around the world farther, faster, deeper, and cheaper than ever before".

According to **Peter Jay**-

Globalization is defined as, "The ability to produce any goods (or service) anywhere in the world, using raw materials, components, capital and technology from anywhere, sell the resulting output anywhere, and place the profits anywhere".

From the above definitions it can be extracted that-

- Globalization leads to international expansion of business.
- It leads to international flow of capital through foreign direct and indirect investments.
- It dilutes the differences between national and international markets.
- It leads to internationalization of markets and facilitates sale and purchase of goods from anywhere in the world.
- It leads to establishment of manufacturing as well as distributing facilities around the globe not restricted by national boundaries.
- It enables gathering the sources of production- men, money, material and information from anywhere around the world.
- It leads to cultural exchange among countries.
- It facilitates foreigners and natives to appear in the same organizational structure.
- It encourages international tie-ups, international agreements and international collaborations.
- Globalization has led to the emergence and growth of Multinational Corporations.
- It has led to the culture of immigration.
- It has led to internationalization of various professions.

- It has increased standardization the world over.
- It has led to harmonization of accounting, law and statutes.
- It has generated international competitiveness.
- It converts the global market into a global village

To conclude the phenomenon of globalization has knotted the world into a single string by harmonizing the economic, social, political, legal and cultural differences.

Rationale of Globalization

There are multiple reasons for countries to go global. The rationale varies as per the state of development of a country. Developing and developed countries have different purposes of becoming global. These are explained as follows-

For developing countries-

1. Venture into foreign markets
2. Earn foreign exchange
3. Break free from saturation in their home markets
4. Extend ownership advantages and utilize the same resources in foreign countries
5. Enjoy economies of scale through larger production in other countries
6. Attain International memberships at common platforms with the developed countries
7. Poverty alleviation
8. Achieve economic growth
9. Create employment opportunities
10. Improve quality of life of the people of the country
11. Learn new skills and improve expertise
12. Improve balance of trade
13. Maintain stabilization in prices

For developed countries-

1. Gain access to cheap labor
2. Gain access to raw material
3. Take benefit from International tie-ups
4. Outsourcing
5. Market penetration into developing countries
6. Trade in countries where greatest competitive advantage is available
7. Obtain a high return on capital employed.
8. Overcome entry barriers in host countries.
9. Take advantage of currency fluctuations
10. Have access in board decisions of firms in developing countries.

3.2. DRIVERS OF GLOBALIZATION

There are various drivers that have led to globalization. These are discussed as follows by dividing them into five categories-

1	**Technological Drivers**
2	**Political Drivers**
3	**Market Drivers**
4	**Cost Drivers**
5	**Competitive Drivers**

1. **Technological drivers**

First and foremost, technology has been one of the major factors expediting the process of globalization. Internet served as a boon for globalization. The concept of e-business and e-commerce was not possible without the internet. In fact, technology is the foundation of modern globalization. Technology has facilitated international trade, communication, exchange of money and has generated virtual platforms to knit the world together and boost the process of globalization.

2. Political drivers

The Governments of different countries and the political leadership has also played a significant role in the process of globalization. Trading rules have been liberalized. Markets have been deregulated by lowering tariffs. Foreign Direct investments have been allowed in all the spheres around the world. Countries have entered into multilateral trade agreements. They have become members of international bodies committing to support international trade and business. For instance, 23 nations are members of GATT (General Agreement on Tariffs and Trade) 1947, which is now WTO (World Trade Organization). These tie ups provide countries with global resources on global platforms.

3. Market drivers

Every product/ corporate/ industry has a life cycle starting from the inception stage to the growth and maturity stage and eventually reaching a stage of maturity and decline. Globalization provides longevity to the life cycle of businesses. When domestic markets become saturated, globalization offers the opportunities for growth in the international markets. There are different routes to make the markets global starting from the traditional route of exporting to the most contemporary channel of outsourcing.

4. Cost drivers

Globalization renders cost advantage to businesses. The cost of production varies from country to country. At some places raw material is cheap whereas in some countries labor is less expensive. For example, in the automobile industry, labor costs in United States accounts for 30-45% of the vehicle's costs while only less than 10% in China (Source from Xinhua). And in India, the workforce is generally more educated, despite the low wages. As such, firm could actually relocate its manufacturing production from developed countries to developing nations such as China and India to take advantage of their low labor costs. The phenomenon of globalization helps to take advantage of cost differences. It leads to global scale economies.

5. Competitive drivers

Global markets bring competitiveness in terms of cost, prices, quality, differentiation, innovation etc. Organizations are forced to play cost effective and quality oriented in order to sustain in the globalized markets. Also, there is a demonstrative effect that when one firm in the industry is global, others in competition follow the suit. Hence globalization has become a trend.

3.3. STRATEGIES FOR GOING GLOBAL

There are various modes of going global. All channels are not universally applicable to all types of businesses. Hence a business must choose its international entry options with prudence keeping into mind its resources and rationale for going global. These strategies and channels are discussed as follows-

1	**Exporting**
2	**Licensing**
3	**Franchising**
4	**Contract Manufacturing**
5	**Management Contracting**
6	**Turnkey Contracts**
7	**Wholly owned subsidiaries**
8	**Joint Ventures**
9	**Mergers and Acquisitions**
10	**Strategic Alliance**

9. **Exporting**- This is the oldest channel of going global. Exporting is defined as, "the marketing of goods and services produced in one country into another country". In this strategy, the production takes place in the home country while the goods are sold and marketed in other countries of the world.

   Advantages of exporting-

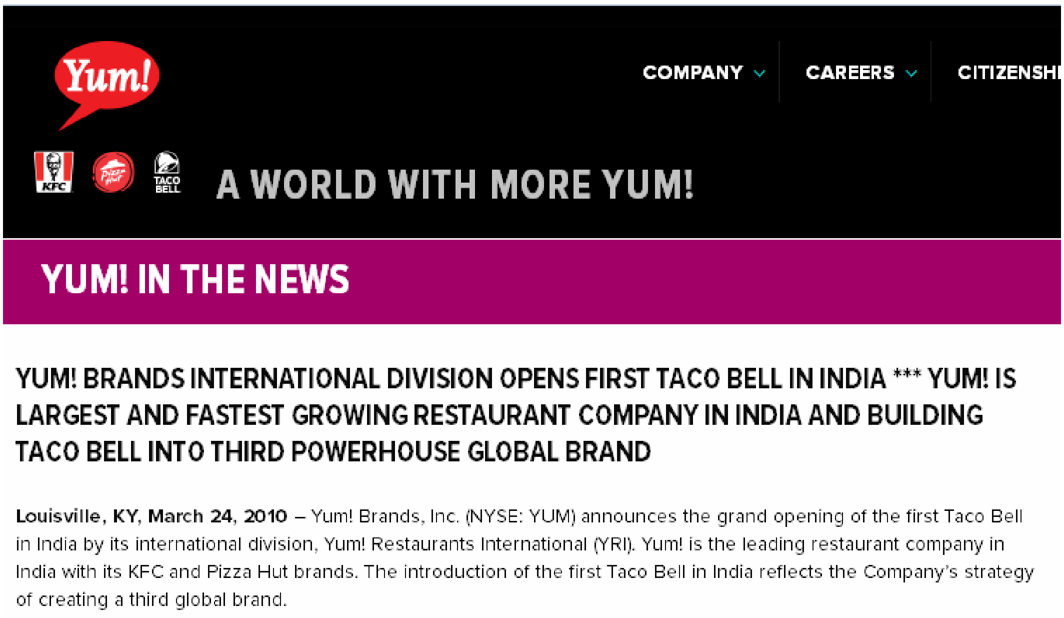
- It is the easiest strategy of going global relative to other options.
- It brings foreign exchange in the country.

- It is free from formalities of foreign direct investments.
- Due to advancements in technology and internet it has become easier to obtain the license for exporting.

Disadvantages of exporting-

- It is suitable for small businesses.
- It is more feasible with countries located nearby.
- Currency differences lead to problems of exchange rate.

10. **Licensing-** Licensing is the cheapest strategy of going global. It is defined as, "the method of foreign operation whereby a firm in one country agrees to permit a company in another country to use the manufacturing, processing, trademark, know-how or some other skills provided by the licensor". It is a business arrangement where the manufacturer of a product (licensor) gives permission to some other person/manufacturer in some other country to manufacture the same product using their trademarks, patents and copyrights in exchange of a royalty fee. For instance, Yum Brands successfully used licensing to establish KFC and Pizza Hut.



YUM! BRANDS INTERNATIONAL DIVISION OPENS FIRST TACO BELL IN INDIA *** YUM! IS LARGEST AND FASTEST GROWING RESTAURANT COMPANY IN INDIA AND BUILDING TACO BELL INTO THIRD POWERHOUSE GLOBAL BRAND

Louisville, KY, March 24, 2010 – Yum! Brands, Inc. (NYSE: YUM) announces the grand opening of the first Taco Bell in India by its international division, Yum! Restaurants International (YRI). Yum! is the leading restaurant company in India with its KFC and Pizza Hut brands. The introduction of the first Taco Bell in India reflects the Company's strategy of creating a third global brand.

Advantages of licensing-

- It is the cheapest channel of entering foreign markets. It does not involve investment on the part of the licensee.
- It is beneficial to both the licensor and the licensee. Licensor get access to international markets while licensee gets the benefit of established patents, copyrights and trademarks at a very little cost.

11. **Franchising**- Franchising is quite similar to licensing. The difference between the two is that in franchising the seller not only gives license for using his brand name and trademark, but also provides technical assistance to the franchisee in organizing, marketing, merchandising and managing the process in return for fees. For example, McDonald, Dominos, KFC use this channel of globalization.

    Advantages of Franchising-

- Technical assistance is also available but for the license and trademarks.
- Chances of success increases because of availability of constant assistance and guidance.
- The goodwill and reputation is maintained in the international markets as well.

12. **Contract Manufacturing**- This is a channel where companies gets the goods manufactured in other countries where it is most cost effective since the labor cost is lower. This arrangement is called international contract manufacturing. The principal company retains the right to market them under their own brand name.

    Advantages of contract manufacturing-

- The channel results in huge cost saving to the principal company. It saves on labor cost as well as the setting business in foreign countries.
- The label used is of the principal company. Hence its brand name is protected.
- Host countries also get a chance to enter into foreign markets.

    Disadvantages of contract manufacturing-

- Meeting quality standards is difficult. Quality could be compromised for saving on cost.
- Trade secrets get leaked.

- Gradually over a period of time the host country may emerge as a competitor bringing substitutes in the market.

13. **Management Contracting-** A management contract "is an arrangement under which operational control of an enterprise is vested by contract in a separate enterprise that performs the necessary managerial functions in return for a fee. Management contracts involve not just selling a method of doing things (as with franchising or licensing) but involve actually doing them. A management contract can involve a wide range of functions, such as technical operation and of a production facility, management of personnel, accounting, marketing services and training".

Advantages of Management Contracting-

- Operation efficiency of business is increased.
- Specialization is introduced in operating the business.

Disadvantages of Management Contracting-

- Confidentiality of business is at risk.
- There may not be matching of culture with the third party which may lead to organizational disputes.
- Difficulties in sticking to the principle of unity of command.

14. **Turnkey Contracts-** Turnkey contract is another strategy of entering into the international market. Here the contract is handed over to another company in a foreign country. The company designs and constructs the project. It trains the personnel to handle it and start up the plants. Once the project is established it is handed over to the client in lieu of consideration.

Advantages of Turnkey Contracts-

- It is the most suitable mode for entering into foreign countries that impose restrictions on Foreign Direct Investments.
- Less botheration to the principal company as the entire responsibility is taken up by the host country.

Disadvantages of Turnkey Contracts –

- It is a costly mode of international entry.

15. **Wholly Owned Subsidiaries**- Here the business firm in one country opens a business in another country which it fully owns. It has 100% stake in the company. It is through a Greenfield venture as the firm creates all operations by itself.

Advantages of Wholly Owned Subsidiaries-

- There is no interference from an outsider as the company is the owner of the subsidiary.
- All risks and returns belong to the company.
- A company has full control over entire operations of the newly opened subsidiary.

Disadvantages of Wholly Owned Subsidiaries-

- It is in fact one of the costliest options of entering foreign markets**.**
- It involves huge risk of newness of market.

16. **Joint Ventures**- When two or more firms belonging to different countries enter into partnership, it is called joint venture mode of international business. The risk is shared among partners.

Advantages of Joint Venture-

- Risk is shared among partners.
- It is a prudent foreign entry strategy.
- The strategy is cost effective.

Disadvantages of Joint Venture-

- Partnerships are not always cordial.
- It involves lot of paper work to reach at an agreement of partnership

17. **Mergers and Acquisitions**- It is a strategy where one company acquires or merges with another company that continues its existence. One company ceases to exist while the other remains. This strategy at the international platform is followed between two companies in two different countries. It helps companies to generate synergy of resources and avoid duplication of assets, manpower and other infrastructure and equipment. For instance, Indian companies had spent $ 711.4 million in acquisitions abroad in 2000 in industries such as InfoTech, drugs and

pharmaceuticals, paints, tele-communication, petroleum and broadcasting. Some of the major acquisitions include investments by Zee Telefilms, Leading Edge System BPL Software and Tata Tea. Dataline Transcription, Teamasia semiconductors, Goa Carbons, Wockhordt and Acro lab are few other firms to name from a long list. A very important acquisition has been the $ 271 billion leveraged buy- out of Tetley by Tata Tea. Indian companies have also acquired foreign brands. Nicholas Piramal India has acquired the Indian rights for three anti-infective brands from the US firm Eli Lilly. (Source- bms.co.in)

Advantages of mergers and acquisitions-

- It brings economies of scale.
- It generates synergies between two companies.
- Cut-throat competition is reduced.
- There is sharing of ideas, resources and finances.

Disadvantages of mergers and acquisitions-

- The strategy can create dysynergies as well.
- There are cultural conflicts among companies from different countries.
- Difficulty in control.
- The strategy leads to monopolies and concentration**.**
- It is a costly strategy.

18. Strategic alliance- It is a long-term cooperative arrangement between two or more independent firms or business units that engage in business activities for mutual gain. Eg; Timex alliance with Titan, Wipro with IBM. Strategic alliance may be formed to obtain or learn new capabilities, obtain access to specific markets, reduce financial risk and political risk.

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Business

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Business

IBM, Wipro form strategic alliance

BANGALORE: Wipro's bid to further its position as leading system integrators got a boost through its strategic alliance with IBM. As part of the alliance, Wipro would market and integrate IBM's server and storage products including pSeries, iSeries, iSCSI and network attached storage products to Indian customers. While the Asia Pacific customers could avail themselves of Wipro's software services including ERP, CRM and workflow implementation services.

3.4. PREREQUISITES OF GLOBALISATION

Globalization involves certain prerequisites. These are explained as follows-

1	**Support from the Government**
2	**Availability of Resources**
3	**Strong Infrastructural Base**
4	**Strategic Advantage**
5	**Flexibility**
6	**Harmonization**

1. **Support from the Government**- Unless the Government of a country liberalizes its policies and renders support, the phenomenon of globalization cannot be successfully implemented. It demands relaxations in trade and tariffs, quotas, taxation etc. All these changes cannot be made without the consent and support from the government.
2. **Availability of resources**- A country to go global must be rich in resources, technology, manpower etc. Countries lacking in these resources cannot think of going global.
3. **Strong infrastructural base**- A country desirous of hosting foreign companies to open businesses in their country must provide them with strong infrastructural bases. The country should have robust systems of transportation, telecommunication, digitization etc.
4. **Strategic advantage**- Those countries that have some strategic advantage in term of abundant raw material, cheap labor, superior technology, differentiated manufacturing, marketing etc. can lead globalization.
5. **Flexibility**- Globalization requires free and flexible market mechanisms. The demand and supply forces should play their role in price determination. Trade should be market oriented.
6. **Harmonization**- Globalization requires standardization in quality standards. A set of international quality standards would have to be followed in production and service.

3.5. CHECK YOUR PROGRESS

Choose the correct option-

1. Globalization involves free flow of-
   a) People
   b) Capital
   c) Resources
   d) All of the above
2. The mode of globalization that offers the advantage of low labor cost is-
   a) Exporting
   b) Turnkey projects

c) Joint venture

d) Contract Manufacturing

3. Which of the following is not a prerequisite for globalization-

a) Citizenship of a foreign country

b) Strong infrastructural base

c) Abundant natural resources

d) Government support

4. Licensing and Franchising differ because-

a) Franchising is free of cost, licensing is costly.

b) Licensing is in case of liquor industry, franchising is in case of fast foods.

c) Licensing gives brand name, franchising gives technical assistance as well.

d) There is no difference between licensing and franchising.

5. Turn key contracts are suitable for-

a) Garment manufacturing

b) Construction contracts

c) Service industry

d) All of the above

3.6 SUMMARY

Today the quantum and volume of trade has increased manifold and hence the relevance of the topic 'globalization' has increased. The phenomenon of globalization picked greater momentum after the liberation of Indian economy in 1991 when foreign and private players were allowed to enter the Indian market. Since then there has been no looking back. The number of multinational corporations entering India and Indian multinationals transiting abroad are showing skyrocketing figures. Globalization is the process of "integration of economic, cultural, political and social systems across geographical boundaries throughout the world". It refers to the "increasing assimilation of economies around the world through trade and financial flows".

Globalization leads to international expansion of business. It increases international flow of capital through foreign direct and indirect investments, facilitates sale and purchase of goods from anywhere in the world, helps in establishment of manufacturing as well as distributing facilities around the globe not restricted by national boundaries and enables gathering the sources of production- men, money, material and information from anywhere around the world. It leads to cultural exchange among countries, encourages international tie-ups and leads to growth of Multinational Corporations. In short it converts the global market into a global village.

There are several drivers of globalization. Among the Technological drivers Internet served as a boon for globalization. It has knit the world together and boosts the process of globalization. Among Political drivers the Governments of different countries and the political leadership has also played a significant role in the process of globalization. Trading rules have been liberalized. Markets have been deregulated by lowering tariffs. Foreign Direct investments have been allowed in all the spheres around the world. Among the market drivers globalization has given different routes to make the markets global starting from the traditional route of exporting to the most contemporary channel of outsourcing. Cost drivers in terms of lower cost motivate globalization. Globalization renders cost advantage to businesses. The cost of production varies from country to country. At some places raw material is cheap whereas in some countries labor is less expensive. Competitive drivers in terms of cost, prices, quality, differentiation, innovation etc have also encouraged globalization.

There are various modes of going global as Exporting, Licensing, Franchising, Contract Manufacturing, Management Contracting, Turnkey Contracts, Wholly Owned Subsidiaries, Joint Ventures, Mergers and Acquisitions etc. But before exercising the option of going global countries must satisfy some prerequisites for the same. They must have government support, availability of resources, technology, infrastructure, and offer some strategic advantages and flexibility in operations. The rationale of going global varies between a developing and a developed country. Developing country goes global to earn foreign exchange, have international ties ups, tap the untapped international markets, gain employment, reduce poverty and increase standard of living of its people. A developed country goes global to enter into countries that can give them competitive advantage in terms of cheap raw material, low cost labor, abundant of natural resources, ready market etc.

3.7 KEY WORDS

1. **Globalization-** Globalization is the process of "integration of economic, cultural, political and social systems across geographical boundaries throughout the world". It refers to the "increasing assimilation of economies around the world through trade and financial flows".
2. **Exporting-** It refers to "the marketing of goods and services produced in one country into another country".
3. **Licensing-** It is defined as, "the method of foreign operation whereby a firm in one country agrees to permit a company in another country to use the manufacturing, processing, trademark, know-how or some other skills provided by the licensor".
4. **Franchising-** in franchising the seller not only gives license for using his brand name and trademark, but also provides technical assistance to the franchisee in organizing, marketing, merchandising and managing the process in return for fees.
5. **Contract Manufacturing-** This is a channel where companies gets the goods manufactured in other countries where it is most cost effective since the labor cost is lower.
6. **Management Contracting-** A management contract "is an arrangement under which operational control of an enterprise is vested by contract in a separate enterprise that performs the necessary managerial functions in return for a fee. Management contracts involve not just selling a method of doing things but involve actually doing them.
7. **Turnkey Contracts-** Here the contract is handed over to another company in a foreign country. The company designs and constructs the project. Once the project is established it is handed over to the client in lieu of consideration

3.8 SELF ASSESSMENT TEST

1. Define globalization. Give rationale of undertaking globalization.
2. Discuss in detail the drivers of globalization.
3. Explain different strategies of going global.
4. What is meant by globalization? Explain the prerequisites of going global.

5. Compare different strategies of going global. Give advantages and disadvantages of the strategies. Which of the strategies do you think is the best?
6. Write notes on-
   a) Concept of globalization
   b) Exporting vs franchising
   c) Turnkey contracts

3.9. ANSWERS TO CHECK YOUR PROGRESS

1. All of the above
2. Contract manufacturing
3. Citizenship of a foreign country
4. Licensing gives brand name; franchising gives technical assistance as well.
5. Construction contracts

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Course: Business Environment	Author: Dr. Aparna Bhatia
Course Code: BCOM- 206	Vetter: Prof. Pardeep Kumar Gupta
LESSON: 04	
Foreign Direct Investment	

Structure

4.0. LEARNING OBJECTIVES

After going through this lesson you should be able to know

- the need of foreign capital and the forms of foreign capital
- the concept of Foreign Direct Investment
- the methods of making Foreign Direct Investment
- the forms and types of Foreign Direct Investment

- The routes for FDIs in India and the statistics of FDIs in India
- The advantages of FDIs along with its criticism.

4.1. INTRODUCTION

Developing countries are usually associated with low saving and low capital formation. This typical characteristic of developing nations keeps them in the bracket of being poor for centuries. These countries are not able to get out of the vicious cycle of poverty. In spite of being abundant in natural resources these countries are unable to exploit these resources due to dearth of capital and technology. Developing countries are not able to industrialize themselves. Without industrialization there aren't any new jobs or employment in the economy. People are poor with low standards of living. That is why it is said especially for India that "India is a rich country with poor people". Being poor, people are less educated. They do not have the expertise and technical skills to make productive use of available resources. Hence to bridge the gap between 'having' resources and 'utilizing' resources, foreign aid in the form of foreign capital is necessary for developing countries.

Foreign capital enters a country in two different forms; first the Private Investment and secondly in the form of Foreign Aid. Private Investment may be the Foreign Direct Investment or the Foreign Indirect Investment. In the former case a foreign company acquires a controlling stake in the company while in the latter simply means an equity or debenture holding by a foreign company in the host country's companies, also called Foreign Portfolio Investment. Foreign Direct Investment is a long term investment by foreign companies into the host country while Foreign Portfolio Investment is a short term investment. In Foreign Direct Investment (FDI) investment is made to build a business while in Foreign Portfolio Investment, money is invested to purchase stock and bonds. Unlike Foreign Direct Investment, Foreign Portfolio Investment can be sold any time by the investing company. Thus, Foreign Direct Investment is the most prominent form of foreign capital sought after by the developing nations.

4.2. MEANING AND NATURE OF FOREIGN DIRECT INVESTMENT

In simple words, "any investment from an individual or firm that is located in a foreign country into another country" is called Foreign Direct Investment. Put differently, Foreign direct investment (FDI) is "an ownership stake in a foreign company or project made by an investor, company, or government from another country" (Source- investopedia.com). Generally, the term is used to describe "a business decision to acquire a substantial stake in a foreign business or to buy it outright to expand operations to a new region". Foreign Direct Investment is "an investment in the form of a controlling ownership in a business, in real estate or in productive assets such as factories in one country by an entity based in another country". Broadly, it includes "mergers and acquisitions, building new facilities, reinvesting profits earned from overseas operations, and intra company loans". In a narrow sense, it refers "just to building new facility, and a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor". FDI is the "sum of equity capital, long-term capital, and short-term capital as shown in the balance of payments" (Source-OECD, Library). It usually involves "participation in management, joint-venture, transfer of technology and expertise".

"Stock of FDI is the net (i.e., outward FDI minus inward FDI) cumulative FDI for any given period. Direct investment excludes investment through purchase of shares (if that purchase results in an investor controlling less than 10% of the shares of the company)".

Methods of Foreign Direct Investment

Foreign Direct Investment can be made by the foreign company in the host country by any of the following methods-

1. By establishing a wholly owned subsidiary in another country.
2. By acquisition of share capital in an associated company.
3. In the form of a merger or an acquisition of an unassociated company.
4. By entering into a joint venture with another investor or company.

Types of Foreign Direct Investment

Foreign direct investments can be classified as follows-

1. **Horizontal Foreign Direct Investment**- When a foreign company establishes the same type of business in another country as it is operating in its own country, it is called Horizontal Foreign Direct Investment. For example, McDonald opens restaurant in India as it is operating in America.
2. **Vertical Foreign Direct Investment**- When a company opens a business in another country that falls on its supply chain it is called Vertical Foreign Direct Investment. Hence, the new business is a related one. When a company opens a business in a foreign country that provides it with necessary raw material, that is, lower on the supply chain, it is called backward vertical integration. When a company opens a business in a foreign country that provides it with retail facilities, that is, higher on the supply chain, it is called forward vertical integration.
3. **Conglomerate Foreign Direct Investment-** When a company opens a business in another country that is unrelated to its current industry it is called Conglomerate Foreign Direct Investment. This type of investment has two difficulties; first the newness of the market and second the newness of the industry. For example, Walmart- a USA based retailer investing in TATA Motors in India.
4. **Platform Foreign Direct Investment:** This is an "export-platform FDI". In this form a foreign company opens business in another country but the output from the foreign operations is exported to a third country. Platform FDI are common in low-cost locations where trading is done free-trade zones. For example, cosmetics manufactured in Bangladesh by a US based company exported to a free trade zone in Dubai.

Features of Foreign Direct Investment

From the above discussion on Foreign Direct Investment, some features of FDIs are given as follows-

1. Foreign Direct Investments are made by one country in another country.
2. The investing company acquires a controlling interest in another company either by opening a subsidiary or an associate company or through a merger or a joint venture with a foreign company.

3. As per the guidelines given by the Organisation for Economic Co-operation and Development (OECD), the threshold for an FDI is a minimum 10% ownership stake in a foreign-based company.
4. These are made for a longer period of time.
5. It is a non-debt source of finance.
6. The host country enjoys not only financing from the investing country, but also technical support and expertise.
7. It is not a compulsion for the investing company to invest in the same line of business. It can invest in unrelated industry as well.
8. Foreign Direct Investments result in mutual gain to the investing and the host country. Investing country gets a destination of deploying the surplus funds and enjoys location- specific benefits. Host country gets capital as well as technical expertise required to run the business.

Advantages of Foreign Direct Investments

Foreign Direct Investments give benefits to both the investing country as well as the host country.

Benefits available to the investing country include-

1. Diversification of the market- The investing company has many choices. It can follow the horizontal, vertical or even the conglomerate FDI method. In all the cases there is diversification of markets of the investing country.
2. Cost advantages- Foreign investors basically invest in other countries for availing the cost advantage as a competitive gain. No country would invest in other unless it gets cost effectiveness.
3. Low labor cost- This is one of the major reasons for countries to invest in the businesses in other countries. For instance developed countries open branches and subsidiaries for the manufacture of products in the developing countries because labor cost is much less in developing countries relative to the developed countries. Resultantly manufacturing of whole or part components is give to the developing countries.

4. Tax benefits- Those countries which have lesser taxes are favorite destinations for investors. So the investors avail tax benefits out of the same business once it is undertaken in countries with low tax structure.
5. Risk reduction- The investing countries are able to reduce risk as FDIs result in horizontal expansion of business. It is unsafe to put all eggs in one basket and foreign direct investments result in diversification of funds into different countries.
6. Profit repatriation- The foreign investors are able to generate significant profit and also repatriate the same to their country.

Benefits available to the host country include-

1. Availability of capital- Foreign Direct Investments provides the host country with ample amount of capital to exploit their resources. They are able to have access to funding that was not available in their country.
2. Employment generation- People are able to get jobs when new businesses are opened by the foreign investors. The employment rates in a country increase because of FDI investment.
3. Technical Expertise- Since FDIs generate controlling interest via a substantial stake of investing country in the business opened in host countries, so the foreign businessmen not only bring capital but also the technology and the expertise to use the same.
4. Development of human capital- People learn new skills and technology with the advent of foreign companies in the country.
5. Economic growth- The host country has improved economic statistics when it is fuelled with capital, technology, infrastructure and expertise by the foreign counterparts.

Disadvantages of Foreign Direct Investments

Foreign Direct Investments have the following disadvantages-

1. Controlling interest by the foreigners- The alien country tends to have controlling interest for a long period of time in the business of host country. There is a bondage to the host country.
2. Local businesses suffer- Due to the formation of Multinational companies that bring FDIs local and indigenous businesses suffer and fade away from the market.

3. Profit Repatriation- The aim of foreign country is to earn profits from money invested in the form of FDI and repatriate the profits to their home country. They may not like to plough back the profits.

4.3. FACTORS AFFECTING FOREIGN DIRECT INVESTMENT DECISIONS

There is multiplicity of factors affecting foreign direct investment decisions. These are explained as follows-

1. **Low Production Cost**- The host country should be able to gain competitive advantage in terms of low production cost in the host country. The preference of countries to invest would always be in such countries where the labor cost is less. For instance, wages in the United States stand at 28.10 USD/Hour (source: U.S. Bureau of Labor Statistics) in contrast to India that stands at 2.16 USD/Hour (source: indiabriefing.com). So, automatically India becomes a favored destination for American companies.
2. **Labor skills**- Foreign companies do not compromise on the skills required in labor. Skill is not compromised against low cost. In India for instance labor is not only cheap but also educated and skillful.
3. **Availability of natural resources**- A country in order to attract Foreign Direct Investments must be rich in natural resources. For example, Africa has abundance of mineral deposits. Many countries favor to invest in Africa. Similarly, Russia is known for its oil and natural gas resources and hence is a favored destination for other countries.
4. **Sales logistics**- Countries should be able to have lower cost of distribution and transportation. The benefit of low labor cost should not be diluted with high transportation costs.
5. **Key technology**- A country must have the key technology available with it. Many countries wish to invest in US because of its high end technology. Today is the era of innovation and digitization. The same cannot be achieved in countries which are technologically weak.

6. **Tax rates**- The companies like to invest in countries where they can have the benefit of low taxation. For instance, Multinationals like Google and Microsoft have invested in Ireland that offers tax benefits.
7. **Potential for growth-** The host country must have reasonably good sized population so that the produce can be sold in that country only. But for production facilities, a country should have a ready market for sale of the product/service as well. Small countries with less population do not attract foreign investment. Rather, countries like China and India are preferred because of their massive population.
8. **Political stability in the country**- There should not be major political disturbances in the country. The Government should be stable. The policies framed by the Government should continue for a reasonable period of time. There should be lesser corruption in the country. Judiciary should be honored. Law and order should prevail. For instance, European Union is regarded as a politically stable group and hence invites FDIs.
9. **Exchange rate**- Since cost is a very major consideration for countries to invest in other countries; hence countries with weak exchange rates become favored destinations for FDIs. It becomes cheaper to purchase material, equipment and assets in such countries. But the exchange rate should be stable as excess volatility in exchange rates increases risk of investment.
10. **External Economies of Scope**- Countries prefer to invest in areas having same type of industry. This generates external economies of scope for them. This is also known as 'clustering effect'. They have easy access to the transportation facilities and other allied services.
11. **Expatriation of funds**- Countries should be allowed to bring back the profits out of foreign investment in their own country. There should not be much local restrictions on the same**.**
12. **Exit**- The companies should have an exit route as well. If at some stage they want to quit, then the laws and regulations should not be too rigid.

4.4. FOREIGN DIRECT INVESTMENT IN INDIA- COMPOSITION AND DIRECTION

Since the liberalization of economy in 1991, India has invited significant amount of FDIs. It is rather a very major monetary source for India's economic development. These have been gradually increasing since then. So much so that today India is a part of top 100-club on Ease of Doing Business (EoDB) and globally ranks number 1 in the Greenfield FDI ranking (DPIIT, Government of India).

Routes through which India gets FDI

There are two roots via which India gets FDIs-

1. Automatic Route
2. Government Route

1. **Automatic route:** Under the Automatic Route, the foreign investor or the Indian company does not require any approval from RBI or Government of India for the investment.

Sectors which come under the ' 100% Automatic Route' category are

Agriculture & Animal Husbandry,

Air-Transport Services (non-scheduled and other services under civil aviation sector),

Airports (Greenfield + Brownfield),

Asset Reconstruction Companies,

Auto-components,

Automobiles,

Biotechnology (Greenfield),

Broadcast Content Services (Up-linking & down-linking of TV channels, Broadcasting Carriage Services, Capital Goods, Cash & Carry Wholesale Trading (including sourcing from MSEs),

Chemicals,

Coal & Lignite,

Construction Development,

Construction of Hospitals,

Credit Information Companies, Duty Free Shops, E-commerce Activities,

Electronic Systems,

Food Processing,

Gems & Jewellery,

Healthcare, Industrial Parks,

IT & BPM, Leather,

Manufacturing, Mining & Exploration of metals & non-metal ores,

Other Financial Services, Services under Civil Aviation Services such as Maintenance & Repair Organizations,

Petroleum & Natural gas,

Pharmaceuticals,

Plantation sector,

Ports & Shipping,

Railway Infrastructure,

Renewable Energy,

Roads & Highways,

Single Brand Retail Trading, Textiles & Garments,

Thermal Power,

Tourism & Hospitality and

White Label ATM Operations.

(Source- rbi.org.in)

Sectors which come under up to 100% Automatic Route' category are

Infrastructure Company in the Securities Market: 49%

Insurance: up to 49%

Medical Devices:up to 100%

Pension: 49%

Petroleum Refining (By PSUs): 49%

Power Exchanges: 49%

(Source- rbi.org.in)

2. **Government Route:** Under the Government Route, prior approval of the Government of India, Ministry of Finance, Foreign Investment Promotion Board (FIPB) is required.

Sectors which come under the 'up to 100% Government Route' category are

- Banking & Public sector: 20%
- Broadcasting Content Services: 49%
- Core Investment Company: 100%
- Food Products Retail Trading: 100%
- Mining & Minerals separations of titanium bearing minerals and ores: 100%
- Multi-Brand Retail Trading: 51%
- Print Media (publications/ printing of scientific and technical magazines/ specialty journals/ periodicals and facsimile edition of foreign newspapers): 100%
- Print Media (publishing of newspaper, periodicals and Indian editions of foreign magazines dealing with news & current affairs): 26%
- Satellite (Establishment and operations): 100%

(Source- rbi.org.in)

Upto 100% FDI permitted under Automatic & Government

- Air transport services (Scheduled Air Transport Service/ Domestic Scheduled Passenger Airline; Regional Air Transport Service) – upto 49% (auto) (Upto 100% under automatic route for NRIs) + above 49% and up to 74% (Govt.)
- Banking (Private sector) – upto 49% (auto) + above 49% and up to 74% (Govt)
- Biotechnology (brownfield) – upto 74% (auto) + above 74% (Govt)
- Defence – upto 74% (auto) + above 74% (Govt)

- Healthcare (Brownfield) – upto 74% (auto) + above 74% (Govt)
- Pharmaceuticals (Brownfield) – upto 74% (auto) + above 74% (Govt)
- Private Security Agencies – upto 79% (auto) + above 49% and up to 74% (Govt)
- Telecom Services – upto 49% (auto) + above 49% (Govt)

(Source- makeinindia.com)

FDI prohibition

As per rbi.org.in, "Foreign investment in any form is prohibited in a company or a partnership firm or a proprietary concern or any entity, whether incorporated or not (such as Trusts) which is engaged or proposes to engage in the following activities":

- Business of chit fund, or
- Nidhi Company , or
- Agricultural or plantation activities or
- Real estate business, or construction of farm houses
- Trading in Transferable Development Rights (TDRs).

*"It is clarified that Real Estate Business does not include development of townships, construction of residential/commercial premises, roads or bridges. It is further clarified that partnership firms/proprietorship concerns having investments as per FEMA regulations are not allowed to engage in Print Media sector".(source- rbi.org.in)

In addition to the above, investment in the form of FDI is also prohibited in certain sectors such as:

i. Retail Trading

ii. Atomic Energy

iii. Lottery Business

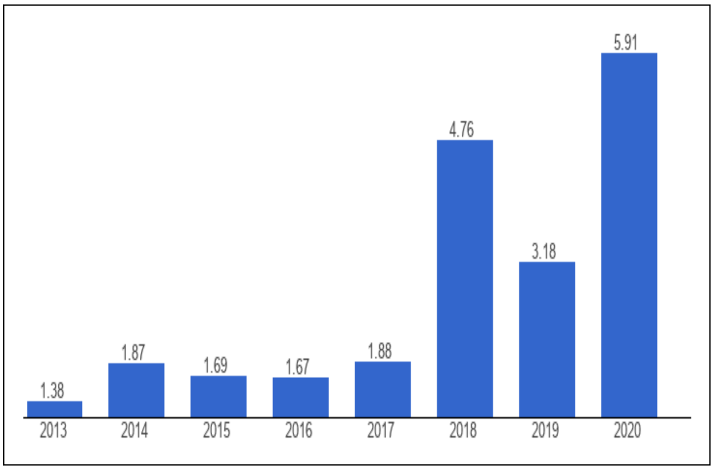
iv. Gambling and Betting

v. Agriculture (excluding Floriculture, Horticulture, Development of seeds, Animal Husbandry, Pisiculture and Cultivation of vegetables, mushrooms etc. under controlled conditions and services related to agro and allied sectors) and Plantations (Other than Tea plantations)

(Source- ribi.org.in)

India's Share in world FDI

For that indicator, we provide data for India from 1993 to 2020. The average value for India during that period was 1.39 percent with a minimum of 0.18 percent in 1999 and a maximum of 5.91 percent in 2020. The latest value from 2020 is 5.91 percent. (thegloabaleconomy.com). India's progress in FDIs from 1993 till 2020 is depicted as follows in the given Figure-



Source- theglobaleconomy.com

India's Global Ranking of FDI

Out of 185 countries surveyed for the average of 2020, China obtained rank 1 while India stood at Rank 8, thus ranking among top 10 countries to received FDIs.

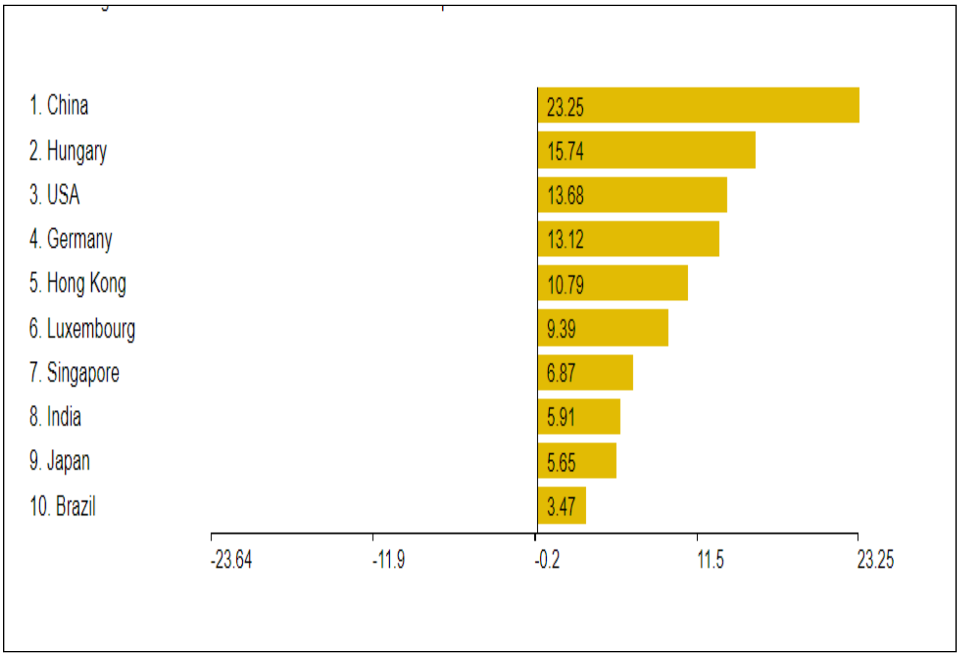
India's Global Ranking of FDI in Top 10 Countries

Countries	Percent of world FDI, 2020	Global rank	Available data
China	23.25	1	1993 - 2020
Hungary	15.74	2	1993 - 2020
USA	13.68	3	1993 - 2020
Germany	13.12	4	1993 - 2020
Hong Kong	10.79	5	1993 - 2020
Luxembourg	9.39	6	2002 - 2020
Singapore	6.87	7	1993 - 2020
India	5.91	8	1993 - 2020
Japan	5.65	9	1993 - 2020
Brazil	3.47	10	1993 - 2020

Source- theglobaleconomy.com

Thus India has a good rank and seems to be a favored destination for foreign countries. The same is depicted in Figure as follows for a better view-

India's Global Ranking of FDI (2020)



(Source- theglobaleconomy.com)

For gauging the latest extent of FDI inflows, following are the statistics generated by Department for Promotion of Industry and International Trade (available at dpiit.gov.in) for the latest quarter of 2022-23

FACT SHEET ON FOREIGN DIRECT INVESTMENT (FDI) INFLOW FROM APRIL, 2000 to SEPTEMBER, 2022

I. CUMULATIVE FDI FLOWS INTO INDIA (2000-2022):

A. TOTAL FDI INFLOW (from April, 2000 to September, 2022):

1	**CUMULATIVE AMOUNT OF FDI INFLOW** (Equity inflow +'Re-invested earnings' +'Other capital')		USD 8,87,762 Million
2	**CUMULATIVE AMOUNT OF FDI EQUITY INFLOW** (excluding, amount remitted through RBI's NRI Schemes)	INR 38,21,824 Crore	USD 6,15,317 Million

B. FDI INFLOW DURING SECOND QUARTER OF FINANCIAL YEAR 2022-23 (July, 2022 TO September, 2022):

1	**TOTAL FDI INFLOW INTO INDIA (Equity inflow + 'Re-invested earnings' + 'Other capital') (as per RBI's Monthly bulletins)**		USD 16,607 Million
2	**FDI EQUITY INFLOW**	INR. 82,333 Crore	USD 10,321 Million

C. FDI EQUITY INFLOW (MONTH-WISE) DURING THE FINANCIAL YEAR 2022-23:

Financial Year 2022-23 (April – September)		**Amount of FDI Equity inflow**	
		(In INR Crore)	**(In USD mn)**
1	April, 2022	49,200	6,459
2	May, 2022	47,563	6,152
3	June, 2022	31,060	3,978
4	July, 2022	39,569	4,971
5	August, 2022	18,906	2,376
6	September, 2022	23,858	2,974
2022-23 (from April, 2022 to September, 2022) #		**2,10,156**	**26,910**
2021-22 (from April, 2021 to September, 2021) #		**2,29,929**	**31,153**
%age growth over last year		**-9%**	**-14%**

Note*: i) Country & Sector specific analysis is available from the year 2000 onwards, as Remittance-wise details are provided by RBI from April, 2000 onwards only. # Figures are provisional, subject to reconciliation with RBI, Mumbai.*

D. SHARE OF TOP INVESTING COUNTRIES FDI EQUITY INFLOW (Financial year):

Ranks	Country	Amt. in Rupees Crores/ Amt. in USD Million	2020-21 (April – March)	2021-22 (April – March)	2022-23 (April – September)	Cumulative inflow (April, 00 – September, 22	%age to total inflow (in terms of USD)
1	Mauritius	Rupees Crores	41,661	69,945	25,748	9,33,295	
		USD Million	5,639	9,392	3,319	1,61,061	26%
		Rupees	1,29,227	1,18,235	78,333	9,35,357	

2	Singapore	Crores					
		USD Million	17,419	15,878	10,021	1,40,988	23%
3	U.S.A.	Rupees Crores	1,02,499	78,527	20,321	3,77,569	
		USD Million	13,823	10,549	2,602	56,753	9%
4	Netherland	Rupees Crores	20,830	34,442	13,793	2,77,387	
		USD Million	2,789	4,620	1,761	43,022	7%
5	Japan	Rupees Crores	14,441	11,187	9,277	2,31,010	
		USD Million	1,950	1,494	1,183	38,126	6%
6	United Kingdom	Rupees Crores	15,225	12,211	7,268	1,85,115	
		USD Million	2,043	1,647	920	32,821	5%
7	UAE	Rupees Crores	31,242	7,699	23,041	1,03,684	
		USD Million	4,203	1,032	2,955	15,180	2%
8	Cayman Islands	Rupees Crores	20,779	28,383	4,510	1,03,521	
		USD Million	2,799	3,818	582	14,735	2%
9	Germany	Rupees Crores	4,910	5,421	1,747	81,023	
		USD Million	667	728	222	13,813	2%
10	Cyprus	Rupees Crores	2,839	1,735	5,950	68,517	
		USD Million	386	233	764	12,131	2%
TOTAL FDI EQUITY INFLOW FROM ALL COUNTRIES *		Rupees Crores	4,42,569	4,37,188	2,10,156	38,21,824	
		USD Million	59,636	58,773	26,910	6,15,317	-

* Includes inflow under NRI

Schemes of RBI. <u>Note</u>:

i. %age worked out in USD terms & FDI inflow received through FIPB/SIA+ RBI's Automatic

Route + acquisition of existing shares only.

ii. Figures are provisional.

E. SECTORS ATTRACTING HIGHEST FDI EQUITY INFLOW:

Ranks	Sector	Amt. in Rupees Crores/ Amt. in USD Million	2020-21 (April – March)	2021-22 (April – March)	2022-23 (April – September)	Cumuulative inflow (April, 00 – September, 22)	% age to total inflow (In terms of USD)
1	SERVICES SECTOR **	Rupees Crores	37,542	53,165	32,460	5,94,897	
		USD Million	5,060	7,131	4,162	98,356	16%
2	COMPUTER SOFTWARE & HARDWARE	Rupees Crores	1,94,291	1,07,762	49,131	6,27,190	
		USD Million	26,145	14,461	6,282	91,799	15%
3	TELECOMMUNICATIONS	Rupees Crores	2,884	4,980	5,314	2,32,367	
		USD Million	392	668	694	39,025	6%
4	TRADING	Rupees Crores	19,349	33,779	25,620	2,54,752	
		USD Million	2,608	4,538	3,280	38,021	6%
5	AUTOMOBILE INDUSTRY	Rupees Crores	12,115	51,624	7,204	2,14,685	
		USD Million	1,637	6,994	932	33,774	5%
6	CONSTRUCTION (INFRASTRUCTURE) ACTIVITIES	Rupees Crores	58,240	24,178	7,731	1,98,532	
		USD Million	7,875	3,248	990	28,959	5%
7	CONSTRUCTION DEVELOPMENT: Townships, housing, built-up infrastructure and construction-development projects	Rupees Crores	3,117	932	223	1,28,235	
		USD Million	422	125	28	26,238	4%
	CHEMICALS	Rupees	6,300	7,202	10,200	1,22,257	

8	(OTHER THAN FERTILIZEINR)	Crores					
		USD Million	847	966	1,307	20,759	3%
9	DRUGS & PHARMACEUTICALS	Rupees Crores	11,015	10,552	5,453	1,14,835	
		USD Million	1,490	1,414	699	20,104	3%
10	METALLURGICAL INDUSTRIES	Rupees Crores	10,002	16,783	619	1,01,999	
		USD Million	1,340	2,272	79	17,094	3%

Note:*(i)** Services sector includes Financial, Banking, Insurance, Non-Financial / Business, Outsourcing, R&D, Courier, Tech. Testing and Analysis, Other*

(ii) FDI Sectoral data has been revalidated / reconciled in line with the RBI, which reflects minor changes in the FDI figures (increase/decrease) as compared to the earlier published sectoral data.

(iii) Figures are provisional.

F. STATES/UTs ATTRACTING HIGHEST FDI EQUITY INFLOW

S. No.	STATE	Amt. in Rupees Crores/ Amt. in USD Million	2020-21 (April – March)	2021-22 (April – March)	2022-23 (April – September)	Cumulative inflow (October, 19 – September, 22)	%age (to total equity inflow of USD)
1	MAHARASHTRA	Rupees Crores	1,19,734	1,14,964	62,425	3,51,331	
		USD Million	16,170	15,439	8,000	47,165	28%
2	KARNATAKA	Rupees Crores	56,884	1,63,795	41,678	2,93,106	
		USD Million	7,670	22,072	5,329	39,361	23%
		Rupees Crores	1,62,830	20,169	26,866	2,28,833	

3	GUJARAT	USD Million	21,890	2,706	3,473	30,660	18%
4	DELHI	Rupees Crores	40,464	60,839	35,486	1,65,460	
		USD Million	5,471	8,189	4,539	22,197	13%
5	TAMIL NADU	Rupees Crores	17,208	22,396	12,272	59,111	
		USD Million	2,323	3,003	1,564	7,896	5%
6	HARYANA	Rupees Crores	12,559	20,971	13,639	52,376	
		USD Million	1,697	2798	1,737	6,959	4%
7	TELANGANA	Rupees Crores	8,618	11,964	7,578	33,025	
		USD Million	1,155	1,607	969	4,411	3%
8	JHARKHAND	Rupees Crores	5,993	48	42	19,290	
		USD Million	792	6	5	2,656	2%
9	RAJASTHAN	Rupees Crores	2,015	5,277	5,594	14,234	
		USD Million	272	707	712	1,881	1%
10	WEST BENGAL	Rupees Crores	3,115	3,195	582	8,262	
		USD Million	415	428	73	1,107	1%

Note:

ii. *%age worked out in USD terms & FDI inflow received through FIPB/SIA+ RBI's Automatic Route + acquisition of existing shares only.*

iii. Figures are provisional.

FINANCIAL YEAR-WISE FDI INFLOW DATA:

A. AS PER INTERNATIONAL BEST PRACTICES:

(Data on FDI have been revised since 2000-01 with expended coverage to approach International Best Practices)

(Amount in USD Million)

S. NO.	Financial Year (April - March)	FOREIGN DIRECT INVESTMENT (FDI)						Investment by FII's Foreign Institutional investor INR Fund (net)
		Equity		Re-invested earnings +	Other capital +	FDI INFLOW INTO INDIA		
		FIPB Route/ RBI's Automatic Route/ Acquisition Route	Equity capital of unincorporated bodies #			Total FDI inlow	%age growth over previous year (in USD terms)	
FINANCIAL YEAR 2000-01 TO 2022-23								
1	2000-01	2,339	61	1,350	279	4,029	-	1,847
2	2001-02	3,904	191	1,645	390	6,130	(+) 52 %	1,505
3	2002-03	2,574	190	1,833	438	5,035	(-) 18 %	377
4	2003-04	2,197	32	1,460	633	4,322	(-) 14 %	10,918
5	2004-05	3,250	528	1,904	369	6,051	(+) 40 %	8,686
6	2005-06	5,540	435	2,760	226	8,961	(+) 48 %	9,926
7	2006-07	15,585	896	5,828	517	22,826	(+) 155 %	3,225
8	2007-08	24,573	2,291	7,679	300	34,843	(+) 53 %	20,328
9	2008-09	31,364	702	9,030	777	41,873	(+) 20 %	-15,017
10	2009-10	25,606	1,540	8,668	1,931	37,745	(-) 10 %	29,048
11	2010-11	21,376	874	11,939	658	34,847	(-) 08 %	29,422
12	2011-12	34,833	1,022	8,206	2,495	46,556	(+) 34 %	16,812

13	2012-13	21,825	1,059	9,880	1,534	34,298	(-) 26%	27,582
14	2013-14	24,299	975	8,978	1,794	36,046	(+) 5%	5,009
15	2014-15	30,933	978	9,988	3,249	45,148	(+) 25%	40,923
16	2015-16	40,001	1,111	10,413	4,034	55,559	(+) 23%	-4,016
17	2016-17	43,478	1,223	12,343	3,176	60,220	(+) 8%	7,735
18	2017-18	44,857	664	12,542	2,911	60,974	(+) 1%	22,165
19	2018-19	44,366	689	13,672	3,274	62,001	(+) 2%	-2,225
20	2019-20	49,977	1,757	14,175	8,482	74,391	(+) 20%	552
21	2020-21	59,636	1,452	16,935	3,950	81,973	(+) 10%	38,725
22	2021-22 (P)	58,773	910	19,347	5,805	84,835	(+) 3%	-14,541
23	2022-23 (P) (up to Sep, 2022)	26,910	426	9,252	2,511	39,099	-	-8,047
CUMULATIVE TOTAL (from April, 2000 to Sep, 2022)		6,18,196	20,006	1,99,827	49,733	8,87,762	-	2,30,939

Source: *(i) RBI's Bulletin for August, 2022 dt.18.11.2022 (Table No. 34 – FOREIGN INVESTMENT INFLOW).*

(ii) Inflow under the acquisition of shares in March, 2011, August, 2011 & October, 2011, include net FDI on account of transfer of participating interest from Reliance Industries Ltd. to BP Exploration (Alpha).

(iii) RBI had included Swap of Shares of USD 3.1 billion under equity components during December 2006.

(iv) Monthly data on components of FDI as per expended coverage are not available. These data, therefore, are not comparable with FDI data for previous years.

(v) Figures updated by RBI up to September, 2022. Figures are provisional.

(vi) Data in respect of 'Re-invested earnings' & 'Other capital' are estimated as average of previous two years. '#' Figures for equity capital of unincorporated bodies are estimates. (P) All figures are provisional.

DPIIT's – FINANCIAL YEAR-WISE FDI EQUITY INFLOW:

(As per DPIIT's FDI data base – equity capital components only):

S. No.	Financial Year (April – March)	Amount of FDI Equity inflow		% age growth over previous year (in terms of USD)
FINANCIAL YEAR 2000-01 TO 2022-23		*In INR Crores*	*In USD Million*	
1	2000-01	10,733	2,463	-
2	2001-02	18,654	4,065	(+)65 %
3	2002-03	12,871	2,705	(-)33 %
4	2003-04	10,064	2,188	(-)19 %
5	2004-05	14,653	3,219	(+)47 %
6	2005-06	24,584	5,540	(+)72 %
7	2006-07	56,390	12,492	(+)125 %
8	2007-08	98,642	24,575	(+)97 %
9	2008-09	1,42,829	31,396	(+)28 %
10	2009-10	1,23,120	25,834	(-)18 %
11	2010-11	97,320	21,383	(-)17 %
12	2011-12 ^	1,65,146	35,121	(+)64 %
13	2012-13	1,21,907	22,423	(-)36 %
14	2013-14	1,47,518	24,299	(+)8%
15	2014-15	1,81,682	29,737	(+)22%
16	2015-16	2,62,322	40,001	(+)35%
17	2016-17	2,91,696	43,478	(+)9%
18	2017-18	2,88,889	44,857	(+)3%
19	2018-19	3,09,867	44,366	(-)1%
20	2019–20	3,53,558	49,977	(+)13%
21	2020-21	4,42,569	59,636	(+)19%
22	2021-22	4,37,188	58,773	(-) 1%

23	2022-23 (up to September, 2022)	2,10,156	26,910	
CUMULATIVE TOTAL (from April, 2000 to September, 2022)		38,22,358	6,15,438	

Note: *i including amount remitted through RBI's-NRI Schemes (2000-2002).*

ii. FEDAI (Foreign Exchange DealeINR Association of India) conveINRion rate from rupees to US dollar applied, on the basis of monthly average rate provided by RBI (DEPR), Mumbai^ inflow for the month of March, 2012 are as reported by RBI, consequent to the adjustment made in the figures of March, '11, August, '11 and October, '11.

4.5. CHECK YOUR PROGRESS

Choose the correct option-

1. Foreign Direct Investment is for a _______ period of time-
   a) Short
   b) Medium
   c) Long
   d) Any of the above
2. Which of the following can be sold of quickly-
   a) Foreign Direct Investment
   b) Foreign Portfolio Investment
   c) Both of the above
   d) None of the above
3. Foreign Direct Investments involve-
   a) Opening business in another country.
   b) Having a controlling interest in a foreign country.
   c) Rendering technical experience and managerial expertise.
   d) All of the above.
4. The minimum threshold fixed for controlling interest in FDI is-
   a) 10%

b) 20%

c) 30%

d) 100%

5. FDI is prohibited in-

a) Business of Chit funds

b) Plantation sector,

c) Ports & Shipping,

d) Railway Infrastructure,

4.6 SUMMARY

Developing countries are usually associated with low saving and low capital formation. In spite of being abundant in natural resources these countries are unable to exploit these resources due to dearth of capital and technology. Hence to bridge the gap between ‘having’ resources and ‘utilizing’ resources, foreign aid in the form of foreign capital is necessary for developing countries. Foreign Direct Investment is “a business decision to acquire a substantial stake in a foreign business or to buy it outright to expand operations to a new region”. Foreign Direct Investment is “an investment in the form of a controlling ownership in a business, in real estate or in productive assets such as factories in one country by an entity based in another country”. Foreign Direct Investment can be made by the foreign company in the host country by establishing a wholly owned subsidiary, acquisition of share capital in an associated company, merger or an acquisition or entering into a joint venture. Foreign direct investments can be classified as Horizontal Foreign Direct Investment, Vertical Foreign Direct Investment, Conglomerate Foreign Direct Investment and Platform Foreign Direct Investment. There is multiplicity of factors affecting foreign direct investment decisions. The host country should be able to gain competitive advantage in terms of low production cost in the host country. It should get skilled labor and abundant natural resources. Countries should be able to have lower cost of distribution and transportation. A country must have the key technology available with it. The companies like to invest in countries where they can have the benefit of low taxation. The host country must have reasonably good sized population so that the produce can be sold in that country only. There should not be major political disturbances in the country. Since cost is a very major consideration for countries to invest in other countries; hence countries with weak exchange rates become favored destinations for FDIs.

There are two routes for FDIs to enter into India- Automatic Route and the Government Route. Under the Automatic Route, the foreign investor or the Indian company does not require any approval from RBI or Government of India for the investment. Under the Government Route, prior approval of the Government of India, Ministry of Finance and Foreign Investment Promotion Board (FIPB) is required. India's share in world's FDI in increasing since liberalization. The latest value from 2020 is 5.91 percent. Out of 185 countries surveyed for the average of 2020, China obtained rank 1 while India stood at Rank 8, thus ranking among top 10 countries to received FDIs.

Foreign Direct Investments give benefits to both the investing country as well as the host country. The investing company has many choices. It can follow the horizontal, vertical or even the conglomerate FDI method. In all the cases there is diversification of markets of the investing country. Foreign investors basically invest in other countries for availing the cost advantage as a competitive gain. Low labor cost is one of the major reasons for countries to invest in the businesses in other countries. Those countries which have lesser taxes are favorite destinations for investors. The investing countries are able to reduce risk as FDIs result in horizontal expansion of business. Foreign Direct Investments provides the host country with ample amount of capital to exploit their resources. People are able to get jobs when new businesses are opened by the foreign investors. Since FDIs generate controlling interest via a substantial stake of investing country in the business opened in host countries, so the foreign businessmen not only bring capital but also the technology and the expertise to use the same. People learn new skills and technology with the advent of foreign companies in the country. The host country has improved economic growth. Foreign Direct Investments have disadvantages as well. The alien country tends to have controlling interest for a long period of time. Due to the formation of Multinational companies that bring FDIs local and indigenous businesses suffer. The aim of foreign country is to earn profits from money invested in the form of FDI and repatriate the profits.

4.7 KEY WORDS

1. **Foreign Direct Investment-** Foreign Direct Investment is "an investment in the form of a controlling ownership in a business, in real estate or in productive assets such as factories in one country by an entity based in another country".
2. **Horizontal Foreign Direct Investment-** When a foreign company establishes the same type of business in another country as it is operating in its own country, it is called Horizontal Foreign Direct Investment
3. **Vertical Foreign Direct Investment-** When a company opens a business in another country that falls on its supply chain it is called Vertical Foreign Direct Investment.
4. **Conglomerate Foreign Direct Investment-** When a company opens a business in another country that is unrelated to its current industry it is called Conglomerate Foreign Direct Investment
5. **Platform Foreign Direct Investment:** This is an "export-platform FDI". In this form a foreign company opens business in another country but the output from the foreign operations is exported to a third country

4.8 SELF ASSESSMENT TEST

a) Define Foreign Direct Investments. Explain their features.

b) Explain the methods and routes through which Foreign Direct Investments can enter a country.

c) What are Foreign Direct Investments? Explain their types.

d) What are the factors that influence receipt of Foreign Direct Investments?

e) Discuss the status of Foreign Direct Investments in India.

f) Write notes on-

   i. Foreign Direct Investments VS Foreign Portfolio Investments

   ii. Advantages of Foreign Direct Investments

   iii. Disadvantages of Foreign Direct Investments

4.9 ANSWERS TO CHECK YOUR PROGRESS

1. Long

2. Foreign Portfolio Investment
3. All of the above
4. 10%
5. Business of chit funds

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Course: Business Environment	Author: Dr. Aparna Bhatia
Course Code: BCOM- 206	Vetter: Prof. Pardeep Kumar Gupta
LESSON: 05 World Trade Organization	

Structure:

5.0. LEARNING OBJECTIVES

After going through this lesson you should be able to know

- The purpose and establishment of WTO, its predecessor GATT, difference between GATT and WTO
- the objectives, principles and functions of World Trade Organization
- organization structure and role at various hierarchal level of World Trade Organization
- reasons in favor and against the membership of World Trade Organization

- concept of trading blocs

5.1. WORLD TRADE ORGANIZATION (WTO) INTRODUCTION

WTO is an organization for liberalizing trade. It's a forum for governments to negotiate trade agreements. It's a place where countries to settle their trade disputes. It operates a system of trade rules. WTO is in fact a negotiating forum where member countries discuss and sort out the trade problems which they encounter while trading with each other. Negotiations are the base of WTO. All issues are settled through negotiations only. After all, the WTO was born out of negotiations. It came into being as a result of negotiations in the Uruguay Round from 1986-94 and earlier negotiations under the General Agreement on Tariffs and Trade (GATT). WTO helps in overcoming trade barriers offering smooth and free flow of trade to its member countries. Member nations sign agreements ensuring to keep their trade policies within the agreed limits. Trade rules become very clear, transparent and predictable. Trading between countries becomes harmonious giving confidence to traders that there shall not be any sudden or abrupt changes in trade rules. The system leads to economic and social development of countries.

Establishment-

WTO came into existence on I January, 1995. The members who participated in the Uruguay Round (UR) collectively took the decision of transforming General Agreement on Tariffs and Trade (GATT) into international organization that oversees the operations of the rules-based multilateral trading systems. Thus, WTO is the result of series of trade agreements that were negotiated during the Uruguay Round from 1986-94, the eighth and final trade round that was conducted under GATT. Thus, WTO became the successor of GATT. The treaty of Marrakesh established WTO at the close of the Uruguay Round in 1994, which began operations with 148 members. Currently, the WTO has over 160 members representing 98 per cent of world trade. Over 20 countries are seeking to join the WTO. Headquarters of WTO are in Geneva, Switzerland. Peter Sutherland was the first director general of WTO till 30th April, 1995. Currently, Ngozi Okonjo-Iweala is the seventh director-general of the WTO. She took office on 1 march 2021, becoming the first woman and the first African to serve as Director-General. Her term of office will expire on 31 August 2025.

Predecessor of WTO- GATT

WTO is the successor of GATT which was formed on January 1, 1948 as a result of agreement between 23 countries to have multilateral trade regulating organization in place of an Internal Trading Organization (ITO), which all of them voted in favor. But since American senate voted against it, the same could not be set up. The objective of GATT was to "ensure substantial reduction of tariffs and other barriers and the elimination of preferences, on a reciprocal and mutually advantageous basis". GATT was based on the following principles-

- It followed the principle of non-discrimination which stated that no member of GATT could discriminate against other nation or favor or give any special privilege to any other nation.
- GATT believed in tariff protection measures rather than Non- tariff measures. This means that GATT used tariff measures for protecting the domestic industry rather than non-tariff measures as fixing import quotas.
- GATT implemented stable basis of trade. This function was carried on by GATT during 1947 to 1994 over three phases. In the first phase from 1947 till Torquay Round, it mentioned the commodities that were covered by the existing trade agreement and fixation of tariffs on these commodities. In the second phase, form 1959 to 1979, the focus was on tariff reduction while in the third phase from 1986-94 the benefits of agreement were extended to new areas as services, intellectual property, investment measures and agriculture. There after this round WTO was formed to take over the function of GATT.

Formation of UNCTAD

GATT was blamed that it served the interests of the developed nations only. So much so that it was nicknamed as "Rich men's club". Consequently the developing countries that were part of GATT, once again recommended establishing ITO. But since America was against it earlier also, so the deadlock was overcome by establishing UNCTAD- United Nations' Conference on Trade and Development in the year 1964. UNCTAD performed the following functions-

- Promoting international trade to achieve economic growth.
- Formulation of principles and policies of international trade.
- Negotiating multinational trade agreements.

- Ensuring that the principles framed are put into effect.

Thus, sequential formation of WTO is shown as follows in Table 1-

Table 1- Genesis of WTO

Year	Event
1947	The General Agreement on Trade & Tariffs (GATT) is drawn up to record the resultof tariff negotiations among 23 countries. The agreement entered into force on January 1, 1948.
1948	The GATT provisionally enters into force. Delegations from 56 countries meet in Havana, Cuba to consider the final draft of the International TradeOrganization (ITO) agreement; in March 1948, 53 countries sign the Havana Charter establishing an ITO.
1950	China withdraws from GATT. The US administration abandons efforts to seekcongressional ratification of the ITO.
1955	A review session modifies numerous provisions of the GATT. The US is granted a waiver from GATT disciplines for certain agricultural policies. Japan accedes to GATT.
1965	Part IV (on trade and development) is added to the GATT, establishing new guidelines for trade policies of & towards developing countries. A Committee on Trade & Development is created to monitor implementation.
1974	The Agreement regarding International Trade in Textiles, better known as theMultiFibre Agreement (MFA), comes into force. The MFA restricts export growth in clothing & textiles to 6% per year. It is renegotiated in 1977 & 1982 & extended in 1986, 1991 & 1992.
1986	The Uruguay Round is launched in Punta del Esta, Uruguay.
1994	In Marrakesh, on April 15, ministers sign the final act establishing the WTO & embodying the results of the Uruguay Round.
1995	The WTO comes into force on January 1.
1996	Ministerial meeting in Seattle fails to launch a new round. Wide scale protests in Seattle and elsewhere on the proposed inclusion of labour clause in the WTO.
2001	Doha Ministerial Meet
2003	Fifth Ministerial Meet in Cancun, Mexico from 10-14 September 2003*
2005	Sixth Ministerial Meet held in December 2005 in Hong Kong
2006	The mini-minterial conference of the WTO held in Geneva during June-July 2006 ended in a deadlock over the issues raised by the developing countries.
2007	Another mini-ministerial proposed in Davos in January and yet another meeting in July to finish negotiations by 2007.

(Source- Statistical Outline of India- TATA Services Ltd.)

Difference between GATT and WTO

The differences between GATT and its successor WTO are highlighted as follows in Table 2.

Table 2- Difference between GATT and WTO

S.No.	GATT	WTO
1	GATT merely represented set of rules. It was a multilateral agreement between	WTO is an international permanent institute with a secretariat.

	member countries with an ad hoc secretariat.	
2	GATT was provisional and temporary.	WTO is a permanent body.
3	GATT followed a selective approach. It was quite later that it adopted plurilateral nature.	WTO is multilateral in nature
4	GATT is applicable only to merchandise goods.	WTO is applicable to multilateral trading system, trade in services, intellectual property and investment.
5	GATT has very slow dispute settlement mechanism.	WTO has very efficient dispute settlement mechanism.
6	GATT was originally formed with 23 members.	WTO was originally formed with 164 member states.
7	Member countries of GATT are called 'contracting parties'.	Member countries of WTO are called 'member states'.
8	Existing domestic legislation is allowed to continue by the GATT system even if it violates the agreement.	This is not allowed under WTO.

Objectives of World Trade Organization

The overall objective of the WTO is "to help its members use trade as a means to raise living standards, create jobs and improve people's lives. The WTO operates the global system of trade rules and helps developing countries build their trade capacity. It also provides a forum for its members to negotiate trade agreements and to resolve the trade problems they face with each other." (Source- wto.org)

The following objectives are laid down in the preamble of World Trade Organization-

- The parties to this agreement, "*should recognize that their relations in trade and economic should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the* *production of and trade in goods and services, while allowing for the optimal use of the world's resources in accordance with the objective of sustainable development, seeking both to protect and preserve the environment and to enhance the means for doing so in a manner consistent with their respective needs and concerns at different levels of economic development".* In simple words, WTO aims at holistic development which includes raising standard of living of people, ensuring full employment, maximum production and optimum utilization of resources for sustainable development.

- *"Recognizing further that there is a need for positive efforts designed to ensure that developing countries, and especially the least developed among them, secure a share in the growth of international trade commensurate with the needs of their economic development".* In simple words, WTO ensures that developing and especially the least developed countries get a significant share of economic growth.
- *"being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the eliminations of discriminatory treatment in international trade relations".* In simple words, WTO ensures non discriminatory treatment and availability of trade concessions to all member nations equally.
- *"resolved, therefore, to develop an integrated, more viable and durable multilateral trading system encompassing the general agreement on tariffs and trade, the results of past liberalization efforts, and all of the results of the Uruguay round of multilateral trade negotiations, determined to preserve the basic principles and to further the objectives underlying this multilateral trading system".* In simple words, WTO ensures that all issues agreed upon in the Uruguay Round are fully put into practice.

(Source- WTO Agreement – Preamble; wto.org)

Core Principles of World Trade Organization

WTO gives global rules of trade between its member nations. Its main aim is to ensure free and smooth flow of trade. Hence, WTO has given the following core principles-

1. **Principle of non-discrimination-** This principle states that WTO follows the Most Favored Nation (MFN) status, that is, a trade concession granted to one-member country shall automatically extent to all other member countries. All member countries shall be treated as the most favored nations. Every time a tariff is lowered or the market is opened, its benefit shall extend to all nations equally.
2. **Principle of National Treatment-** WTO also follows the national treatment, implying that equal treatment is extended to imported goods in a member's market as are granted to its domestically produced goods. There shall not be any discrimination between domestic and imported goods. Both shall be treated at par. The principle states that, "any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties."
3. **Principle of Free Trade-** This principle promotes free trade between nations. Several tariff and non-tariff barriers should be relaxed amongst nations to facilitate free flow of goods and services. There should be "progressive liberalization of trade regimes".
4. **Principle of predictability of rules of trade-** This principle states that the governments of different member countries should not arbitrarily raise the tariff or non-tariff barriers.
5. **Principle of Fair competition-** WTO provides open and fair competition to all nations. There has to be 'level playing field' between foreign and domestic goods in order to promote competition between them. This ensures that there are no disruptive trade practices as dumping and export subsidies.
6. **Principle of economic development through trade-** This principle states that the developing countries shall be able to benefit through trade assistance. They shall be allowed to enter into preferential trade agreements where certain concessions in tariffs may be granted to them in order to boost trade and economic growth.
7. **Principle of environment protection-** WTO focuses on environmental protection and sustainable development. It contains provisions to protect human, animal and plant life, health and environment.

Functions of World Trade Organizatoin

The functions of WTO include the following-

- To ensure implementation of all multilateral agreements and trade negotiations.
- Acting as a mechanism of trade dispute settlement.
- Overseeing national trade policies
- Giving cooperation to all other institutions and bodies engaged in global policy making.
- Ensuring implementation of both tariff and non-tariff cuts to all member nations.
- Maintain databases about trade statistics as provided by various countries.

Arguments In Favor of Joining WTO

The WTO "aspires for free trade by binding its members with international commitments in terms of access to the goods and services markets, the use of economic policy instruments affecting trade, and the state support of agriculture".

WTO membership provides:

1. most favored nation treatment, which means equal access for all companies of all WTO Members to the markets of all Members of the Organization;
2. national treatment that prohibits national producers from gaining advantages over importers; — reduction of trade barriers, primarily tariffs and quantitative restrictions, which provides for increased trade between Members;
3. predictability and transparency of international trade – WTO Members have bound their tariffs and cannot, except for good reason, introduce other import restrictions, such as bans or quotas;
4. increased competitiveness by eliminating unfair practices between trading partners aimed at stimulating trade, primarily export subsidies and dumping;
5. opportunity to defend trade interests at the WTO Dispute Settlement Body, (Source: https://mfa.gov.)

Arguments against Joining WTO

1. The World Trade Organization's has narrow national objectives. It only concern is to regulate trade conditions and the security of governments in this area. It does not take responsibility of any other aspect of national security.
2. WTO has been unfair to developing countries. It is often accused of conducting trade deals where powerful governments and large corporations dictate policies. Developing countries usually suffer more than gain from the cutting off trade deals with other nations due to their low impact on the global economic system.
3. The primary concern of WTO has been protecting the interests of large corporations and governments. It does not focus on unfair behavior towards workers and laborers involved in the trade
4. The rules and regulations of WTO are more in favor of powerful multinational companies only. It is not able to treat all companies equally. This reduces the trade balance and makes it difficult for small businesses to succeed.
5. There is higher environmental degradation of WTO member countries. The member countries establish more industries and technical enterprises, which leads them to use more resources and degrade the environment

5.2. ORGANIZATIONAL STRUCTURE OF WTO

Highest authority: the Ministerial Conference

The Ministerial Conference is WTO’s top-level decision-making body. It consists of representatives of all WTO member countries. It has authority to deal with all multi trade agreements. It usually meets every two years. The first Ministerial Conference of WTO was held in Singapore in 1996.

Second level: General Council in three guises

- **The General Council**
- **The Trade Policy Review Body**
- **The Dispute Settlement Body**

Below the Ministerial Conference is the General Council (normally ambassadors and heads of delegation in Geneva, and sometimes officials sent from members' capitals). Routine work is handled by the General Council. These meet several times a year in the Geneva headquarters. The 'General Council' also meets as the 'Trade Policy Review Body' (TPRB) and the 'Dispute Settlement Body' (DSB). The TPRB reviews the trade policies of WTO members while DSB meets twice a month to resolve complaints of violations of rules and regulations of WTO.

Third level: councils for each broad area of trade, and more

- **The Council for Trade in Goods (Goods Council)**
- **The Council for Trade in Services (Services Council)**
- **The Council for Trade-Related Aspects of Intellectual Property Rights (TRIPS Council)**

At the next hierarchal level, the Goods Council, Services Council and Intellectual Property (TRIPS) Council report to the General Council. Three more councils, each handling a different broad area of trade, report to the General Council. Several specialized committees, working groups and working parties deal with the individual agreements and other areas such as the environment, development, membership applications and regional trade agreements. All WTO members may participate in all councils and committees, with the exceptions of the Appellate Body, Dispute Settlement panels and plurilateral committees.

Fourth level: down to the nitty-gritty

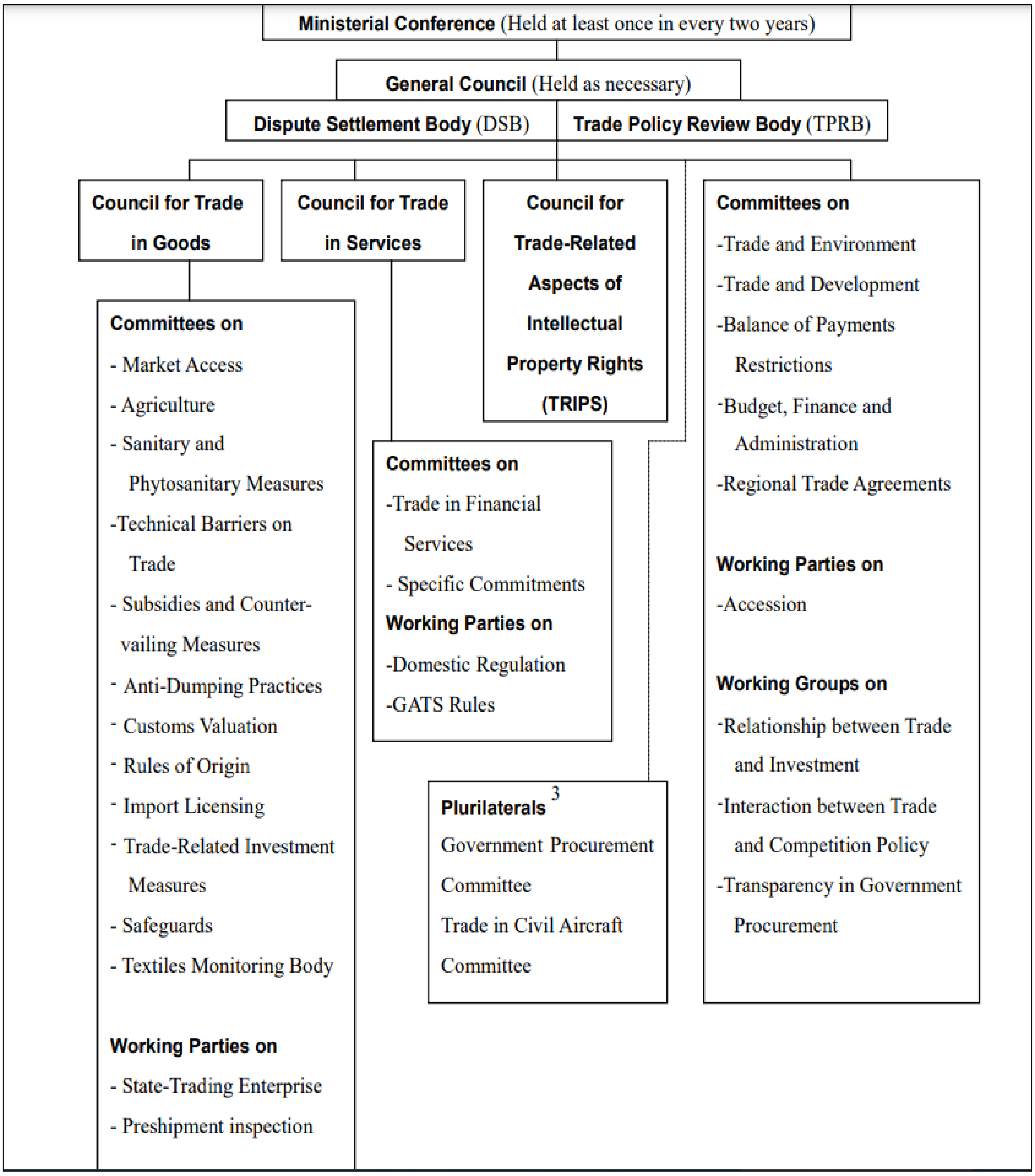
Each of the higher level councils has subsidiary bodies. The Goods Council has 11 committees dealing with specific subjects (such as agriculture, market access, subsidies, anti-dumping measures and so on). Again, these consist of all member countries. Also reporting to the Goods Council is the Textiles Monitoring Body, which consists of a chairman and 10 members acting in their personal capacities, and groups dealing with notifications (governments informing the WTO about current and new policies or measures) and state trading enterprises.

The Services Council's subsidiary bodies deal with financial services, domestic regulations, GATS rules and specific commitments.

At the General Council level, the Dispute Settlement Body also has two subsidiaries: the dispute settlement "panels" of experts appointed to adjudicate on unresolved disputes, and the Appellate Body that deals with appeals. The structure of WTO is shown in the following figure.

(Source- World Trade Organization)

Figure 1- Organizational Structure of WTO



(Source-wto.org)

Since inception of WTO twelve ministerial conferences have been held. The details are shown as follows in Table 2-

Table 2- Ministerial Conferences of WTO

S.No.	Country	Year
1	Singapore	9-13 December 1996
2	Geneva	18-20 May 1998
3	Seattle	30 November-3 December 1999
4	Doha	9-13 November 2001
5	Cancun	10-14 September 2003
6	Hong Kong	13-18 December 2005
7	Geneva	30 November to 2 December 2009
8	Geneva	15-17 December 2011
9	Bali	3-6 December 2013
10	Nairobi	15-19 December 2015
11	Buenos Aires	10-13 December 2017
12	Geneva	12-16 June 2022

(Source- World Trade Organization)

5.3. TRADING BLOCS

A trading bloc is a "type of intergovernmental agreement, often part of a regional intergovernmental organization, where regional barriers to international trade, (tariffs and non-tariff barriers) are reduced or eliminated among the participating states, allowing them to trade with each other as easily as possible". Here members trade freely with each other unlike non-member states which are subject to restrictions and barriers to trade. International trade agreements open up new opportunities for exporters. They also generate access to competitively priced imports from other countries.

Trading blocs result in Trade Creation and Trade Diversion. Trade creation involves "new trade that would not exist without the Free Trade Agreement and is always beneficial for the countries in terms of national welfare". Trade diversion involves "the shifting of trade away from one country toward one's free trade partner and is sometimes detrimental to the countries in terms of national welfare".

Common agreements in trading blocs are of two types-

i. Bilateral agreements

ii. Multilateral agreements

Bilateral agreements are those that are between two countries and/or trading blocs.

For instance, an agreement between the EU and some other country is a bilateral agreement.

Multilateral agreements are those that involve at least three countries and/or trading blocs.

Types of Trading Blocs

The following are the kinds of trading blocs-

1. Preferential Trading Areas

Preferential Trading Areas (PTAs) are areas where any trade barriers, such as tariffs and quotas, are reduced on selected goods but not all goods traded between member countries. Preferential trading areas (PTAs) are the most basic form of trading blocs. These kinds of agreements are relatively flexible.

Example- India and Chile have a PTA agreement. This allows the two countries to trade 1800 goods between them with reduced trade barriers. (Source- economicsonline.co.uk)

2. Free Trade Areas

Free Trade Areas (FTAs) are agreements that remove all trade barriers or restrictions between the countries involved. Also, each member continues to retain the right to decide on their trade policies with the non-members (countries or blocs not part of the agreement).

Example- The **USMCA** (United States-Mexico-Canada Agreement) is an example of an FTA. As its name says, it is an agreement between the US, Canada, and Mexico. Each country freely trades with one another and can trade with other countries that are not a part of this agreement. (Source- economicsonline.co.uk)

3. Customs unions

Custom unions are an agreement between countries/trading blocs in which member countries of a customs union agree to abolish trade restrictions between each other, but also agree to impose the same import restrictions on non-member countries.

Example The European Union (EU) and Turkey have a customs union agreement. Turkey can trade freely with any EU member but it has to impose common external tariffs (CETs) on other countries that are not EU members. (Source- economicsonline.co.uk)

4. Common markets

The common market type of trading bloc is an extension of the customs union agreements. **A** common market is the "removal of trade barriers and the free movement of labor and capital between its members". It is also called a 'single market'.

Example- European Union (EU) is an example of a common/single market. All 27 countries freely enjoy trading with each other without restrictions. There is also free movement of labor and capital. (Source- economicsonline.co.uk)

5. Economic unions

An economic union is an extension of common market. It is also known as a **'**monetary union**'**. It involves the removal of "trade barriers, the free movement of labor and capital**,** and the adoption of a single currency between its members". In this bloc since a single currency is adopted, so the member countries that choose to adopt the same currency must also have a common monetary policy, and to some extent common fiscal policy.

In European Union 20 countries out of 27 have replace their national currencies with Euro forming the Eurozone or the Euro area. (Source- European Unio)

Ten major Trading Blocs

ASEAN – Association of South East Asian Nations

ASEAN was established on 8^{th} August 1967 in Bangkok, Thailand. There are 10 member countries of ASEAN including Brunei, Malaysia, Singapore, Vietnam, Indonesia, Laos, Cambodia, Thailand, Philippines and Myanmar.

1. APEC – Asia Pacific Economic Cooperation

APEC consists of 21 member countries including Brunei Darussalam, Canada, Chile, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Philippines, Russia, Singapore, Taipei, Thailand, United States and Vietnam.

2. BRICS

BRICS is an association of five national economies such as Brazil, Russia, India, China and South Africa.

3. EU – European Union

European Union is the most integrated trade block in the world and formed in the year 1951. EU consists of 27 member countries which are Austria, Belgium, Bulgaria, Denmark, Finland, Germany, France, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden, Cyprus, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.

4. NAFTA – North America Free Trade Agreement

NAFTA was established on 1st January 1994 and comprises three giant member countries which are Canada, United States and Mexico.

5. CIS – Commonwealth of Independent States

CIS group was founded in the year 1991 and it is a group of 12 member countries including Azerbaijan, Armenia, Russia, Ukraine, Kazakhstan, Belarus, Turkmenistan, Uzbekistan, Georgia, Moldova, Kyrgyzstan and Tajikistan.

6. COMESA – Common Market for Eastern and Southern Africa

It is an economic union of southern and eastern African countries. It consists of 19 member countries such as Burundi, Comoros, DR Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Libya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia and Zimbabwe.

7. SAARC – South Asian Association for Regional Cooperation

SAARC comprises of South Asian countries. It was founded on 8th December 1985 and its member states include Afghanistan, Bangladesh, Bhutan, India, Nepal, Maldives, Pakistan and Sri Lanka.

8. MERCOSUR- Mercado Comun del Cono Sur

MERCOSUR stands for Mercado Comun del Cono Sur which means Southern Common Market and it was established on 26th March 1991. It is tariff union of South American countries covering the market of Brazil, Argentina, Venezuela, Paraguay and Uruguay. Its associate members include Bolivia, Chile, Colombia, Ecuador and Peru

9. IOR-ARC – Indian Ocean Rim Association for Regional Cooperation

IOR-ARC comprises 21 member countries such as Australia, Bangladesh, Comoros, India, Indonesia, Iran, Kenya, Madagascar, Malaysia, Mauritius, Mozambique, Oman, Seychelles, Somalia, Singapore, South Africa, Sri Lanka, Tanzania, Thailand, UAE and Yemen.

Advantages and Disadvantages of Trading Blocs

The following section discusses the advantages and disadvantages of trading blocs-

Advantages

1. **Promotion of free trade-** Trading blocs result in free trade between member nations. This results in lowering of prices, improvement in exports, cheap imports and hence economic growth and development.
2. **Improves legal framework and governance mechanism-** All member countries fall in common ambit of agreements and governance mechanisms. Hence the state of law and governance improves in member countries**.**
3. **Increase in employment-**. Trading blocs like customs and economic unions encourage foreign direct investment (FDI). This helps in increasing employment and creating job opportunities in countries.
4. **Increase in purchasing power-** . Trading blocs promote free trade. This results in increase in real income and resultantly increases in purchasing power of member countries.
5. **Good international relations**. Trading blocs help in promoting good international relationships between its members. Countries move harmoniously in setting the rules of trade.

Disadvantages

Some main disadvantages of trading blocs are:

1. **Trade diversion-** Trade diversion involves "the shifting of trade away from one country toward one's free trade partner and is sometimes detrimental to the countries in terms of national welfare**".** Hence trading blocs distort world trade. The trade gets based on bloc membership rather than specialization
2. **Loss of sovereignty-** In certain types of trading blocs countries lose control over the decision making of their monetary and fiscal policies. This may not be suitable to individual countries during different economic cycles in their respective countries.
3. **Higher interdependence-** Trading blocs result in greater economic interdependence of the member countries. Extreme reliance creates problems during the times of political disturbances amongst countries.
4. **Difficult to exit-** It is a very hard decision for countries to exit the trading bloc. Other non-member countries may not cooperate with the member countries of a particular trading bloc.
5. **Detrimental impact of trading blocs on developing countries-** Developing countries may sometimes be losers in becoming member of trading blocs along with developed countries. They lose their freedom of decision making. Their economic development gets limited. They become highly dependent on their developed counterparts. They get bound by the terms and conditions set for the whole block.

5.4. CHECK YOUR PROGRESS

Choose the correct option-

1. Which body has been the predecessor of WTO-
   a) IMF
   b) NABARD
   c) RBI
   d) GATT
2. WTO was established in the year-
   a) 1995

b) 1948

c) 2001

d) 2016

3. 'National treatment' means-

a) Domestic goods are superior to imported goods.

b) Imported goods are superior to domestic goods.

c) Imported goods should be treated at par with domestic goods

d) None of the above

4. Which of the following is at the top of hierarchy of WTO-

a) The General Council

b) The Dispute Settlement Body

c) The Trade Policy Review Body

d) The Ministerial Conference

5. Trading blocs extend their benefits to-

a) Developing countries only

b) Developed countries only

c) Member countries only

d) Non-member countries only

5.5 SUMMARY

WTO is an organization for liberalizing trade. It's a forum for governments to negotiate trade agreements. It's a place where countries to settle their trade disputes. It operates a system of trade rules. WTO is in fact a negotiating forum where member countries discuss and sort out the trade problems which they encounter while trading with each other. WTO was born out of negotiations, It came into being as a result of negotiations in the Uruguay Round from 1986-94 and earlier negotiations under the General Agreement on Tariffs and Trade (GATT). WTO helps in overcoming trade barriers offering smooth and free flow of trade to its member countries. Member nations sign agreements ensuring to keep their trade policies within the agreed limits set by various member countries. WTO came into existence on 1 January, 1995. The members who participated in the Uruguay Round (UR) collectively took the decision of transforming general agreement on tariffs and trade (GATT) into international organization that oversees the operations of the rules-based multilateral trading systems. Currently, the WTO has over 160 members representing 98 per cent of world trade. Currently, Ngozi Okonjo-Iweala is the seventh director-general of the WTO.

WTO is the successor of GATT which was formed on January 1, 1948 as a result of agreement between 23 countries to have multilateral trade regulating organization in place of an internal trading organization (ITO), which all of them voted in favor. But since American Senate voted against it, the same could not be set up. The objective of GATT was to "ensure substantial reduction of tariffs and other barriers and the elimination of preferences, on a reciprocal and mutually advantageous basis".

The overall objective of the WTO is "to help its members use trade as a means to raise living standards, create jobs and improve people's lives. It also provides a forum for its members to negotiate trade agreements and to resolve the trade problems they face with each other." WTO aims at holistic development which includes raising standard of living of people, ensuring full employment, maximum production and optimum utilization of resources for sustainable development. It ensures that developing and especially the least developed countries get a significant share of economic growth. It also ensures non-discriminatory treatment and availability of trade concessions to all member nations equally.

WTO follows the most favored nation (MFN) status. WTO also follows the national treatment. It promotes free trade between nations. It ensures that the governments of different member countries should not arbitrarily raise the tariff or non-tariff barriers. WTO provides open and fair competition to all nations. There has to be 'level playing field' between foreign and domestic goods.

Organization Structure of WTO suggest that the Ministerial Conference is WTO's top-level decision-making body. It consists of representatives of all WTO member countries. Below the Ministerial Conference is the General Council (normally ambassadors and heads of delegation in Geneva, and sometimes officials sent from members' capitals). Routine work is handled by the General Council. At the next hierarchal level, the Goods Council, Services Council and Intellectual Property (TRIPS)

Council report to the General Council. Three more councils, each handling a different broad area of trade, report to the General Council. Each of the higher level councils has subsidiary bodies.

WTO encourages formation of trading blocs. A trading bloc is a "type of intergovernmental agreement, often part of a regional intergovernmental organization, where regional barriers to international trade, (tariffs and non-tariff barriers) are reduced or eliminated among the participating states, allowing them to trade with each other as easily as possible". Here members trade freely with each other unlike non-member states which are subject to restrictions and barriers to trade. Common agreements in trading blocs are of two types- Bilateral agreements and multilateral agreements. There are different kinds of trading blocs namely Preferential Trading Areas, Free Trade Areas, Customs Unions, Common Markets and Economic Unions.

5.6 KEY WORDS

1. **Most Favored Nation (MFN) status**- MFN implies that a trade concession granted to one member country shall automatically extent to all other member countries.
2. **National Treatment**- It implies that equal treatment is extended to imported goods in a member's market as are granted to its domestically produced goods.
3. **Trade creation**- It involves "new trade that would not exist without the Free Trade Agreement and is always beneficial for the countries in terms of national welfare".
4. **Trade diversion**- It involves "the shifting of trade away from one country toward one's free trade partner and is sometimes detrimental to the countries in terms of national welfare".
5. **Bilateral agreements**- These are those agreements that are between two countries and/or trading blocs.
6. **Multilateral agreements**- These are those agreements that involve at least three countries and/or trading blocs.
7. **Preferential Trading Areas (PTAs)- These** are areas where any trade barriers, such as tariffs and quotas, are reduced on selected goods but not all goods traded between member countries.
8. **Free Trade Areas (FTAs)- These** are agreements that remove all trade barriers or restrictions between the countries involved.

9. **Custom unions**- These are an agreement between countries/trading blocs in which member countries of a customs union agree to abolish trade restrictions between each other, but also agree to impose the same import restrictions on non-member countries.

5.7 SELF ASSESSMENT TEST

1. What is WTO? How was it formed?
2. What is GATT? How does it differ from its successor the WTO?
3. Explain objectives and functions of WTO.
4. Give core principles of WTO.
5. Explain the organizational structure of WTO
6. What is meant by Trading blocs? Discuss its types.
7. Explain-
   a) Arguments in favor and against the membership of WTO
   b) Advantages and disadvantages of Trading blocs.
8. Write notes on-
   a) Genesis of WTO
   b) The Ministerial Conference and its role.
   c) Most-Favored-Nation Status

5.8 ANSWERS TO CHECK YOUR PROGRESS

1. GATT
2. 1995
3. Imported goods should be treated at par with domestic goods
4. The Ministerial Conference
5. Member countries only

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Course: Business Environment	Author: Dr. Aparna Bhatia
Course Code: BCOM- 206	Vetter: Prof. Pardeep Kumar Gupta

LESSON: 06

Multinational Companies in India

STRUCTURE:

6.0. LEARNING OBJECTIVES

After going through this lesson you should be able to know

- the concept of multinational companies
- nature and characteristics of Multinational Companies
- various phases through which a company passes in the process of internationalization
- benefits and threats of becoming international

6.1. INTRODUCTION

The present era is the era of liberalization, privatization and globalization. Countries across the world have opened their economies to foreign partners and foreign trade. In a globalised world there is free flow of goods, services, people and money. The barriers of trade are lowered or even abolished. It is like a 'global village' where all live together and are highly interdependent on each other for their needs. There are many ways and channels of exchanging capital, technology, expertise and infrastructure amongst countries. Emergence of multinational corporations (MNCs) is one such mode of going global. The number of MNCs has been on the rise as a result of globalization. Nowadays, multinational firms can be found in all kinds of industries, including retail, automobile, technology, fashion, food, and beverages. To quote a few examples, Amazon, Toyota, Google, Apple, Zara, Starbucks, McDonald's, etc. are some of the world's most well-known multinational corporations.

In earlier times companies doing business in several countries followed the ethnocentric approach and considered that the rule and regulations followed in their home country would work well in rest of the world as well. But now the geocentric approach works with the expedition in the process of globalization. It is believed that the entire world has to be considered. The global business practices need to be adopted for the development of business at the global level.

6.2. MULTINATIONAL COMPANIES- MEANING AND DEFINITIONS

A multinational company (MNC) is "a large and influential firm with a presence in two or more countries". It is headquartered in one country with its branches spread in different counties of the world. The country where the multinational company headquarters are located is called the home country. Countries that allow a multinational company to set up its operations are called host countries. In other words multinational corporation (MNC) is "registered and operates in more than one country at a time. Generally the corporation has its headquarters in one country and operates wholly or partially owned subsidiaries in other countries. Its subsidiaries report to the corporation's central headquarters". Multinational companies are also called Transnational companies. These have decentralized structures with little control from the Head Office over its wide spread branches. Though major decisions are made at the head office still the subordinate branches have high degree of independence in its daily operations. For instance- Nestle Ltd.

Definitions of Multinational Companies

According to Jones (1996)

"An MNE is usually defined as firm that controls operations or income generating assets in more than one country."

According to The Editors of Encyclopedia Britannica-

"Multinational Corporation **(MNC)** also called transnational corporation**,** any corporation that is registered and operates in more than one country at a time. Generally, the corporation has its headquarters in one country and operates wholly or partially owned subsidiaries in other countries. Its subsidiaries report to the corporation's central headquarters".

According to Moore & Lewis (1999)-

Multinational company is "an enterprise that engages in foreign direct investment (FDI) and own or controls value – adding activities in more than one country is known as multinational enterprise".

According to Foreign Exchange Regulation Act, 1973 (FERA)-

"A corporation incorporated in a foreign country or territory shall be deemed to be multinational corporation if such corporation' (a) is a subsidiary or a branch or has place of business in two or more countries or territories, (b) carries on business or otherwise operations in two or more countries or territories".

According to Prof. John H. Dunning,

"A multinational enterprise is one which undertakes foreign direct investment, i.e., which owns or controls income gathering assets in more than one country; and in so doing produces goods or services outside its country of origin, i.e., engages in international production."

According to Black's Law Dictionary-

A company or group should be considered a multinational corporation "if it derives 25% or more of its revenue from out-of-home-country operations".

From the above definitions following features of Multinational companies can be noted-

- MNCs have worldwide business presence
- These are big and powerful firms
- The business of MNCs is carried in multiple languages around several countries of the world.
- MNCs have decentralized structures and complex business models.
- MNCs make direct foreign investments in different countries.
- MNCs generate worldwide employment and pay substantially higher than the local wage rates.
- MNCs have large market shares
- MNCs generate economies of scale with wider production operations.
- MNCs end up in lower production costs.
- These companies incur more expenses on following rules and regulations of foreign countries.
- MNCs are covered under multiple tax jurisdictions.
- The transnational firms need to follow universal standards of reporting and hence reports financial information according to International Financial Reporting Standards (IFRS).
- MNCs often lead to detrimental impact on environment.
- Since MNCs follow outsourcing, they are sometimes blamed to create unemployment in their own native country.

To conclude, Multi National companies are international and stateless companies. They could be as large as some of the small states. They are the engines of globalization in the current times.

Advantages of Multinational Companies

The following are the advantages of multinational companies-

1. **Access to worldwide production facilities**- MNCs enter into those countries where production facilities either exist or can be generated. As a result, these companies venture into best of markets with abundant of natural resources, human resources, technical resources and the physical resources.

2. **Access to global markets**- But for production MNCs get access to huge selling opportunities across the globe. Exports pose hindrances in terms of trade and tariff barriers. But opening up of subsidiaries gives readymade markets to MNCs to sell their production.
3. **Advantages of innovation**- MNCs over a period of time have huge resources. As a result, they can invest high amount in innovation and Research and Development.
4. **Huge capital investment**- MNCs become huge companies. These gather and earn resources for deployment into business.
5. **Economies of scale and operations**- Since MNCs open subsidiaries in multiple countries; they have high sales and turnover. They are able to generate economies of scale and achieve their break-even very fast.
6. **Tax advantages**- MNCs open their subsidiaries in countries where tax structures are beneficial for them. They even dilute the total effect of operating in the high tax countries with the low tax ones.
7. **Generation of world-wide employment**- Since MNCs operate in multiple countries they are able to give jobs to many people. Both skilled and semi-skilled people get employment in these companies.
8. **Access of managerial and technical expertise-** People in developing countries are good in management as well as in techniques. These people have dearth of opportunities to deploy their skills. MNCs benefit from such people in developing countries.
9. **Access to skilled and cheap labor**- MNCs are usually from developed countries who venture into developing countries where skilled labor is available at cheap rates. Developing countries in themselves are not able to generate sufficient employment for their people and MNCs tend to take advantage of the same.
10. **Reduction in cost of production**- Since MNCs are able to access best of raw materials at negotiated prices and best of labor at cheap rates; the overall cost of production tends to get reduced.
11. Good relations between countries- MNCs provide a means of co-operation between developed countries and developing or underdeveloped countries. This allows both to benefit from the partnership.

12. Bilateral agreements between countries- The multinational corporations also help promote bilateral trade relations between countries. This is beneficial to both the countries and the global market and economy.

Disadvantages of Multinational Companies

Multinational Companies also pose many threats and challenges. These are discussed as follows-

1. They become monopoly powers- With the increase in size and control of production in several countries, MNCs tend to create monopolies. They tend to control production, demand, supply as well as the prices.
2. Routes of tax avoidance- MNCs are able to manipulate with the tax structure of various countries in such a manner that they are able to avoid taxes in aggregate and retain huge profits for themselves. So ultimately the social good is less and the economic gain is high to such companies.
3. Damage to indigenous industries- When MNCs are established with international brands, the local industry with domestic production tend to suffer and vanish.
4. Brand consciousness in the society- People become conscious and aware of international brands. There is unhealthy competition in the society. People run after brands and compete with each other.
5. Repatriation of profits to the home country- MNCs ultimately bring back the profits earned from other countries to their country. As a result, the level of development in the host countries is limited and the economic gain to the MNCs and their home counties is massive.
6. Excessive dependence of host countries on multinational companies- Host countries which are usually the developing countries become extremely dependent on the multinational companies operating in their countries. Instead of improving the infrastructural facilities in their countries, it is seen that the consumption levels go high in these countries. So instead of learning skills of the trade, host countries end up bare handed.
7. Resource exploitation- MNCs actually exploit resources of other countries be it in terms of natural resources, raw material or labor.

8. Environmental damage- MNCs have always received allegations of environmental damage from various countries.

6.3. NATURE OF MULTINATIONAL COMPANIES

Following points bring out the nature of multinational companies-

1	**Huge Economic Power**
2	**Network of Branches**
3	**Huge Sales and Asset base**
4	**Central Control**
5	**Updated Technology**
6	**Management by Professionals**
7	**Marketing facilities**
8	**Quality Focused**
9	**Strategies of MNCs**

1. **Huge Economic Power**

MNCs grow up into big companies with abundant of financial resources. They have multiple subsidiaries spread across the globe. These subsidiaries are their branches that collectively make MNCs a massive economic power.

2. **Network of Branches**

MNCs are formed as network of branches spread across different countries. These branches are called subsidiaries. These branches undertake production and marketing activities.

3. **Huge Sales and Asset base-**

MNCs operate on a large global scale. They have huge asset base as they operate in multiple countries simultaneously. They are also able to generate massive sales. To quote a few examples- According to Coca-Cola's latest financial reports for the year 2022, the company's current revenue is $42.34 B**.** In 2021 the company made a revenue of $38.65 B an increase over the years 2020 revenue that were of $33.01 B. The revenue is the total amount of income that a company generates by the sale of goods or services (companiesmarketcap.com). McDonald's generated total revenue of 23.22 billion U.S. dollars in 2021. In that year, McDonald’s revenue by region suggests that the country that generated the highest portion of revenue was the United States - accounting for 8.71 billion U.S. dollars. However, internationally operated markets including, but not exclusive to, Australia, France, Canada, and the UK, contributed the largest sum to the McDonald's total revenue in 2021 (Source-statista.com).

4. Central Control

Though MNCs have many branches in several countries, the central control remains with the Head Office in the country of origin. Branches are no doubt quite independent with their own management and offices, still the major control remains with the head office. If the central control is not followed, it shall become difficult to manage the vast paraphernalia of widespread MNCs.

5. Updated Technology

MNCs over a period of time turn to be big companies with huge wealth and investments. As a result they have sufficient resources to spend on technological advancements. MNCs also spend on Research and Development and hence compete with the changing times and succeed.

6. Management by Professionals

MNCs these days follow a geocentric approach. They believe that the whole globe is their house. They hire best of talent from several countries. They introduce specialization at all hierarchal levels. The companies get managed with professional expertise.

7. Marketing facilities

But for excelling in manufacturing, MNCs spend lot of money on marketing and advertising also. They have international customer and audience to cater to. So they adopt channels that can reach out to vast spread population at the global level.

8. Quality Focused

Multinational companies operate worldwide. So, their reputation also travels to different countries. As a result, these companies are much quality conscious. The goodwill they earn at one place transit to other branches in other countries. Hence these firms do not compromise on quality.

9. Strategies of MNCs

There are two strategies followed by MNCs- Standardization and Adaptation. In standardization the same product is offered in other countries with minor modifications and variations. This saves costs to MNCs and helps them to achieve economies of scale. However, in adaptation major changes are made according to the tastes and preferences of audience. This strategy is costly but results in higher acceptance.

6.4. STAGES OF INTERNATIONALIZATION

In the world of Professor Welch, Internationalization is "the process of involvement in international operations". It involves designing of production in such a manner that it is able to meet the needs of users in several countries or at least can be conveniently adopted to do so.

A firm in order to become a multinational company passes through various stages since its inception. There are primarily five stages of firm's operations to reach internationalization- Domestic operations, Export operations, Subsidiary or Joint Venture, Multinational operations and Trans- national operations. These stages are shown in the following figure 1 as follows-

Figure 1- Stages of Internationalization

The details of stages of internationtionalization are given as follows-

1. **Domestic Operations-** In the first stage every firm starts its business in the domestic market. Inception of international firms begins from domestic operations only. The production and marketing are done in the domestic market only. For instance- Patanjali is a firm with domestic business only.

2. **Export Operations**- This is the second stage of internalization. Firms producing in the home country sell and market their produce in the other countries. This is in fact the easiest route of going global and crossing one's national boundaries. However, this is an initial stage and hence it is only the sales that are made to other countries. Production facilities are located within the domestic boundaries only. For instance- Indian companies selling their textiles, spices, pulses etc to the neighboring countries.
3. **Subsidiaries and Joint Ventures**- This stage is the next level of internationalization. Here the domestic firms become partners with other foreign counterparts. They share resources, costs, management and profits. For instance- Joint venture between Japanese company (Suzuki) and Indian company (Maruti).
4. **Multinational operations**- In this stage of internationalization firms open its branches in several countries. The production facilities are also carried on in those countries. These branches are independent but ultimate decision making still remains centralized with the headquarters. For instance- McDonalds.
5. **Transnational corporations**- This is the final stage of internationalization. There is total transition to foreign lands. Units are not only independent but decision making is also completely decentralized. Global markets are used for both production as well as operations. For instance- Coca Cola.

The differences between different stages of internalization is given below in Table 1-

Table 1- Differences in Stages of Internalization

Stage and Company/Attributes	Domestic	International	Multi domestic	Global	TN
Strategy Model	Domestic NA	International Co-ordinated federation	Multidomestic decentralised federation	Global centralized hub	Global integrated network
View of World	Home Country	Extension Markets	National Markets	Global Markets or Resources	Global Mkts & Resources
Orientation	Ethnocentric	Ethnocentric	Polycentric	Mixed	Geocentric
Key Assets	Located in Home Country	Core centralized, others dispersed	Decentralised self sufficient	All in Home country Except Mktg or sourcing	Dispersed interdependent & specialised
Role of country units	Single country	Adapting and leveraging competencies	Exploiting local opportunities	Mktg. Or sourcing	Contributions to company world wide
Knowledge	Home country	Created at center and transferred	Retained with in operating units	Mktg. developed jointly and shared	All functions developed jointly and shared

(Source- slideshare.net)

6.5. CHECK YOUR PROGRESS

Choose the correct option-

1 MNCs are companies that-

a) Manufacture several products.

b) Operate in several countries.

c) Have several employees.

d) Have high net worth.

2 The first stage of internationalization is____________operations-

a) Domestic

b) Exports

c) Multinational

d) Joint venture

3 The strategy of adaptation means making-

a) Same product in different countries.

b) Modified product in one country

c) Product as per the taste and preferences of population of host country.

d) Any of the above

4 The disadvantage of MNCs includes-

a) Lowering cost of production

b) Giving employment to people in other countries

c) Increasing production in foreign countries

d) Creation of monopolies

5 Which is not an MNC-

a) Google India

b) Amazon India

c) Infosys

d) Patanjali

6.6. SUMMARY

The present era is the era of liberalization, privatization and globalization. Countries across the world have opened their economies to foreign partners and foreign trade. The barriers of trade are lowered or even abolished. There are many ways and channels of exchanging capital, technology, expertise and infrastructure amongst countries. Emergence of multinational corporations (MNCs) is one such mode of going global.

A multinational company (MNC) is "a large and influential firm with a presence in two or more countries". It is headquartered in one country with its branches spread in different counties of the world. The country where the multinational company headquarters are located is called the home country. Countries that allow a multinational company to set up its operations are called host countries. In other words multinational corporation (MNC) is "registered and operates in more than one country at a time. Generally the corporation has its headquarters in one country and operates wholly or partially owned subsidiaries in other countries. Its subsidiaries report to the corporation's central headquarters". Multinational companies are also called transnational companies.

Thus, MNCs have worldwide business presence. These are big and powerful firms. The business of MNCs is carried in multiple languages around several countries of the world. MNCs have decentralized structures and complex business models. They make direct foreign investments in different countries. These generate worldwide employment and pay substantially higher than the local wage rates. They have large market shares. MNCs generate economies of scale with wider production operations and have very low production costs. These companies incur more expenses on following rules and regulations of foreign countries. MNCs are covered under multiple tax jurisdictions. The transnational firms need to follow universal standards of reporting and hence reports financial information according to International Financial Reporting Standards (IFRS). MNCs often lead to detrimental impact on environment. Since MNCs follow outsourcing, they are sometimes blamed to create unemployment in their own native country.

MNCs grow up into big companies with abundant of financial resources. They have multiple subsidiaries spread across the globe. MNCs are formed as network of branches spread across different countries. MNCs operate on a large global scale. They have huge asset base as they operate in multiple countries simultaneously. They are also able to generate massive sales, the central control remains with the Head Office in the country of origin. MNCs over a period of time turn to be big companies with huge wealth and investments. As a result they have sufficient resources to spend on technological advancements. MNCs these days follow a geocentric approach. They believe that the whole globe is their house. But for excelling in manufacturing, MNCs spend lot of money on marketing and advertising also. These companies are much quality conscious. The goodwill they earn at one place transit to other branches in other countries. There are two strategies followed by MNCs- Standardization and Adaptation.

Internationalization is “the process of involvement in international operations”. A firm in order to become a multinational company passes through various stages since its inception. There are primarily five stages of firm’s operations to reach internationalization- Domestic operations, Export operations, Subsidiary or Joint Venture, Multinational operations and Trans- national operations. In the first stage every firm starts its business in the domestic market. In the second stage, firms producing in the home country sell and market their produce in the other countries. In the next level of internationalization, the domestic firms become partners with other foreign counterparts. In multinational operations stage of internationalization firms open its branches in several countries. The production facilities are also carried on in those countries. A transnational corporation is the final stage of internationalization. There is total transition to foreign lands. Global markets are used for both production as well as operations.

There are many advantages of multinational companies. There is access to worldwide production facilities and global markets. There are high levels of innovation due to large capital investment. Economies of scale are witnesses. Companies avail tax advantages and become even profitable. MNCs generate large scale employment with high managerial and technical expertise. There is reduction of overall cost of production. MNCs facilitate several bilateral agreements between nations that result in improved relationships amongst countries.

However, MNCs also pose threats and challenges. They result in big monopoly powers controlling demand, supply and prices. There is fear to local, domestic and indigenous industry. Manipulations are done in tax structures of countries. Ultimately these companies repatriate profits back to their country of origin leaving the host countries in the same state as they were before.

6.7. KEY WORDS

1. **Multinational Company (MNC) -** It is a company which is headquartered in one country with its branches spread in different counties of the world. The country where the multinational company headquarters are located is called the home country. Countries that allow a multinational company to set up its operations are called host countries.
2. **Standardization** - In standardization the same product is offered in other countries with minor modifications and variations.
3. **Adaptation** - In adaptation major changes are made according to the tastes and preferences of audience.
4. **Export Operations**- This is the second stage of internalization. Firms producing in the home country sell and market their produce in the other countries. This is in fact the easiest route of going global and crossing one's national boundaries.
5. **Subsidiaries and Joint Ventures-** This stage is the thirdt level of internationalization. Here the domestic firms become partners with other foreign counterparts. They share resources, costs, management and profits.
6. **Transnational corporations**- This is the final stage of internationalization. There is total transition to foreign lands. Units are not only independent but decision making is also completely decentralized. Global markets are used for both production as well as operations.

6.8. SELF ASSESSMENT TEST

1. Define a multinational company. Give its characteristics.
2. What is a multinational company? Discuss its nature.
3. Explain the stages of internationalization of a multinational company.
4. Explain the advantages of going global and becoming a multinational company.
5. What are threats and challenges of a multinational company?
6. Write notes on-

a) Domestic operations versus export operations

b) Multinational versus transnational operations

c) Disadvantages of multinational companies

6.9. ANSWERS TO CHECK YOUR PROGRESS

1. Operate in several countries.
2. Domestic
3. Product as per the taste and preferences of population of host country.
4. Creation of monopolies
5. Patanjali

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Course: Business Environment	Author: Dr. Aparna Bhatia
Course Code: BCOM- 206	Vetter: Prof. Pardeep Kumar Gupta
LESSON: 07 Indian Foreign Trade and Balance of Payment	

STRUCTURE:

7.0. LEARNING OBJECTIVES

After going through this lesson you should be able to know

- the need for foreign trade
- the concept and definitions of foreign trade
- the quantum of imports, exports and deficit in trade through figures and statistics

- significance of foreign trade for nations
- the concept of balance of payments and its impact on foreign trade.

7.1. INTRODUCTION

No country is self sustaining. All countries have limited resources. As a result there is interdependence among countries for goods and services. Production of goods and services require resources. Resources are also limited in all countries. No single country can have all the resources required for production for all the goods and services needed in the economy. So what is deficient in one country is purchased by it from other countries while what is surplus in one country is sold by it to other countries in the world. This phenomenon takes the shape of foreign/ international trade.

Trading with foreign countries is not a new phenomenon for India. India has been doing business with other foreign countries even in BC. *'The Periplus of the Erythraean Sea'* is a document, written by an anonymous sailor from Alexandria about AD 100, explaining trade between countries, including India. "Since 1498, Europeans did trade with the rulers of India using the sea route. The main export items then were spices like pepper, ginger, cinnamon, cardamom, nutmeg, mace, and cloves. From 1947-1991, the Indian economy remained largely as a closed economy. High taxes were levied on import of items. Foreign investments like FDIs were restricted. However, after the liberalization in 1991, foreign trade improved significantly. Now, India exports around 7500 commodities to about 190 countries, and imports around 6000 commodities from 140 countries. Exports and Imports are not only restricted to commodities (merchandise). Service is also a major export/import item". The sequence of India's trade is given below in Table 1-

Table 1- Sequence of India's Foreign Trade

Time Period	Event
Around 100CE	The Periplus of the Erythraean Sea is a document written by an anonymous sailor from Alexandria about 100CE describing trade between countries, including India.

Around 1500	In 1498 Portuguese explorer Vasco da Gama landed in Calicut (modern day Kozhikode in Kerala) as the first European to ever sail to India. The tremendous profit made during this trip made the Portuguese to undertake more trade with India and this attracted other European navigators and tradesmen to India. Pedro Álvares Cabral left for India in 1500 and established Portuguese trading posts at Calicut and Cochin (modern day Kochi), returning to Portugal in 1501 with many Indian spices as pepper, ginger, cinnamon, cardamom, nutmeg, and cloves.
1991 economic reform	Prior to the 1991 economic liberalization, India was a closed economy as the average tariffs exceeded 200 percent and there were extensive quantitative restrictions on imports. Foreign investment was strictly restricted to only allow Indian ownership of businesses. Since the liberalization, India's economy has improved and shows expedited foreign trade.

Prior to independence figure of Indian Foreign Trade were as follows shown in Table 2-

Table 2- Foreign Trade of India during 1938-39 to 1947-48

(₹ crore)

Year	Exports	Imports	Trade Balance
1938-39	169	152	+17
1945-46	266.	245	+21
1946-47	319	288	+31
1947-48	403	389	+14

(Source- https://www.businessmanagementideas.com)

7.2. MEANING OF FOREIGN TRADE

Foreign trade means trade between the two or more countries. It is the exchange of goods across national boundaries. Foreign trade includes all imports and exports to and from a country. The foreign trade of a country consists of inward (import) and outward (export) movement of goods and services, which results into outflow and inflow of foreign exchange. Thus it is also called EXIM Trade. The ability of some nations to produce what other nations want is what makes foreign trade work. The backbone of any foreign trade between nations is those products and services which are being traded to some other location outside a particular country's borders.

International trade involves different currencies of different countries. It is regulated by laws, rules and regulations of the concerned countries. For providing, regulating and creating necessary environment for its orderly growth, several Acts have been put in place. The foreign trade of India is governed by the Foreign Trade (Development & Regulation) Act, 1992 and the rules and orders issued there under. Payments for import and export transactions are governed by Foreign Exchange Management Act, 1999. Customs Act, 1962 governs the physical movement of goods and services through various modes of transportation.

Definitions-

Some definitions on foreign trade by renowned authors are given as follows-

According to Prof. J.L. Hanson,

"An exchange of various specialized commodities and services rendered among the corresponding countries is known as foreign trade."

According to Wasserman and Haltman,

"International trade consists of transaction between residents of different countries".

According to Anatol Marad,

"International trade is a trade between nations".

According to Eugeworth,

"International trade means trade between nations".

Thus, foreign trade is exchange of capital, goods, and services across international borders or territories. It includes-

Export of goods (merchandise/commodities)

Export of services

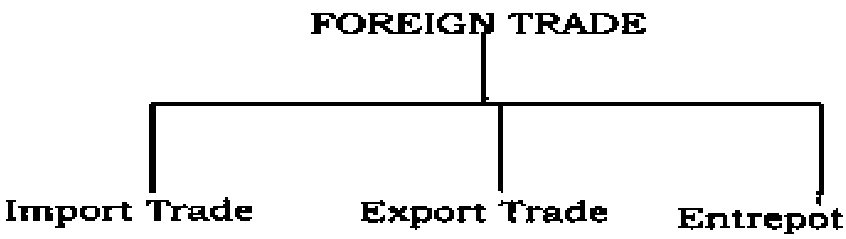
Import of goods (merchandise/commodities)

Import of services

Types of Foreign Trade

There are three different types of foreign trade. These are shown as follows in Figure 1-

Figure 1-Types of Foreign Trade



These are explained below-

1. **Import trade:** It is the "purchase of goods and services by one country from another country. Here the flow of goods is from a foreign land to the home nation. Countries import goods and services when they need raw materials for producing goods or when they need a finished product for domestic consumption".
2. **Export trade:** It is "the selling of goods and services to another country. Here the flow of goods is from the home nation to a foreign land. Countries export goods and services to another nation when they have that particular commodity in abundance".
3. **Entrepot trade:** This process is also called re-export. In this form of trade, "a business purchases goods or services from one country, reprocesses those products, and then sells them to another country".

Hence, to summarize the features of foreign trade are as follows-

1. It is a two country process- one importer and another exporter.
2. Since India has more demand of foreign goods, here imports tend to be greater than exports.
3. Difference between exports and imports is called Balance of Trade.
4. When imports are more than exports there is deficit in Balance of Trade.

5. It also involves entreport trade.
6. In India, Directorate General of Foreign Trade (DGFT) Organization is an attached office of the Ministry of Commerce and Industry and is headed by Director General of Foreign Trade and regulates foreign trade in the country.
7. Foreign trade contributes significantly in the country's GDP and hence improves the economic development.

Significance of Foreign Trade

The following points explain the need and importance of foreign trade to a nation.

1. **Leads to Division of Labor**

Foreign trade leads to world- wide division of labor. This introduces specialization at the world level. Some countries have abundant natural resources while others have world class labor. So things manufactured by countries are as per their specialization and availability of resources. The best things get exported/ imported via the channel of foreign trade. Not only this even the raw material and labor can be shifted from one country to another.

2. **Optimum Allocation and Utilization of Resources**

Since countries have specialization in whatever they manufacture, it leads to reduction of wastages in the production processes. Countries import what is not available within their national boundaries and export the surplus.

3. **Equality of Prices**

Prices can be stabilized by foreign trade. Countries manufacture the products as per their capabilities. The wastages are eliminated. The demand and supply is determined world-wide and then production is undertaken. Barriers of trade are relaxed. Foreign trade has become a process of mutual exchange. Economies of scale arise and reduction and equality in prices is witnessed in the process of foreign trade.

4. **Availability of Vast Choices**

Foreign trade facilitates consumers with wide choices. New varieties are available to consumers from all over the world.

5. Ensures Quality and Standardization of Goods

Foreign trade is highly competitive. No country wants to lose its share of exports and profits. Hence quality is not compromised in foreign trade. Also the production is standardized. Every time the order is made, the quality and standards remain internationally homogenous.

7. Increase in employment levels

The levels of employment rise in a country due to foreign trade. First there is increase in demand. As a result more people are required in the production processes. Factories and manufacturing units demand more labor. Secondly, more people are required even in the service sectors as banking, insurance etc.

8. Economic Development of a country

Imports can be made for raw material, machinery, technology etc from the best parts of the world due to foreign trade. The country is able to generate novelty and growth in various sectors of its economy. Similarly, exports of goods produced from latest infrastructure and technology generates foreign income to a country. This raised the economic development in a nation.

9. Assistance during Natural Calamities and other Adversities

The world has recently witnesses a pandemic in the form of COVID-19. Countries exported and imported medical aid, medicines, oxygen cylinders and other essentials via foreign trade. Countries could not have combated with the disease so well if the facility of foreign trade was not available. Even at the times of other natural calamities import-export facilitate mutual exchange of essentials among countries of the world.

10. Maintains Balance of Payment Position

A balance is maintained in the Balance of Trade and Payment. The country that imports pays in foreign currency so it ensures that it indulges in exports as well to earn the foreign exchange and maintain equilibrium.

11. World-wide Goodwill

A country is able to establish its name and reputation in the international market. The product gets known and the name gains fame. For instance, Japanese technology is famous world-wide.

12. Healthy international relations

Countries across the globe realize the importance of cordial relations amongst each other and try to maintain the same. Countries get interdependent. They cannot afford to spoil the relations with each other. Hence, foreign trade facilitates world peace.

7.3. INDIAN FOREIGN TRADE- SOME STATISTICS

India's Foreign Trade picture for the year 2021-22 is presented as follows in Table 3-

Table 3- India's Foreign Trade 2021-22

(Financial Year **2021—22**) in US Billion dollars

Exports	Imports	Total Trade	Trade Balance
421.894	612.608	1,034.502	-190.714

(Source- Trade Statistics, Ministry of Commerce and Industry)

The last data on Import Export of India shows a rising trade deficit. It is shown as below in Table 4.

Table 4- India's Trade deficit

Year	Export	Import	Trade Deficit
1999	36.3	50.2	-13.9
2000	43.1	60.8	-17.7
2001	42.5	54.5	-12.0
2002	44.5	53.8	-9.3
2003	48.3	61.6	-13.3
2004	57.24	74.15	-16.91
2005	69.18	89.33	-20.15
2006	76.23	113.1	-36.87
2007	112.0	100.9	11.1
2008	176.4	305.5	-129.1
2009	168.2	274.3	-106.1
2010	201.1	327.0	-125.9
2011	299.4	461.4	-162.0
2012	298.4	500.4	-202.0
2013	313.2	467.5	-154.3
2014	318.2	462.9	-144.7
2015[15]	310.3	447.9	-137.6
2016	262.3	381	-118.7
2017	275.8	384.3	-108.5
2018	303.52	465.58	-162.05
2019	330.07	514.07	-184
2020	314.31	467.19	-158.88
2021	420	612	-192

(Source- Trade Statistics, Ministry of Commerce and Industry)

As per the latest statistics of Government of India Ministry of Commerce & Industry Department of Commerce Economic Division, *New Delhi, Dated 15th* December, 2022 PRESS RELEASE INDIA'S FOREIGN TRADE: November 2022 India's overall exports (Merchandise and Services combined) in November2022 are estimated to be USD 58.22 Billion, exhibiting a positive growth of 10.97 per cent over the same period last year. Overall imports in November2022 are estimated to be USD 69.33 Billion, exhibiting a positive growth of 5.60per cent over the same period last year. India's trade during November 2021 and 2022 is shown as follows in Table5-

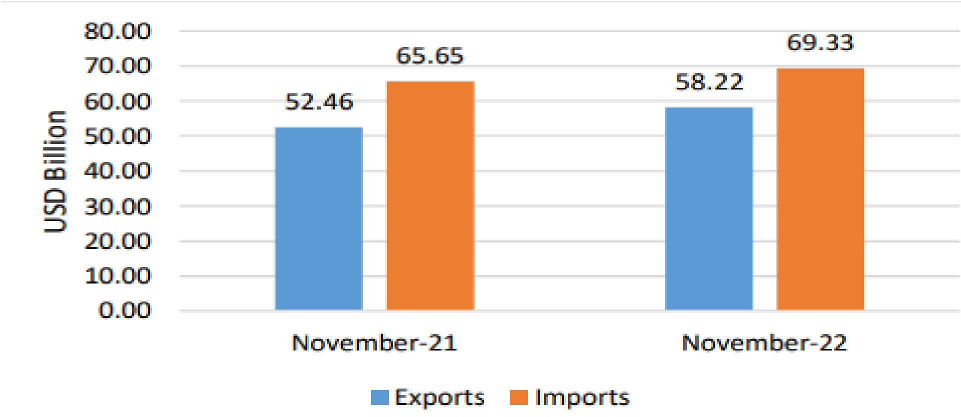
Table 5- India's Foreign Trade during November 2021-2022

		November 2022 (USD Billion)	November 2021 (USD Billion)
Merchandise	Exports	31.99	31.80
	Imports	55.88	53.03
Services*	Exports	26.23	20.67
	Imports	13.44	12.63
Overall Trade (Merchandise +Services) *	Exports	58.22	52.46
	Imports	69.33	65.65
	Trade Balance	**-11.11**	**-13.19**

(Source- Trade Statistics, Ministry of Commerce and Industry)

The same can be presented in Figure 2 as follows-

Figure 2- India's Foreign Trade during November 2021-2022

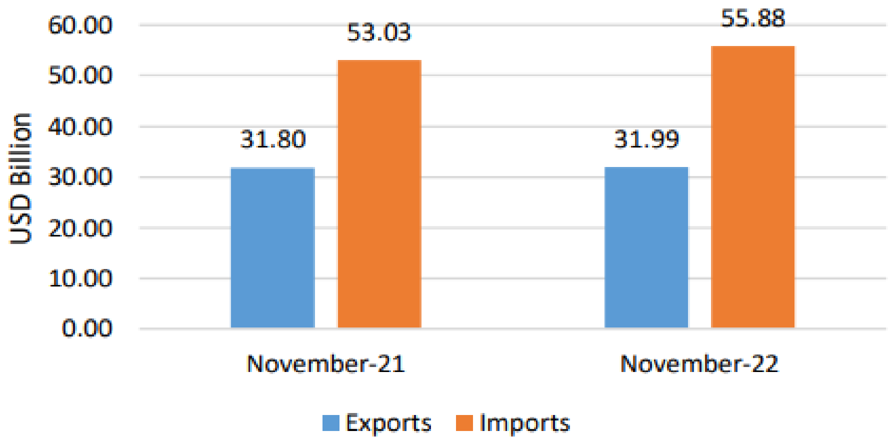


(Source- Trade Statistics, Ministry of Commerce and Industry)

Out of the total trade, Merchandise exports during November 2021 and 2022 were USD 31.99 Billions as compared to USD 31.80 Billion in November 2022.

Merchandise imports during November 2021 and 2022 were USD 53.03 Billions as compared to USD 55.88 Billion in November 2022. The same are shown in following Figure 3.

Figure 3- Merchandise Exports and Imports in November 2021 and 2022

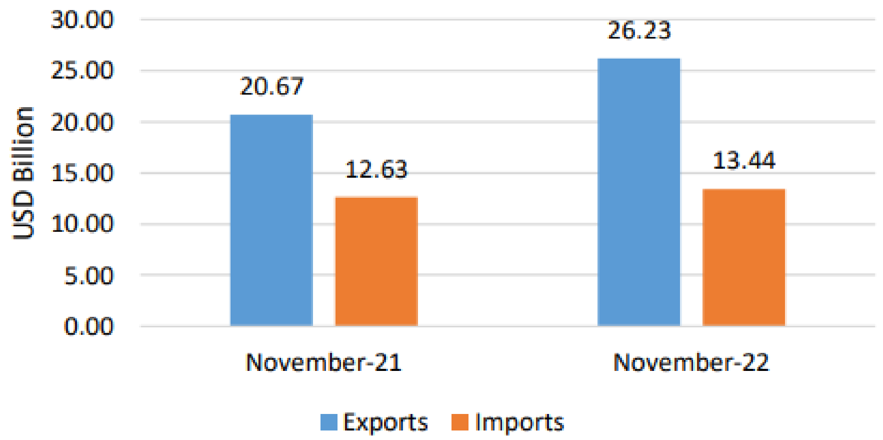


(Source- Trade Statistics, Ministry of Commerce and Industry)

Out of the total trade, Service exports during November 2021 and 2022 were USD 20.67 Billions as compared to 26.23 USD Billion in November 2022.

Service imports during November 2021 and 2022 were USD 13.44 Billions as compared to USD 12.63 Billion in November 2022. The same are shown in following Figure 4.

Figure 4- Service Exports and Imports in November 2021 and 2022



(Source- Trade Statistics, Ministry of Commerce and Industry)

India's Largest Trade Partners for 2021-22

India exported about $422 billion merchandise in the financial year 2021-2022 and about $250 billion of services exports in the same financial year. India's largest trade partners with their total trade (sum of imports and exports) in billions of US dollars for the financial year 2021–22 were as follows in Table 6:

Table 6- India's largest trading partners 2021-22

Rank	Country	Exports	Imports	Total Trade	Trade Balance
1	United States	76.11	43.31	119.42	32.80
2	China	21.25	94.16	115.41	-72.91
3	United Arab Emirates	28.10	44.80	72.90	-16.7
4	Saudi Arabia	8	34.00	42	-28
5	Russia	1.00	21.00	22.00	-20.00
6	Germany	8.21	13.69	21.9	-5.48
7	Hong Kong	13.7	20.34	34.04	-6.64
8	Indonesia	4.12	15.06	19.18	-10.94
9	South Korea	4.85	15.65	20.5	-10.8
10	Malaysia	3.71	9.08	16.93	-5.30
11	Singapore	7.72	9.31	16.93	-1.59
12	Nigeria	2.22	9.95	16.36	-11.00
13	Belgium	5.03	8.26	16.33	-5.29
14	Qatar	0.90	9.02	15.66	-13.55
15	Japan	4.66	9.85	15.52	-4.75
16	Iraq	1.00	10.84	15.08	-13.42
17	Kuwait	1.25	4.97	14.58	-12.18
18	United Kingdom	8.83	5.19	14.34	4.30
19	Iran	2.78	6.28	13.13	-4.78
20	Australia	3.26	8.90	13.03	-7.47
21	Venezuela	0.13	5.70	11.99	-11.47
22	South Africa	3.59	5.95	11.72	-3.40
-	*Remaining Countries*	126.78	104.92	231.70	21.86
India's Total		**422.08**	**612.61**	**1034.69**	**-192.0**

(Source- tradingeconomics.com)

India exports approximately 7500 commodities to about 192 countries. The following table 7 shows India's 10 largest destinations for exports in 2019–2020.

Table 7- India's largest exporters

Rank	Country	Value (US$ billion)	Share of overall exports
1	United States	57.7	16.94%
2	United Arab Emirates	28.8	9.20%
3	China	16.6	5.47%
4	Hong Kong	10.9	3.53%
5	Singapore	8.9	2.90%
6	United Kingdom	8.7	2.80%
7	Netherlands	8.3	2.69%
8	Germany	8.29	2.65%
9	Bangladesh	8.20	2.61%
10	Nepal	7.16	2.28%

(Source- tradingeconomics.com)

India imports around 6000 commodities from 140 countries. The following table 8 shows India's 10 largest sources of imports in 2019–2020.

Table 8- India's largest importers

Rank	Country	Value (US$ billion)	Share of overall imports
1	China	57.8	14.37%
2	United States	30.5	7.57%
3	United Arab Emirates	25.8	6.39%
4	Saudi Arabia	23.0	5.70%
5	Russia	21	4.91%
6	Switzerland	14.8	3.67%
7	Hong Kong	14.6	3.63%
8	South Korea	13.2	3.28%
9	Indonesia	12.8	3.17%
10	Singapore	12.2	3.02%

(Source- tradingeconomics.com)

7.4. BALANCE OF PAYMENT AND ITS IMPACT ON FOREIGN TRADE

The balance of payments (BOP) "is a statement of all transactions made between entities in one country and the rest of the world over a defined period, such as a quarter or a year. It summarizes all transactions that a country's individuals, companies, and government bodies complete with individuals, companies, and government bodies outside the country".

A country deals with other countries of the world in relation to three types of items-

1. **Visible items**- This includes the exports and imports of physical goods.

2. **Invisible items**- This includes the exports and imports of services, workers, remittances.
3. **Capital transfers**- This includes capital receipts and capital payments that one country makes to other country/countries.

Every country like an ordinary trader calculates its net balance from these items to determine if at the end the country has surplus or deficit, that is, if it is a receiver or a giver. The Balance of Payment Account can present three results- a zero which highlights a balanced account; a positive figure which highlights that receipts are greater than the payments and a negative figure which highlights that payments are greater than the receipts.

When the difference of only exports and imports of goods and services is taken, it is called Balance of Trade but when the difference of all three- visible, invisible and capital transfers are taken, it is called Balance of Payments.

Definitions-

According to Kindleberger,

"The balance of payments of a country is a systematic record of all economic transactions between residents and residents of foreign countries".

According to Benham,

"Balance of Payments of a country is a record of the monetary transactions over a period of time with the rest of the world".

According to Sodersten,

"The Balance of Payments is merely a way of listing receipts and payments of international transactions for a country".

According to James O Ingram,

"Balance of Payment is summary record of all economic transactions between residents of one country and rest of the world during a given period of time".

Thus Balance of Payment is summarizes the statistics of receipts and payments of a country for a specified period of time.

Features of Balance of Payments

1. It is a statistical record of economic transactions of a country for its receipts and payments.
2. The statement of Balance of Payments is usually made for one year.
3. It is broader than Balance of Trade and includes physical goods, services as well as capital transfers.
4. Balance of trade is in fact part of Balance of Payments.
5. Government adjusts the difference in Balance of Payment account. If it is in deficit and payments are more than the receipts, government has to take borrowings or encourage foreign investments.

Difference between Balance of Trade and Balance of Payments

The differences between Balance of Trade and Balance of Payments are discussed as follows-

1. Balance of trade captures the net effect of exports and imports of goods between countries; Balance of Payment captures the net effect of all economic transactions between countries.
2. Balance of trade includes transactions related to goods and services; Balance of Payment includes transactions related to goods, services and capital transfers.
3. Balance of trade is narrower than Balance of trade which includes Balance of Trade.
4. Any deficit in Balance of trade can be met from Balance of trade but not vice versa.
5. From the point of view of formation of country's Foreign Trade Policy, Balance of payments is a more significant concept than Balance of trade.

Structure of Balance of Payment

The structure of Balance of Payment has three forms-

1. **Current Account**- Balance of payment on current account refers to the value of exports and imports of visible goods and invisible services. In simple words these are actual transactions of exports and imports of goods and services. When receipts and payments on account of exports and imports of goods and services are equal, Balance of Payment on current account is balanced. But when receipts from exports are less than payments from imports, the account is in deficit. When receipts from exports are more than payments from imports, the account is in surplus.

2. **Capital Account**- Balance of Payment on capital account refers to various financial transactions between countries. It includes all short term and long term capital transfers, debts, investments, payments and receipts on account of interest and grants etc. These are all inter-country financial transfers.
3. **Overall Balance of Payments**- The total of balance on country's current account and capital account is referred as the Overall Balance of Payments.

To summarize, Balance of Payment in totality refers to-

Balance of Payment= (Export of Goods + Export of Services + Capital Receipts) - (Import of Goods + Import of Services + Capital Payments)

Impact of balance of payment on foreign trade

Balance of Payment can be favorable or unfavorable. When receipts are more than the payments, the Balance of Payment is said to be favorable. But when receipts are less than the payments it results in unfavorable Balance of Payment. In the former case there is increase in foreign exchange reserves as the export of goods, services and capital receipts are more than the import of goods, services and the capital payments. This is also called surplus Balance of Payment. In the latter case, there is deficit in Balance of Payment account and the country has to pay in terms of gold or foreign borrowings.

The deficit in Balance of Payment has an adverse effect on the international trade of a country. The relationship between balance of payments and exchange rates under a floating-rate exchange system is driven by the supply and demand for the country's currency and all transactions taking place with other countries. The value of its currency weakens. There is fall in reserves of a country and depreciation in the value of its currency.

At this crucial time the government of a country must try to promote exports. It should capitalize its trade agreements. Foreign investment should be encouraged in the country. Foreign direct investments should be invited through liberal policies. Even foreign tourism should be promoted. Inflationary tendencies should be avoided in the economy because that will make exports even expensive. Import substitution should be undertaken in order to further worsen the situation of trade deficit.

7.5. CHECK YOUR PROGRESS

Choose the correct option-

1. When a company purchases goods from another country and sells it to third country, it is called-
   a) Exports
   b) Imports
   c) Entrepot
   d) Any of the above
2. Largest trading partner of India is-
   a) USA
   b) Russia
   c) China
   d) Brazil
3. **Trade deficit means-**
   a) Sales are less than purchases
   b) Assets are less than liabilities
   c) Exports are less than imports
   d) All of the above
4. Current account is related to-
   a) Financial transactions and goods
   b) Goods and services
   c) Services and financial transactions
   d) Any of the above
5. Capital account is related to-
   a) Goods
   b) Services
   c) Financial transactions

d) All of the above

7.6. SUMMARY

All countries have limited resources. As a result there is interdependence among countries for goods and services. No single country can have all the resources required for production for all the goods and services needed in the economy. So what is deficient in one country is purchased by it from other countries while what is surplus in one country is sold by it to other countries in the world. This phenomenon takes the shape of foreign/ international trade. Foreign trade means trade between the two or more countries. It is the exchange of goods across national boundaries. Foreign trade includes all imports and exports to and from a country. The foreign trade of a country consists of inward (import) and outward (export) movement of goods and services, which results into outflow and inflow of foreign exchange. Thus it is also called EXIM Trade. There are three different types of foreign trade. Import trade, Export trade and the Entrepot trade. To summarize foreign trade is a two country process- one importer and another exporter. Since India has more demand of foreign goods, here imports tend to be greater than imports. Difference between exports and imports is called Balance of Trade. When imports are more than exports there is deficit in Balance of Trade. It also involves entreport trade. In India, Directorate General of Foreign Trade (DGFT) Organization is an attached office of the Ministry of Commerce and Industry and is headed by Director General of Foreign Trade and regulates foreign trade in the country. Foreign trade contributes significantly in the country's GDP and hence improves the economic development.

Foreign trade leads to world- wide division of labor. This introduces specialization at the world level. Since countries have specialization in whatever they manufacture, it leads to reduction of wastages in the production processes. Prices can be stabilized by foreign trade. Countries manufacture the products as per their capabilities. The wastages are eliminated. The demand and supply is determined world-wide and then production is undertaken. Foreign trade facilitates consumers with wide choices. New varieties are available to consumers from all over the world. Foreign trade leads to world- wide division of labor. Foreign trade is highly competitive. No country wants to lose its share of exports and profits. Hence quality is not compromised in foreign trade. The levels of employment rise in a country due to foreign trade. Imports can be made for raw material, machinery, technology etc from the best parts of the world due to foreign trade. The country is able to generate novelty and growth in various sectors of its economy. Similarly, exports of goods produced from latest infrastructure and technology generates foreign income to a country. This raised the economic development in a nation. Countries could not have combated with the disease so well if the facility of foreign trade was not available. Even at the times of other natural calamities import-export facilitate mutual exchange of essentials among countries of the world. A balance is maintained in the Balance of Trade and Payment. The country that imports pays in foreign currency so it ensures that it indulges in exports as well to earn the foreign exchange and maintain equilibrium.

The balance of payments (BOP) “is a statement of all transactions made between entities in one country and the rest of the world over a defined period, such as a quarter or a year. It summarizes all transactions that a country's individuals, companies, and government bodies complete with individuals, companies, and government bodies outside the country”.

A country deals with other countries of the world in relation to three types of items-Visible items, Invisible items and Capital transfers. The Balance of Payment Account can present three results- a zero which highlights a balanced account; a positive figure which highlights that receipts are greater than the payments and a negative figure which highlights that payments are greater than the receipts. The structure of Balance of Payment has three forms-

Current Account refers to the value of exports and imports of visible goods and invisible services. Capital Account refers to various financial transactions between countries. Overall Balance of Payments is the total of balance on country’s current account and capital account is referred as the Overall Balance of Payments. The deficit in balance of payment has an adverse effect on the international trade of a country. There is fall in reserves of a country and depreciation in the value of its currency.

7.7. KEY WORDS

1. **Foreign Trade**- Foreign trade means trade between the two or more countries. It is the exchange of goods across national boundaries. Foreign trade includes all imports and exports to and from a country. The foreign trade of a country consists of inward (import) and outward (export) movement of goods and services, which results into outflow and inflow of foreign exchange. Thus it is also called EXIM trade.

2. **Entrepot trade:** This process is also called re-export. In this form of trade, "a business purchases goods or services from one country, reprocesses those products, and then sells them to another country".
3. **Balance of Payment-** The balance of payments (BOP) "is a statement of all transactions made between entities in one country and the rest of the world over a defined period, such as a quarter or a year. It summarizes all transactions that a country's individuals, companies, and government bodies complete with individuals, companies, and government bodies outside the country".
4. **Visible items**- This includes the exports and imports of physical goods.
5. **Invisible items**- This includes the exports and imports of services, workers, remittances.
6. **Capital transfers-** This includes capital receipts and capital payments that one country makes to other country/countries.
7. **Balance of Trade**- It is the difference between exports and imports of only goods and services. It is narrow than the concept of Balance of Payment.
8. **Current Account-** Balance on payment on current account refers to the value of exports and imports of visible goods and invisible services.
9. **Capital Account**- Balance of Payment on capital account refers to various financial transactions between countries. It includes all short term and long term capital transfers, debts, investments, payments and receipts on account of interest and grants etc. These are all inter-country financial transfers.

7.8. SELF ASSESSMENT TEST

1. Define foreign trade. Give its characteristics.
2. What is meant by foreign trade? Discuss its need and significance.
3. What is meant by balance of trade in foreign trade? Explain the types of foreign trade.
4. What do the trends of foreign trade tell in India? Discuss with the help of statistics?
5. What has been the status of Indian foreign trade in the past ten years? Which countries have been India's major exporters and importers?

6. Write notes on-
   - a) Difference between Balance of Trade and Balance of Payment
   - b) Balance of Payment is broader than Balance of Trade
   - c) Impact of foreign trade on Balance of Payment

7.9. ANSWERS TO CHECK YOUR PROGRESS

1. Entrepot
2. USA
3. Exports are less than imports
4. Goods and services
5. Financial transactions

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Course: Business Environment	Author: Dr. Aparna Bhatia
Course Code: BCOM 206	Vetter: Prof. Pardeep Kumar Gupta
LESSON: 08 Economic System	

STRUCTURE:

8.0. LEARNING OBJECTIVES

After going through this lesson you should be able to know

- the concept of an economic system
- types of economic systems
- capitalism, features, merits and demerits of a capitalist society
- socialism, features, merits and demerits of a socialist society
- mixed economy, features, merits and demerits of a mixed economy

- the need for economic reforms

8.1. ECONOMIC SYSTEM- THE CONCEPT

All economic activities take place within the framework give by the economic system of an economy. It is not only an economic system but also includes social and political systems and is based on historical and cultural considerations. Few definitions that highlight the concept of economic system are given as follows-

The economic system refers to the “system of economic processes like production, consumption, and investment prevailing in a geographical location. The role and significance of the participants like government and private entities vary with the types of the economic system”.

An economic system is “a system of production, resource allocation and distribution of goods and services within a society or a given geographic area. It includes the combination of the various institutions, agencies, entities, decision-making processes, and patterns of consumption that comprise the economic structure of a given community”.

An economic system is a “means by which societies or governments organize and distribute available resources, services, and goods across a geographic region or country. Economic systems regulate the factors of production, including land, capital, labor, and physical resources. An economic system encompasses many institutions, agencies, entities, decision-making processes, and patterns of consumption that comprise the economic structure of a given community”.

The economic system includes the following issues-

1. The quantity and the type of goods to be produced in the economy- Since the resources are scarce so every economy has to decide whether consumer or capital goods have to be produced in the country. The demographics of population in terms of size, age, gender, occupation etc. needs to be studied in deciding the issue.
2. The method of production of goods- The issue to be decided includes whether production has to be labor-intensive or capital intensive. In simple words it has to be decided whether more men should be hired for production of goods and services or more machinery should be installed.

3. The time of production of goods- The issue as to when should the goods be produced is connected with the demand and supply dynamics. The seasons variations and the conditions in economy must be considered in deciding the issue of time in producing goods and services.
4. Distribution of output- The purpose of production is to deliver the goods till the final point of consumption. Hence an economic system must facilitate distribution of goods and services till the customer. It must decide the best and cheapest method of distributing the finished goods to the ultimate consumer.

An economic system must resolve these issues. An economic system must decide and consider, "what to produce", "how to produce", "when to produce", "how it is distributed", and "which entity controls the economic processes" . It must establish linkages between various agencies, institutions, intermediaries forming the economic structure. The type of economic system in an economy influences the working of business.

8.2. TYPES OF ECONOMIC SYSTEMS

There are three types of economic systems-

1. Capitalism
2. Socialism
3. Mixed economy

These are discussed in detail as follows-

1. Capitalism-

In a capitalist economy there is least interference by the Government. The production is controlled and owned by private individuals for the purpose of earning profits. The products are allocated among people on the basis of their purchasing power. What they require is not important but what they can purchase is the criteria of production and distribution under a capitalist economy. In brief the forces of demand and supply dominate the consumption and distribution.

Features of a capitalist economy-

i. **Right to Private property-** This is the most important feature of a capitalist economy. People have right to own property and use it or sell it at their will. Ownership of property not only gives legal right to people but also gives a moral boost to them to use the property in the most productive manner for their benefit. Unlike if the property is owned by a State and not by an individual, an individual does not show much interest to work hard on that property. Thus, due to this prominent feature of capitalism there is abundant growth of economy.

ii. **Consumer Orientation-** The consumer is the king in a capitalist economy. He decides the quantum and quality of production. Prices are market driven, that is, prices are determined by market forces of demand and supply. No producer can self-determine the prices. Similarly consumer has a complete choice to spend or save his income. He has full right to purchase any quantity and quality depending upon his purchasing power.

iii. **Freedom of enterprise-** The capitalist economy gives freedom to an entrepreneur to open any business or industry within the limits of law and statutes. This is the major reason that economies governed by capitalism prosper tremendously. Individuals come up with diversified businesses producing both consumer and capital goods. There is availability of vast variety of goods and services. There is advancement in technology. Resultantly, a capitalist economy shows growth and progress.

iv. **Enlightened Self interest-** In a capitalist economy every individual works for his prosperity first. Resultantly, when every individual puts efforts for his personal growth and well-being the whole economy prospers. Since every individual performs his duties to the best of his capabilities, it has its affect on the progress of whole nation. Also the concept of self-interest is "enlightened" which means that people do not create hurdles in other people's progress. So everyone fulfills his interest and automatically the economy flourishes.

v. **Profit motive-** In capitalism earning profits is the main motive of every individual. The function of production as well as distribution is undertaken for the purpose of personal gains. Philanthropy or charity is not the purpose of business. Even if production of certain goods as liquor, cigarettes, tobacco etc is harmful for society, businesses undertake such manufacturing as it yields them profits. Hence, capitalist economy runs for profits.

vi. **High Competition**- There is market driven competition in a capitalist economy. Businesses try to produce the best of products at the cheapest prices to compete with each other. There is free and fair competition. Producers take efforts to provide wider choices of goods at competitive prices. There are no monopolies. As a result consumer is also happy and satisfied.

vii. **Market driven prices**- No state or government interferes in determination of prices in an economy. These are determined by the forces of demand and supply. The competition determines the prices. It is a laissez- faire economy. If demand is more than the supply, prices will rise and vice versa.

viii. **No central planning**- Central planning is "the process of consciously and systematically organizing economic and technical information into an internally consistent conceptual framework within the context of the economic and non-economic constraints toward the realization of a prescribed goal". The economy is driven by market forces rather than economic planning by the State.

ix. **Limited role of government**- Classical economists believed that, "omnipotent government is incompetent government". The duty of a government is to protect its citizens from external aggressions and provide a peaceful political environment. Additionally the government's responsibility is to provide its people with basic amenities as water and sanitation, power and electricity, public transport etc and hence provide with the good social environment. Economics of demand, supply and production should be left to the industrialists and business houses. Classical economists advocated that, "that government is the best; which governs the least." Government should be interested in collecting taxes from the produce of businesses to run the society. The task of production should be left for the private entrepreneurs only.

x. **Role of entrepreneurship**- Entrepreneur is the pivotal of a capitalist economy. An entrepreneur brings together the factors of production, remunerates them and bears the risk of losses and uncertainty. He invests his money; earns profits and takes the responsibility of losses as well. The Government must support entrepreneurial growth in an economy by providing low cost financing, cheaper lands and tax concessions and rebates in the country.

xi. **Conflict among owners and workers**- There usually arise conflict between the owners of capital and the workers working under them. Owners feel that workers demand increased wages and perks even though they idle away time. Workers on the other hand feel that they are not compensated fully for their efforts and work. Works feel exploitation while owners feel unnecessary pressures from unions of workers.

xii. **Modern technology**- Since in a capitalist economy, production is undertaken by an entrepreneur for self interest with his own resources, so in order to earn more as well as compete with others, there is high usage of advanced technology in capitalist system of economy. Producers believe in innovation and up gradation to produce novel products at low cost. Hence there is improvement in technology and R&D under capitalism.

xiii. **Division of labor**- Specialization is seen in production in a capitalist economy. There is high degree of competition. Best quality goods need to be produced at the lowest prices. So, division of labor is preferred in production processes. However, market should be large enough to be able to take benefits of specialization. Smaller markets cannot enjoy the advantages of division of labor.

Merits of Capitalism

A capitalist economy has many advantages. These are given as follows-

i. **Self regulated**- A capitalist economy does not require instructions from the government. There is no central planning authority. People are self-regulated, self-directed and self-controlled. It is driven by market forces. The imperfections are automatically set right by the market. There is no need for an external agency to administer. For instance- if supply is more than the demand, prices will fall. This will indicate the producers to stop over- production.

ii. **Motivation to work hard**- In a capitalist economy, there is right to private property and greater freedom to work. The owner of the property does his best to make the best out of his means of production. There are no limitations or constraint from any central planning authority. Self interest prevails. People work to become rich and earn profits. Hence there is immense motivation to work hard.

iii. **No wastage of resources-** The businessman ensures that the limited resources are put into use in the most productive manner. This will ensure cost reduction and enhanced profitability.

iv. **Higher capital formation**- Since people have right to buy and sell private property, so instead of spending their money on consumption they believe in saving it more. The saved money is invested for putting up factories which they can own in their own name. This makes them even rich. The country overall enjoys high rate of capital formation.

v. **Growth of entrepreneurship-** People in a capitalist economy feel motivated to grow and start their own ventures. There is motivation to save and invest in capital goods rather than consumer goods. Hence, new businesses develop with new ideas and new people.

vi. **Economic growth**- Capitalism on its own generates higher economic growth. It is all an individual approach who is driven by market drivers. An individual produces, sells and distributes for himself. The profits as well as the losses belong to him with least interference from the government. As a result, people work for their own welfare. When mass population follows the concept of self interest fulfillment, there is higher economic growth.

Demerits of Capitalism

A capitalist economy has many disadvantages. These are given as follows-

i. **Materialistic System-** The capitalist economy promotes materialistic approach in the society. People work only for earning profits and becoming rich. There is no intention of serving the society. Profits are the sole drivers to work.

ii. **Unequal distribution of wealth**- The society on the whole gets divided into ‘have’ and ‘have not’ population. The rich businessmen become richer at the expense of poor people.

iii. **Conflict between owners and workers**- The owners think that workers demand more wages and incentives; while the workers believe that owners exploit them and pay them less. Government does not interfere in a capitalist economy between the two parties. Both the groups should be working collectively for the growth of economy but there are disputes between the two groups.

iv. **Monopolies**- Competition takes an unhealthy shape gradually in a capitalist economy. Since the government does not regulate anything, so richer focus on earning profits, acquiring more properties and fulfill self interest. There are monopolies in business and growth.

v. **No social welfare**- People work only for self-interest. Whatever is earned is deployed back to earn even more. Businesses do not believe in charity or social welfare.

vi. **Unbalanced growth**- More money is invested in production of luxury goods which are consumer durables. Certain sectors as agriculture are under-invested. So on the whole a capitalist economy does not grow as it claims to grow.

vii. **Malpractices of businesses**- Businesses follow many malpractices in their conduct as there is no external or central control on them. There is family ownership of businesses. Consequently the society gets divided into the rich and the poor class.

2. Socialism-

In socialism there is a conscious effort of some public authorities to manage economic priorities of an economy. In a socialist economy the Government controls and manages the production and distribution of the goods and service in an economy. It is believed that Government best knows the needs of the people. This system is based on the needs of people and not what people can buy.

Features of a socialist economy-

i. **Central Planning-** The socialist economies run on the directions of a central planning authority established by the State. Generally a Planning Commission is established with economic motives and agendas. The planning commission draws out long term plans for the economy for a period of five or seven years. Objectives are well defined by the planning commission. Targets are fixed and end-results are evaluated and controlled against these targets. For instance, Indian has so far had 12 Five Year Plans developed by Planning Commission of India since 1951. But now the planning commission is replaced by NITI Aayog in 2014. It carries a long term vision of 15 years with action plans of 3 years.

ii. **Public Ownership of Property-** The property in a socialist economy belongs to the state. Since land is a nature's gift to mankind so all rights attached to land are vested with the State and not any individual. The State is the entrepreneur and deploys resources and people on the property. Private individuals do not own any means of production. Hence, they cannot use any property for personal gains or profits. Private people cannot hire labor at low wage rates and exploit them. Hence, there are no class conflicts between owners and workers in a socialistic society.

iii. **High degree of involvement of public sector-** Private ownership of land, labor, capital and other factors of production is considered "anti-social". All means of production belong to the State. Socialism is public oriented form of economic system.

iv. **Economic equality-** Since resources belong to the society and not any individual, these are judicially distributed among people. All are given equal access to resources and opportunities. As a result the distinction between haves and have nots is less in a socialist economy. Though socialism brings economic equality but it does not guarantee perfect equality. The reason is that inefficient people cannot be rewarded in any kind of system or economy.

v. **Equality of opportunity-** People are given equal right to education. Irrespective of the class they belong to, the State provides equal opportunities of learning, training and education to people. In a capitalistic society education is the right of only those who can afford it, but in a socialistic society government provides free education to people.

vi. **Welfare of the society and not an individual-** Socialist economy is society oriented. Production of those goods is undertaken which are needed and required by all the income segments of the society rather than producing just the luxury items for the rich. The purpose of economic activity is social welfare rather than profit motive. The State looks after the basic needs required for decent livelihood as free education, medical facilities, and recreation and entertainment facilities of the masses.

vii. **Classless society-** The society is not divided into rich and poor class. There is no class conflict. All are given equal resources and opportunities. Those who avail and work hard, benefit from the resources given by the Government.

Merits of Socialism

There are many advantages of a socialist economic system. These are discussed as follows-

i. **Overcome demerits of Capitalism**- Socialist economic system escapes disadvantages of capitalist economic system in terms of concentration of power in the hands of few individuals leading to lopsided development of the economy with rich becoming richer and poor becoming poorer. The resources and the means of production are controlled by the central authority of the country that ensures holistic economic development.

ii. **Planned economic development**- The central planning authority of the country has pre decided objectives and fixed targets. The economy moves with a vision to be achieved over a fixed period of time. As a result there is overall planned development of the economy.

iii. **Social justice**- All units of population are given equal rights and opportunities and access to resources. No one is denied opportunity to education, health and medical facilities and other public utilities on the basis of caste or creed or religion. There is social justice in the economy.

iv. **Social welfare**- Profit is not the only motive of running business. Production is undertaken to cater to the needs of high, middle and low income groups. Resources are not wasted just on the production of luxurious items. Also, every individual has equal access to social welfare schemes of education, health, sanitation and recreation.

v. **Efficiency in production**- Production is undertaken for the benefit of the society as a whole and not only for the rich. Also State spends heavily on advanced technology which results in cost reduction and availability of affordable goods and services.

Demerits of Socialism-

There are many disadvantages of a socialist economy. These are discussed as follows-

i. **Excessive bureaucratic control**- The business is run by civil servants and bureaucrats. They cannot have the same interest in business as a private entrepreneur. They derive their fixed salaries irrespective of the outcome. He does not have any stake in the company. As a result they are not interested in profits or losses. Similarly, the investment is made by the State and not individuals, so civil servants are simply the employees and do not share any risk or uncertainty. Their job is more focused on smooth running of the business rather than profit generation unlike a private entrepreneur who runs the risk of capital investment and losses as well.

ii. **Unequal distribution and lack of opportunities for all**- Socialism claim that it grants equal opportunities to the whole population. The disparities between rich and poor vanish. But this seems to be untrue. As actually witnessed there are high disparities and inequalities in the society. Poor are still poor only while the rich are enjoying several benefits. Government efforts are not fully fruitful even in a socialistic society.

iii. **Lack of autonomy**- There is no freedom in a socialistic society. People cannot choose their occupation and jobs. They have to adhere strictly to the State regulations and any deviation is punishable.

iv. **No motivation for individual growth**- Socialism does not promote growth of an individual. It discourages private entrepreneurship. The Government creates jobs and facilities which people have to avail. They cannot hold private property or private ownership. Hence, they cannot open private businesses. There is lack of motivation to earn profits. This kills the innovative spirit and entrepreneurial abilities in the society.

v. **Slow pace of economic development**- In a socialistic society the control is too much centralized in the hands of the bureaucrats. Since they do not have any personal interest in the businesses, the process of advancement is slow. The whole system is sluggish as the civil servants do not respond quickly to the changing environment and needs.

vi. **Not much social welfare**- Socialism results in social welfare also seems a myth. Not all people are able to avail facilities granted by the State. There is red tapism in the bureaucratic regime. All units do not get equal benefits and opportunities. The income disparities continue even in a socialistic society.

3. Mixed Economy

A Mixed economy has features of both the capitalist and the socialist economy. Here means of production are controlled both by the state as well as the private players. The central planning in the country and the demand and supply forces both has a role in a mixed economy.

A mixed economy is also known as a ‘mixed or controlled capitalistic system’. This is because in a mixed economic system the means of production are controlled by the private entrepreneurs under the legal framework and regulations set by the Government. The government controls the economy through its various policies as the fiscal policy, monetary policy, licensing system, price controls, import and export controls etc. The right of private ownership prevails unless it is detrimental for the general public interest. Thus, government controls the private system of production in national interest. Government ensures price stability, full employment, exchange rate stability, Balance of payment equilibrium through its various economic policies etc. Production is given in private hands but for few sectors which are reserved by the Government as the Defence Equipments and certain public utility services like electricity, water, gas and transportation.

Features of a Mixed economy-

The features of a mixed economy are discussed as follows-

i. **Economic Development through Central Planning**- The economic development in the country takes place through centrally planned systems. Though the production is given to the private players but the central planning authority of the country earmarks the objectives of production in the country. For instance- India adopted a system of Five year planning since 1951 till 2014 by establishing Planning Commission in the country. It took up different agendas in the 12 five year plans undertaken by it. These included development of agriculture, industry, energy, irrigation, transport, human welfare etc. Now this has been replaced by NITI Aayog which has long term vision for the economic development of the country.

ii. **Market forces along with Government Directions**- In a mixed economy prices are determined through the forces of demand and supply. Similarly, resource allocation is done through the market forces. For instance when delicensing was undertaken in India the industries were liberalized and resultantly the investment flowed to industries other than agriculture and wage goods producing primary sector industries. Though it seemed that industries catering to the needs of the poor were ignored still the market forces of demand and supply had to be followed. However, in certain industries as power and electricity, postage, railways etc. government had full control in resource allocation as well as fixation of prices.

iii. **Protection of Consumer Sovereignty subject to Government control**- In a mixed economy consumers have full right to choose goods and services they want to consume. But Government can put restrictions on certain production, consumption and distribution through various statutes as the MRTP Act, Industrial licensing, EXIM Policy, foreign trade policy etc. in India.

iv. **Protection of the masses**- In a mixed economy though production of consumer goods is in the hands of private players but still government ensures public welfare. For instance- in India the minorities are protected through reservations and quotas in education and jobs. There is old age pension for retired people. Labor is protected through various laws as the Minimum Wage Act, Industrial Dispute Act etc. They have the right to form unions and bargain collectively.

v. **Restricting formation of Monopolies**- In a mixed economy since the business is handed over in private hands there is tendency of formation of monopolies. But Government oversees and restrict the same through various laws as the MRTP Act, FERA etc.

Merits of Mixed Economy-

There are many advantages of a mixed economy. These are explained as follows-

i. **Balanced growth of economy**- Since both private and public players play together in the market, there is balanced economic growth. Private players uplift the consumer goods sector while the public utilities and services are managed by the Government. Also freedom is given to the private sector to undertake production but regulations are given by the Government. For instance- in India Government frames the industrial policies to regulate the functioning of the private sector.

ii. **Public Private Partnership**- Both the sectors work together in a mixed economy. There is lesser confrontation as in a purely capitalist or a socialist economy where one sector alone dominates. On one hand the market forces play their role and on the other hand the Government oversees the market forces in the mass public interest.

iii. **Achievement of social welfare**- Those who can afford go in for purchase of goods and services offered by the private sector where prices are market determined. Those who cannot afford purchase goods and services offered by the Government at controlled prices in the interest of the public. As a result all people get right to receive goods and services as per their economic viability.

iv. **Optimum allocation of resources-** Resources are allocated to those products that are in demand. Market forces play their role and there is optimum allocation of resources. Those goods are produced which are in high demand. Though prices go up for such goods but consumers get the goods they want and sellers are able to make sufficient profits. Investment is not made in the goods and services that are not in demand. Hence, scarce resources of the economy are not wasted.

v. **Healthy competition-** Since two distinct sectors- Public and Private sector operate simultaneously in an economy there is competition between the two to perform better and serve the consumer. Since the market drivers determine the success of an organization, so even the prices cannot be manipulated. Rather both sectors try to achieve quality targets with cost reductions.

vi. **Heavy capital investment and innovations-** The economic success much depends upon innovations in an economy. Since both private and public sector works together, they can invest huge amounts towards Research and Development and innovation.

Demerits of a Mixed Economy

There are many disadvantages of a mixed economy. These are explained as follows-

i. **Dominance of State-** Though it seems that both the private and public sectors are working together in an economy, still the Government has full control on the private sector. The government has the right even to nationalize a business but it is not vice versa. Though market forces operate in the economy but the government still conserves the right to restrict and control them through their economic policies.

ii. **Unhealthy competition-** Both the sectors in a mixed economy want to establish their supremacy and grab the largest market share. It is often seen that there is unhealthy competition in both the sectors leading to wastage of resources.

iii. **Blame game-** None of the two sectors is ready to accept the flaws and mistakes resulting in less economic development. Private players blame the government while the Government holds private participants responsible for the inefficiencies.

iv. **Confusion in the minds of the stakeholders-** The customers in a mixed economy seem to enjoy wider choices in purchase and consumption of goods and services. But the customer is confused between the two sectors. Also player from both sectors try to manipulate and grab the customer.

v. **Social imbalance-** The gap between the rich and poor is evident in a mixed economy. Rich can afford branded goods and services produced by the private sector while the poor purchases indigenous goods produced by the government. Since market forces are dominant in price determination, so the gap between rich and poor prevails in a mixed economy.

Difference between the Economic Systems

The differences between the three economic systems are explained in the following Table1.

Table 1- Differences between Capitalist, Socialist and Mixed Economy

Parameters	Capitalist economy	Socialist economy	Mixed economy
Ownership of property	Private ownership	Public ownership	Both public and private ownerships
Price determination	Prices are determined by the market forces of demand and supply.	Prices are determined by the central planning authority.	Prices are determined by the central planning authority, and demand and supply.
Motive of production	Profit motive	Social welfare	Profit motive in the private sector and welfare motive in the public sector
Role of government	No role	Complete role	Full role in the public sector and limited role in the private sector
Competition	Exists	No competition	Exists only in the private sector
Distribution of income	Very unequal	Quite equal	Considerable inequalities exist

Source- byjus.com

8.3. ECONOMIC REFORMS

In 1991, “the Government of India initiated a series of economic reforms due to a financial crisis and pressure from international organisations like World Bank and IMF. These reforms came to be known as the New Economic Policy (NEP)”.

Need for Economic Reforms

1. **“Fall in foreign exchange reserves**: In 1991, India met with a foreign exchange or external debt crisis”.

   A. “The government was not able to make repayments on its borrowings from abroad.

   B. The foreign exchange reserves declined to a level that was not adequate- to finance imports for more than two weeks and to pay the interest that needs to be paid to international lenders”**.**

2. **“Financial crisis**: the origin of the financial crisis can be traced from the inefficient management of the Indian economy in the 1980s”.

   A. “Development policies required that even though the revenues were very low, the government had to overshoot its revenue to meet challenges like unemployment, poverty and population explosion. The continued spending on development programs of the government did not generate additional revenue”.

   B. Moreover, “the government was not able to generate sufficient revenue from internal sources such as taxation”.

   C. The government was “spending a large share of its income on areas which do not provide immediate returns such as the social sector and defence”.

   D. “The income from public sectors undertakings (PSUs) was also not very high to meet the growing expenditure. Hence our foreign exchange, borrowed from other countries and international financial institutions, was spent on meeting consumption needs”.

3. **Mounting government debts**: “In the late 1980s, government expenditure began to exceed its revenue by such large margins that meeting the expenditure through borrowings became unsustainable. Moreover, no attempt was made to reduce such profligate government spending”**.**

4. **Adverse Balance of Payments**: “Imports grew at a very high rate without matching growth of exports. Slow growth of exports was due to low quality and high prices of Indian goods in the

international market. Also, no sufficient attention was given to boost exports to pay for the growing imports".

5. **Rising prices of essential goods**: "The economic crisis in 1991 was further compounded by rising prices. Prices of many essential goods rose sharply due to inefficiencies in private as well as public sector production and high tariffs even on essential imports".

Economic reforms refer to "the fundamental changes that were launched in 1991 with the plan of liberalising the economy and quickening its rate of economic growth. The Narasimha Rao Government, in 1991, started the economic reforms in order to rebuild internal and external faith in the Indian economy".

The reforms intended at bringing in "larger cooperation of the private sector in the growth method of the Indian economy. Policy changes were proposed with regard to technology up-gradation, industrial licensing, and removal of restrictions on the private sector, foreign investments, and foreign trade".

The essential features of the economic reforms are – Liberalisation, Privatisation, and Globalisation, commonly known as LPG.

Liberalization: "Liberalization was brought about with an idea that any regulations or restrictions that were imposed on free trade must loosen up its grip to allow trade. It allowed opening up the economic borders for foreign investments and MNCs. Several economic reforms that were imposed under Liberalization include expansion of production capacity, de-servicing producing areas, abolishing industrial licensing by the government, and freedom to import goods".

Privatization: Privatization refers to "giving more opportunities to the private sector in regulating different services and reducing the role of the public sector(government-owned enterprises) in them. With privatization, FDI (Foreign Direct Investment) was introduced in India giving healthy competition to the Indian goods and services".

Globalization: In the context of economic reforms, Globalization means "integration of the Indian economy with the world economy. It means that the economy of India will now also depend on the world economy and vice versa. It encourages FDI and foreign trade with different countries".

Major Reforms Carried Out in 1991

Economic Reforms in India in 1991 carried out several changes. A few important reforms are-

Fiscal Stabilisation

“The effectiveness of economic reforms depends on the achievement of fiscal stabilization. In order for the reforms to succeed, the Central Government’s fiscal deficit, which had reached 8.4% in the 1990–1991 fiscal year, needed to be reduced. The below actions were performed in order to decrease the budget deficit.

- Export subsidies were abolished in 1991–1992, and fertilizer subsidies were partially restructured in 1992–1993.
- Budget assistance to loss-making public-sector units in the form of government loans to cover their losses was gradually phased out.
- Some development expenditure, such as spending on social and economic infrastructure, was reformed”.

Industrial Policy

“Industrial policy has seen the most radical changes as a result of the reform plan. There is no longer a need for the government to grant approval for new investments or for the significant expansion of current capacity as it was previously under industrial licensing (License Raj)”.

- “Nowadays, only a small number of businesses are required to have licenses, mostly due to environmental and pollution concerns. Additionally, the MRTP Act was also eliminated”.
- “The list of industries that were solely for the public sector to operate was drastically reduced, and many crucial sectors were made available to the private sector, including power generation, hydrocarbons (oil and gas exploration, production, and refining), air transportation, telecommunications, and others”.

De-licensing of items reserved for the MSME Sector

Since 1991,” the Ministry of Commerce and Industry has been gradually de-licensing the products specified for the MSME sector through a proactive approach”.

Foreign Investment

Prior to 1991, “India had an extremely restrictive and often regarded hostile foreign investment policy”.

“The new strategy supported foreign investment considerably more actively in a variety of ways. For foreign equity investments of up to 51 percent in a lengthy list of 34 industries, permission is automatically granted; for investments of more than 51 percent, government approval was required”.

Trade and Exchange Rate Policy

“With certain required exceptions, all raw materials, other production inputs, and capital products can now be imported without restriction. Prior to 1991, the RBI-determined an official exchange rate on which the Indian Rupee was converted into foreign currency. The value of the rupee dropped by nearly 24 percent in July 1991. (for alignment of the exchange rate with the market rate). In 1993, India switched to a market-based exchange rate system (managed float/floating rate)”.

Tax Reforms

- “In June 1991, the highest marginal rate of personal income tax was 56%. This was decreased to 40%”.
- “For publicly listed enterprises, corporate income tax was lowered from 51.75% to 46%”.
- “The average amount of customs duty drastically decreased from 200% to only 65%”.

Public Sector Reforms

“The government started a restricted process of disinvesting its ownership and equity in public sector enterprises instead of going through full privatization, keeping 51% of the equity and management control”.

Financial Sector Reforms

- “New private banks were allowed to compete in the banking sector, and numerous new banking licenses were granted”.
- “Trading practices in capital markets are kept under transparent and strict control. In order to oversee the major players in the capital markets and regulate stock exchanges, an independent statutory entity called SEBI was created in 1988”.

- "The capital market was made available for portfolio investments, and Indian businesses were permitted to access global capital markets by issuing equity or shares overseas through Global Depository Receipts (GDR)".

(Source- Liberalization, Privatization And Globalization: An Appraisal https://sbpsranchi.com/)

8.4. CHECK YOUR PROGRESS

Choose the correct option-

1. Right to Private property is available in-
   a) Capitalist economic system
   b) Socialistic economic system
   c) Mixed economic system
   d) All of the above
2. The role of Planning Commission has been dominating in-
   a) Capitalist economic system
   b) Socialist economic system
   c) Mixed economic system
   d) All of the above
3. Capitalism is-
   a) Social oriented and market driven
   b) Profit oriented and market driven
   c) Both profit and social oriented
   d) Non- profit oriented and state controlled
4. In a mixed economy-
   a) Public utilities and services are in the domain of the Government
   b) Consumer goods are produced by the private sector

c) Both A and B are correct

d) Both A and B are incorrect

8.5. SUMMARY

An economic system is a "means by which societies or governments organize and distribute available resources, services, and goods across a geographic region or country. Economic systems regulate the factors of production, including land, capital, labor, and physical resources. An economic system encompasses many institutions, agencies, entities, decision-making processes, and patterns of consumption that comprise the economic structure of a given community". The type of economic system in an economy influences the working of business. An economy may have three types of economic systems- Capitalist economy, Socialist economy and a Mixed Economy. In a capitalist economy there is least interference by the Government. The production is controlled and owned by private individuals for the purpose of earning profits.

In a capitalist economy, there is right to private property and greater freedom to work. The owner of the property does his best to make the best out of his means of production. The businessman ensures that the limited resources are put into use in the most productive manner. Since people have right to buy and sell private property, so instead of spending their money on consumption they deploy it on capital formation to build their properties. People in a capitalist economy feel motivated to grow and start their own ventures. It encourages entrepreneurship. Capitalism on its own generates higher economic growth. People work for their own welfare. When people grow, economy grows automatically. A capitalist economy has many disadvantages. The capitalist economy promotes materialistic approach in the society. The society on the whole gets divided into 'have' and 'have not' population. There is Conflict between owners and workers. Competition takes an unhealthy shape gradually in a capitalist economy. People work only for self-interest. Businesses do not believe in charity or social welfare. Certain sectors as agriculture are under-invested. Businesses follow many malpractices in their conduct as there is no external or central control on them.

In a socialist economy the Government controls and manages the production and distribution of the goods and service in an economy. It is believed that Government best knows the needs of the people. There are many advantages of a socialist economic system. Socialist economic system escapes disadvantages of capitalist economic system in terms of concentration of power in the hands of few individuals leading to lopsided development of the economy. The central planning authority of the country has pre decided objectives and fixed targets. As a result there is overall planned development of the economy. No one is denied opportunity to education, health and medical facilities and other public utilities. Profit is not the only motive of running business. Production is undertaken for the benefit of the society as a whole and not only for the rich.

A Mixed economy has features of both the capitalist and the socialist economy. Here means of production are controlled both by the state as well as the private players. The central planning in the country and the demand and supply forces both has a role in a mixed economy. Since both private and public players play together in the market, there is balanced economic growth. Both the sectors work together in a mixed economy. There is lesser confrontation as in a purely capitalist or a socialist economy where one sector alone dominates. People get right to receive goods and services as per their economic viability. Resources are allocated to those products that are in demand. Market forces play their role and there is optimum allocation of resources. There is competition between the two to perform better and serve the consumer. Since both private and public sector works together, they can invest huge amounts towards Research and Development and innovation.

The Narasimha Rao Government, in 1991, started the economic reforms in order to rebuild internal and external faith in the Indian economy. The essential features of the economic reforms are – Liberalisation, Privatisation, and Globalisation. Economic Reforms in India in 1991 carried out several changes. Export subsidies were abolished in 1991–1992, and fertilizer subsidies were partially restructured in 1992–1993. Budget assistance to loss-making public-sector units in the form of government loans to cover their losses was gradually phased out. Some development expenditure, such as spending on social and economic infrastructure, was reformed. Nowadays, only a small number of businesses are required to have licenses, mostly due to environmental and pollution concerns. Additionally, the MRTP Act was also eliminated. Since 1991, the Ministry of Commerce and Industry has been gradually de-licensing the products specified for the MSME sector through a proactive approach. Prior to 1991, India had an extremely restrictive and often regarded hostile foreign investment policy". "With certain required exceptions, all raw materials, other production inputs, and capital products can now be imported without restriction. Prior to 1991, the RBI-determined an official exchange rate on which the Indian Rupee was converted into foreign currency. "The government started a restricted process of disinvesting its ownership and equity in public sector enterprises instead of going through full privatization, keeping 51% of the equity and management control". Many tax reforms and Financial Sector Reforms were introduced.

8.6. KEY WORDS

1. **Economic System-** An economic system is "a system of production, resource allocation and distribution of goods and services within a society or a given geographic area. It includes the combination of the various institutions, agencies, entities, decision-making processes, and patterns of consumption that comprise the economic structure of a given community".
2. **Capitalism-** In a capitalist economy there is least interference by the Government. The production is controlled and owned by private individuals for the purpose of earning profits. The products are allocated among people on the basis of their purchasing power. What they require is not important but what they can purchase is the criteria of production and distribution under a capitalist economy. In brief the forces of demand and supply dominate the consumption and distribution.
3. **Socialism-** In a socialist economy the government controls and manages the production and distribution of the goods and service in an economy. It is believed that government best knows the needs of the people.
4. **Mixed Economy-** A mixed economy has features of both the capitalist and the socialist economy. Here means of production are controlled both by the state as well as the private players. The central planning in the country and the demand and supply forces both has a role in a mixed economy.
5. **Economic reforms-** Economic reforms refer to the fundamental changes that were launched in 1991 with the plan of liberalising the economy and quickening its rate of economic growth.
6. **Liberalization:** Liberalization was brought about with an idea that any regulations or restrictions that were imposed on free trade must loosen up its grip to allow trade. It allowed opening up the economic borders for foreign investments and MNCs.

7. **Privatization:** Privatization refers to giving more opportunities to the private sector in regulating different services and reducing the role of the public sector government-owned enterprises) in them.
8. **Globalization-** Globalization means "integration of the Indian economy with the world economy. It means that the economy of India will now also depend on the world economy and vice versa. It encourages FDI and foreign trade with different countries".

8.7. SELF ASSESSMENT EXERCISE

1. Define Economic System. Discuss their types.
2. What is capitalism? Discuss its features.
3. What is socialism? Discuss its features.
4. What is mixed economy? Discuss its features.
5. Is socialism preferred over capitalism? Discuss the reasons for your answer.
6. Explain the merits and demerits of capitalism.
7. Explain the merits and demerits of socialism.
8. What are economic reforms? Why were they needed in India? Explain the economic reforms in India since 1991.
9. Write notes on-
   a) Capitalism VS Socialism
   b) Mixed economy as the best economic system
   c) Need for economic reforms
   d) New Economic Policy

8.8. ANSWERS TO CHECK YOUR PROGRESS

a) Capitalist economic system
b) Socialist economic system
c) Profit oriented and market driven

d) Both A and B are correct

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Course: Business Environment	Author: Dr. Aparna Bhatia
Course Code: BCOM 206	Vetter: Prof. Pardeep Kumar Gupta

LESSON: 09

Monetary and Fiscal Policy in India

STRUCTURE:

9.0. LEARNING OBJECTIVES

After going through this lesson you should be able to know

- the concept and need of economic policies in the country
- the need of monetary policy, its nature, instruments and impact
- the need of fiscal policy, its nature, instruments and impact

9.1. INTRODUCTION

The Government administers and implements the economic policies of a country for the economic development of a country. It refers to “set of controls used by the Government to govern the economy”. These include various measures that are used to manage the economy. These are guidelines that control the behavior of an economy. These include decisions relating to money supply, taxation, income redistribution, government spending etc. Economic policies must manage and boost investment in the country, lead to employment, development of technology, infrastructural improvements and public welfare. Economic policies must be able to manage the macroeconomic forces.

Objectives of Economic Policy

Every economy requires an economic policy to regulate its working. An economic policy has some basic objectives to be achieved. These include the following-

1. **Fast economic growth**: Every economy wants to achieve a rapid economic growth especially a developing economy. Hence the economic policies of a country must ensure increased production and output. This would boost employment levels in the country. Consequently money would exchange hands from the rich to the poor and people would have more purchasing power. The disparities between the rich and the poor shall fade out. The increased production would add to the national income of the country and the country shall witness optimum levels of employment and escalated growth.
2. **Full employment**: Full employment refers to a situation where the eligible population gets employment at the current wage rate prevailing in the economy. Economic policies should boost the level of investment in the country. For instance- taxation policies should motivate people to save and invest. This shall lead to capital formation and infrastructural developments in the country which in turn would lead to generation of employment.
3. **Equal distribution of income**: Economic systems need to be managed in a way that the disparities between rich and poor are minimized. Economic policies should ensure that the income in the hands of the rich is circulated to reach the poor. For instance a progressive tax structure imposes more taxes on high income groups relative to the low income groups. The tax collected is used for public welfare by the Government of the country.

4. **Human development**: Economic development is overlapping with human development. A nation cannot progress if its people are poor. So the economic policy must bring employment, income and wealth to people. It must be helpful in promoting education, health, nutrition, life expectancy etc.
5. **Price stability**: Economic policy has a prime objective of controlling fluctuation in prices. Both inflation and deflation are bad for the economy. Hence inflation is controlled by lowering money supply while deflation is controlled by public expenditure by the government.
6. **Fair competition**: Economic policy must target to restrict monopolies and ensure healthy competition between different units.
7. **Managing business cycles**- Economic policy should be comprehensive enough to control the affect of cyclical fluctuations in an economy. The economy should not collapse during the recessionary phases. The instruments of economic policy should be able to avoid the adverse effects of cyclical fluctuations.

Thus**,** economic policies are "statements of aims and ideals to be achieved through various instruments outlined by the government to guide the process of economic development. In a way, it can be termed as a structural response to correct economic imbalances (and inequality). Government, by manipulating economic and social variables, influences the process of resource allocation to achieve desired level of economic development with social justice and stability. An economic policy essentially relates to either or all of the three basic economic decisions viz., 'what to produce', 'how to produce' and 'for whom to produce' at macro level".

Types of Economic Policies

There are two types of economic policies

1. **Macro-economic policies-** Those policies that control the macro variables, like employment, national output, inflation, saving and investment, exchange rate, money supply etc are the macro- economic policies.
2. **Micro-economic policies-** Those policies that control the micro variables, are called the micro-economic policies. These are sectoral policies address to the growth in the individual sectors of the economy, like agriculture, industry, services, etc.

9.2. THE MONETARY POLICY

Monetary Policy is one of the most important macro- economic policies of the country that controls and regulates supply of money, credit and interest rate in the economy. The monetary policy is formed and administered by the central bank, the Reserve Bank of India. Some definitions of monetary policy are discussed below to have better understanding of the concept of monetary policy.

Definitions of Monetary Policy

Some of the definitions of monetary policy given by popular authors are as follows-

According to G.K.Shaw -

“By monetary policy we mean any conscious action undertaken by the monetary authorities to change the supply of money and rate of interest”.

According to Harry Johnson-

“Monetary policy is a policy employing central banks control of the supply of money as an instrument of achieving the objectives of general economic policy”.

According to D.C.Rowan-

“Monetary policy is defined as a discretionary act undertaken by the authorities designed to influence

(a) the supply of money,

(b) cost of money or rate of interest and

(c) the availability of money for achieving specific objectives.”

According to Todaro and Smith-

“Monetary policy refers to the activities of a central bank designed to influence financial variables such as money supply and interest rates”.

Thus, monetary policy controls supply of money and credit creation by banks in the economy.

Features of Monetary Policy

From the above definitions following features of monetary policy are derived-

1. It regulates supply of money.

2. It regulates the interest rates.
3. It regulates the credit creation function of banks.
4. It administers allocation of loans to various industrial sectors.
5. It ensures economic stability in the country.

Objectives/influence of monetary policy

Following are the objectives/influence of monetary policy on the economy-

1. **Economic growth**- Monetary policy leads to optimum money supply and credit in the economy. Money is the back bone of a progressive nation and its availability in the correct proportion leads to economic growth.
2. **Price stability-** Price instability is caused by excessive or deficit supply of money and credit available in the country. Excess money supply brings inflation while deficit brings deflation. Monetary policy ensures price level stability.
3. **Capital formation**- Monetary policy overviews the savings and investments in an economy. It manipulates with the interest rates to encourage savings which can be invested for the purpose of capital formation in the country.
4. **Managing boom/recession**- During the period of boom RBI contract credit and thus restricts money supply. This lowers down the purchasing power and reduces prices. On the other hand, in recession RBI expands credit thereby increasing purchasing power of people and reviving the economy from deflation and the recessionary phase.
5. **Stability in money market**- Through its instruments as open market operations and Liquidity Adjustment Facility RBI lends/borrows money against money market instruments as government securities and T-bills. As a result, it ensures stability in the financial market.
6. **Increase in Employment**- With the expansionary policy more credit is available in the market. New entrepreneurs appear with new ventures thereby generating more employment in the country.

7. **Development of Priority Sectors**- Monetary policy has a right to exercise selective control and grant credit to certain priority sectors and industries. Thus priority sectors get a boost in the economy.

Types of Monetary Policy

There are two types of monetary policies-

1. Expansionary Monetary Policy
2. Contractionary Monetary Policy

Expansionary Monetary Policy- The policy that increases money supply in the economy is the expansionary Monetary Policy. In this policy the rate of interest is lowered. As a result savings become less attractive. Consumer spending increases. Greater borrowings are made from the banks. Unemployment is reduced and there is larger economic growth.

Contractionary Monetary Policy- The policy decreases money supply in the economy. In this policy the rate of interest is increased. Preference of savings increases. There is lesser purchasing power available with people. As a result inflation decreases.

Techniques/Measures of Monetary Policy of India

Monetary policy regulates currency as well as credit control. Hence in order to achieve the control of both it adopts two measures-

1. **Measures for Expansion of Currency**- Reserve Bank of India (RBI) has the sole right to print and issue currency notes. But RBI follows the Minimum Reserve System. According to this system, the Reserve Bank of India needs to keep up resources of at any rate 200 crore rupees on all occasions. Out of this 200 Crore, the 115 Crore rupee ought to as Gold or gold bullion and the rest 85 cr. should be as unfamiliar monetary forms.
2. **Measures for credit control**- But for currency, RBI also performs the function of credit control in money supply. It has to regulate the circulation of money in the economy to achieve various objectives of monetary policy as price stability, employment, saving and investment, controlling business cycles. For this RBI uses quantitative and qualitative instruments of credit control.

Instruments of credit control

Credit control refers to increase and decrease of credit in the economy according to the requirements of an economy. The following measures are adopted for controlling credit given in Table 1-

Table 1-Measures of Credit Control

Quantitative Credit Controls	**Qualitative Credit Controls**
Bank rate	Margin Requirement
Cash Reserve Ratio	Regulation of Consumer Credit
Statutory Liquidity Ratio	Discriminatory Interest Rates
Open Market Operations	Moral Persuasion
Liquidity Adjustment Facility - Repo Rate - Reverse Repo Rate	Direct Action
Marginal Standing Facility	

I. Quantitative Credit Controls

1. Bank Rate

The bank rate is the minimum rate at which the central bank of a country (as a lender of last resort) is prepared to give credit to commercial banks. RBI can encourage both contraction and expansion of credit by increasing or lowering the bank rate. Current bank rate in India is 6.5%.

Contraction of credit

Increase in Bank rate → increases the rate of interest

↓

Demand for credit is reduced ← Credit becomes dear

"Central bank adopts dear money policy when supply of credit needs to be reduced during inflation."

Expansion of credit

Decrease in Bank rate → decreases the rate of interest

↓

Demand for credit increased ← Credit becomes cheaper

Central bank adopts cheap monetary policy when credit needs to be expanded during deflation.

Success of bank rate policy depends on

- Degree of dependence of commercial banks upon the central bank for loans.
- Degree of sensitivity of bank's demand for funds from the central bank – depending on business conditions, commercial banks may not be very sensitive to small variations in bank rate.
- Structure of interest rates in money market– if non banking financial institutions in market vary their interest rates in accordance with what the central bank expects from the commercial banks, the bank rate policy may not succeed.
- Overall supply of funds in the market– bank rate policy may not be a success if non banking sources of funds are of greater importance

2. Cash Reserve Ratio

It refers to the minimum percentage of bank's total demand and time liabilities which it is required to keep with the Reserve Bank of India. The current Cash Reserve Ratio (CRR) is 4.5%.

Contraction of credit

When credit is to be decreased → minimum CRR is increased

Expansion of credit

When credit is to be increased → minimum CRR is decreased

3. Statutory Liquidity Ratio

Apart from the Cash Reserve Ratio, the commercial banks have to keep a certain proportion of their time deposits in liquid form, gold and short term securities is known as Statutory Liquidity Ratio (SLR).

Contraction of credit

To reduce the flow of credit → central bank increases SLR

Expansion Of Credit

To expand the flow of credit → central bank reduces SLR

Success of CRR and SLR depends on the amount excess reserves with the commercial banks.

4. **Open Market Operations**

It refers to sale/ purchase of government securities and treasury bills in open market by the central bank.

Contraction of credit

Sale of securities → central bank withdraws cash balances from within the economy

↓

credit will decrease

Expansion of credit

Purchase of securities → central bank contributes cash balances in the economy

↓

credit will increase

Success of open market operations (OMO) depends on:

- Existence of securities market – well organized and well functioning of market for sale and purchase of securities.
- Reserves with the banks – if commercial bank tends to keep their own excess reserves with themselves, they need not buy securities.

5. **Liquidity Adjustment Facility**

Liquidity Adjustment Facility (LAF) allows commercial banks to borrow money from Reserve Bank of India in case of shortage or deposit excess funds in case of excess liquidity on an overnight basis against the collateral of government securities. . LAF includes-

i. **Repo rate/ Repurchase option-** When commercial banks borrow money from RBI by selling securities to RBI with an agreement to repurchase the same at a predetermined rate. The rate charged by RBI is the repo rate. Current repo rate is 6.25%.

Contraction of credit

Increase in repo rate → commercial banks get credit at higher rate

↓

credit will decrease

Expansion of credit

Decrease in repo rate → commercial banks get credit at Lower rate

↓

credit will increase

ii. **Reverse Repo rate/ Reverse Repo Option-** It is the interest rate given by Reserve Bank of India to commercial banks on deposits make by them with it. When commercial banks have more funds they can deposit those with RBI. Current reverse repo rate is 3.35%.

Contraction of credit

Increase in reverse repo rate → commercial banks deposit more funds with RBI

↓

credit will decrease

Expansion of credit

Decrease in reverse repo rate → commercial banks deposit less funds with RBI

↓

credit will increase

6. Marginal Standing Facility

Marginal Standing Facility is a penal rate through which banks can borrow from RBI over and above the LAF. LAF limits the borrowing of banks to a certain percentage of deposits. In case banks want to borrow further they can do it at MSF. Since it is a penal rate, MSF is always higher than repo rate. Current MSF rate is 6.5%.

Contraction of credit

Increase in MSF rate → commercial banks get funds at higher rate

↓

credit will decrease

Expansion of credit

Decrease in MSF rate → commercial banks get funds at lower rate

↓

credit will increase

II. Qualitative Credit Controls

These instruments direct or restrict the flow of credit to specified areas of economic activity. These are the selective credit controls. These include the following-

1. **Margin Requirement**

The loan is granted against a collateral security. Margin requirement refers to difference between the current value of security offered for loan and the value for loans granted. If the margin requirement is 20%, the bank will grant loan of 80%. If bank wants to control credit it increases the margin requirement. If bank wants to expand credit it decreases the margin requirement.

2. **Discriminatory Interest Rates**

RBI charges different rate of interest from different sectors. It gives cheaper credit to weak or poor sectors or prioritized sector by offering a concessional rate of interest. Through this method RBI directs the flow of credit to important sectors and restricts the flow of credit to undesirable sectors.

3. **Regulation of Consumer Credit**

This requires that certain percentage of loan taken for purchase of durable goods called the down payment has to be made by the customer in cash. The balance amount is financed by the bank which is later repaid by the customer in installments over a period of time. When RBI wants to contract credit it increases the down payment and reduces the number of installments. But when RBI wants to expand credit it decreases the down payment and increases the number of installments.

4. **Moral Persuasion**

RBI issues periodical letters to commercial banks to exercise control over credit either in general or for particular goods. Discussions are held with the executives of banks to persuade them to follow the instructions of credit control. The success of this measure depends on the cooperation of commercial banks.

5. **Direct Action**

This is a coercive method to control credit. When persuasion fails, direct action is taken. The central bank may initiate direct action against the member banks in case these do not comply with its directives. Direct action includes derecognition of a commercial bank as a member of the country's banking system, cancellation of bank's license, refusal from RBI to discount the bills.

Limitations of Monetary Policy

Following are some limitations of monetary policy-

1. **Limited applicability in under developed countries-** Organized financial institutions are not fully developed in developing countries. Also the capital markets are not fully developed.
2. **Ignores the role of non-banking financial institutions-** Non banking financial institutions like insurance corporations and UTI which provide major proportion of their credits to the industry, also create obstacle to achieve the objectives of the monetary policy as RBI cannot exercise direct control over these companies.
3. **Inflationary constraint-** Established facts makes it clear that the measures of policy failed to control the rising prices in the developing countries including India.
4. **Disequilibrium in balance of payment**

Expansionary monetary policy	→	increases money supply
		↓
Causes unfavorable balance		leads to increase in
Of payment	←	demand of imports

5. **Deficit financing-** Deficit financing increases the supply of money whereas monetary policy during inflation restricts the supply of money. Hence both work in opposite direction and as a result monetary policy cannot prove its worth.

Suggestions for improving the performance of monetary policy

1. There must be proper coordination between monetary and fiscal policy.
   - Lack of coordination between these two policies leads to imbalance between aggregate demand and supply in the economy which further leads to economic instability in the economy.
   - Every year the increasing fiscal and budgetary deficit and deficit financing to fill these deficits leads to ineffectiveness of monetary policy.
2. The government must emphasis on non-inflationary sources of finances to fill the budgetary deficit.
3. RBI and government must exercise control over rise in prices in the economy.
4. The government and RBI must ensure that the interest rates in the economy must be determined by demand and supply forces.
5. The allocation of credit must be made in accordance with plan priorities of the country.
6. Introduction of some new instruments in the money market on the lines of developed money markets of the world.
7. Exercising strict control over black money in the economy.
8. RBI and government must be given more powers in addition to CRR and SLR to exercise control over credit creation by commercial banks

9.3. THE FISCAL POLICY

The fiscal policy is the revenue and expenditure policy of the Government. Revenue side refers to the sources of income of the Government while the expenditure side is related to various types of expenditures undertaken by the Government out of its funds. Since fiscal policy is related to revenues and expenditures, it is also called budgetary policy. With the help of fiscal policy government uses the revenues and expenditures to achieve the desirable affects and avoid undesirable affects on the various economic parameters of the economy as the national income and employment. In the fiscal policy government makes adjustments in its spending and taxation rates in order to influence the performance of an economy.

Definitions of Fiscal Policy

Some of the definitions of fiscal policy given by popular authors are as follows-

According to G.K.Shaw -

"We define fiscal policy to include any design to change the price level, composition or timing of government expenditure or to vary the burden, structure of frequency of the tax payment." Otto Eckstein defined fiscal policy as "changes in taxes and expenditure which aim at short run goals of full employment price level and stability."

According to Harvey and Joanson, M-

"Fiscal policy as "changes in government expenditure and taxation designed to influence the pattern and level of activity."

According to D.C.Rowan-

"Monetary policy is defined as the discretionary act undertaken by government to change

(a) the level of government expenditure on goods and services and transfer payments and

(b) the yield of taxation at given level of output."

Objectives/Influence of Fiscal Policy

Following are the objectives of fiscal policy-

1. **Economic development**- Since through fiscal policy the government increases public expenditure, it leads to capital formation and infrastructural development in a country. These are the backbone for economic growth of a country. The dearth of capital investment is overcome through government expenditure and hence economic growth is fuelled.
2. **Generation of employment**- In order to generate employment in the country, the Government makes public expenditure and reduces taxes. This increases the aggregate demand. To fulfill the same private entrepreneurs, spend more on economic activities. Lowering of taxes also encourages corporate investment. Hence more employment is generated in the economy.
3. **Stability in prices**- Government tries to control inflation/deflation with the help of fiscal policy. When there is inflation the government reduces public expenditure and increases taxation rates.

Consequently people have less purchasing power and there is reduction of aggregate demand and hence reduction in prices. Exactly opposite is followed in case of deflation with government increasing public expenditure and reducing taxes.

4. **Economic equalities in the society-** Fiscal policy aims at removing the disparities between the rich and the poor and transferring the income from the hands of the rich to the poor. For instance fiscal policy allows progressive taxation. In this people in higher income slab have to pay more taxes relative to the people in the lower income slab. The revenue generated through taxation is then used for the benefit of the weaker sections of the society.
5. **Balanced regional development**- Through the fiscal policy government tries to develop the underdeveloped regions by increasing expenditure in particular regions and also giving tax concessions and exemptions to certain regions. Government spends on opening schools, building roads, starting industrial project in those regions which it wants should develop. Hence there is balanced growth and development in the country as a whole.

Types of Fiscal Policy

Fiscal policy is of two types-

1. Expansionary Fiscal Policy
2. Contractionary Fiscal Policy

Expansionary fiscal policy involves increasing government expenditure and reducing taxes so that people have more purchasing power and there is increase in aggregate demand. This policy is used during recessionary phases in the economy when the national income is low.

Contractionary fiscal policy involves reduction in government spending and increase in taxes. This results in decrease in purchasing power available with people and hence decreases aggregate demand. This type of fiscal policy is when there is inflation in the economy and high unemployment rate.

Tools/techniques/instruments of fiscal policy

The government uses fiscal policy for the economic development of the country as it is believed that changes in government spending and government revenues can bring changes in aggregate demand, inflation and employment levels in a country. Hence to achieve the same government uses the following instruments in its fiscal policy.

1. **Public Expenditure Policy**- Public expenditure refers to the spending made by the government on infrastructural developments, law, order and social security schemes like pension, health, education etc. in a country. Through the public expenditure the government provides essential services in the economy for public welfare which is not catered to by the private sector. Increase in public expenditure by the government results in economic growth, infrastructural developments, employment generation, balanced regional development, social justice and equality and investment from the private sector.

   Public expenditure by the government is of two types-

   i. **Development Public Expenditure**- It is the expenditure by the government in infrastructural development like construction of roads, damns, bridges, industrial projects, irrigation, land development etc.

   ii. **Non- Development Public Expenditure**- This is the expenditure made by the government on defence services, maintenance of law and order, debt servicing, interest payments, health and education of the public etc. This expenditure too is much required and cannot be avoided by the government.

   Private sector would not incur such massive expenditure. Hence in order to increase the pace of economic development public expenditure is an important tool of government's fiscal policy. Increase in public expenditure especially during recession increases the aggregate demand in the economy. But during inflation, reduction in public expenditure reduces aggregate demand. Hence it lowers prices in the economy and brings price stabilization.

2. **Taxation-** Taxes are the financial charges levied on the individuals and the corporate sector. These represent the revenue collected by the Government for undertaking public expenditure. Taxes are very important instruments as these have a direct impact on consumption, savings and investment. Taxes remove regional disparities. They are helpful in correcting the balance of payment disequilibrium by encouraging exports against imports. Taxes are of two types-

i. **Direct taxes**- Direct taxes are the taxes the burden on which is borne by the person on whom the tax is levied. For instance the income tax. In India direct taxes are progressive in nature meaning that the taxes increase with the increase in income. Therefore, taxes are levied more on the rich and less on the poor.

ii. **Indirect taxes**- Indirect taxes are those taxes the burden of which is not borne by the person on whom the tax is levied. For instance Goods and Services Tax. These taxes are not progressive in nature. As a result whether rich or poor, both have to pay the same indirect tax.

Taxes are major source of income to the government with the help of which the government takes developmental and infrastructural projects and also undertakes social security schemes and poverty alleviation programs.

Reduction in taxes increases the disposable income of people which increases their consumption and investment.

Increase in taxes, on the other hand, decreases the disposable income of people which decreases their consumption and investment.

3. **Public Debt Policy**- The revenue generated from the taxes may not be sufficient to incur public expenditure, therefore government borrows public debt to finance budget deficit. There are two types/sources of public debt-

   i. **Internal Debt**- This refers to the borrowings made within the country. This includes marketable debts like government securities and treasury bills, and not marketable debt like National Small Savings Funds, borrowing from financial institutions.

   ii. **External Debt**- This refers to borrowings from outside the country like the debt taken from international financial institutions and foreign governments. It includes institutes like Asian Development Bank, International Bank for Reconstruction and Development etc.

   There is direct relation between budget deficit and public debt. With the increase in budget deficit, public debt increases.

4. **Deficit Financing**- Deficit financing involves printing of new currency by the Reserve Bank of India to cater to the budget deficit of the government. This tool leads to increase of money in the

economy and hence increase in purchasing power of people. As a result aggregate demand goes up and there is price rise. Deficit financing is a beneficial tool during recession but not at times of inflation.

Limitations of Fiscal Policy

Fiscal policy is a powerful instrument in the hands of the government, yet it suffers from some limitations. These are explained as follows-

1. **Tax evasion-** In developing countries like India there is excessive problem of tax evasion. As a result the revenue generated from taxes is less. The tax structure is also inelastic, hence government is able to use tax instrument in a limited way.
2. **Cause of inflation**- Ironically fiscal policy becomes the cause of inflation instead of its solution. In countries where there is high tax evasion, government has to often resort to tools like deficit financing. It increases money supply and results in inflation.
3. **Income inequalities**- The tax structure is progressive in the country like India. Hence rich should pay more taxes than the poor. But salaried class shoulders maximum responsibility of tax contributions unlike business class that can evade taxes. As a result income inequalities prevail in spite of the fiscal policy.
4. Huge debt burden- Public borrowings as a tool of fiscal policy leads to huge tax burden on the government. When government borrows from public and recessionary period extends for a longer than expected time, public borrowings become burdensome. This results in higher debt ratio as a percentage of GDP which is a bad economic indicator for a country.
5. Futile expenditure in the fiscal policy- Government makes a discretionary fiscal policy for balanced regional development. It incurs expenditure for development of certain areas and regions. It also incurs expenditure on public utilities and social security schemes. These are non-developmental expenses. There are expenditures which do not justify and just increase fiscal deficit.

Difference between Fiscal Policy and Monetary Policy

Fiscal Policy and Monetary Policy are the important economic policies of the government. Both have common objectives in terms of economic development of the country, control of inflation, full employment etc. Still there are differences between the two. These are explained as follows in Table 2-

Table 2- Difference between Fiscal Policy and Monetary Policy

No.	Basis of Distinction	Fiscal Policy	Monetary Policy
1	Agenda	It deals with government expenditure and taxation	It deals with money supply, credit control and interest rates.
2	Authority	It is administered by the Central Government	It is formulated by Reserve Bank of India.
3	Affected parameters	It affects aggregate demand by changing government expenditure and taxation.	It affects demand and supply of money by changing interest rates.
4	Variables affected	It affects government's budget	It affects money lending rates and investment.
5	Political intervention	There is high political intervention in fiscal policy. The change in fiscal policy is a political decision.	There is not much political intervention as RBI can modify the monetary policy in case of need.

9.4. CHECK YOUR PROGRESS

Choose the correct option-

1. Monetary Policy-
    a) Control money supply
    b) Control rate of interest
    c) Controls credit
    d) All of the above

2. Cash Reserve Ratio is required to be-
    a) Deposited with RBI
    b) Deposited with other commercial banks
    c) Kept with the bank only
    d) Any of the above
3. If credit has to be contracted repo rate is-
    a) Decreased
    b) Increased
    c) Kept constant
    d) None of the above
4. Issue of new currency notes is involved in-
    a) Public borrowings
    b) Deficit financing
    c) Taxation
    d) All of the above
5. Public Expenditure involves expenditure of government on-
    a) Opening of shopping complexes
    b) gymnasium facilities to the public
    c) pension schemes to the population
    d) opening private schools and hospitals

9.5. SUMMARY

Economic policies refer to "set of controls used by the Government to govern the economy". These include decisions relating to money supply, taxation, income redistribution, government spending etc. Economic policies must manage and boost investment in the country, lead to employment, development of technology, infrastructural improvements and public welfare. Those policies that control the macro variables are the macro- economic policies. Those policies that control the micro variables are called the micro-economic policies.

Monetary Policy is one of the most important macro- economic policies of the country that controls and regulates supply of money, credit and interest rate in the economy. The monetary policy is formed and administered by the central bank, the Reserve Bank of India. In brief monetary policy regulates supply of money, interest rates, credit creation function of banks, administers allocation of loans to various industrial sectors and ensures economic stability in the country. There are two types of monetary policies. The policy that increases money supply in the economy is the expansionary Monetary Policy. The policy that decreases money supply in the economy is called Contractionary Monetary Policy. Monetary policy regulates currency as well as credit control. For credit control RBI uses quantitative and qualitative instruments of credit control. Quantitative credit controls include the bank rate which is the minimum rate at which the central bank of a country is prepared to give credit to commercial banks; Cash Reserve Ratio which refers to the minimum percentage of bank’s total demand and time liabilities which it is required to keep with the Reserve Bank of India; Statutory Liquidity Ratio which refers to the a certain proportion of their time deposits in liquid form, gold and short term securities the commercial banks have to keep is known as Statutory Liquidity Ratio (SLR). These also include Open Market Operations that refers to sale/ purchase of government securities and treasury bills in open market by the central bank. Liquidity Adjustment Facility (LAF) allows commercial banks to borrow money from Reserve Bank of India in case of shortage or deposit excess funds in case of excess liquidity on an overnight basis against the collateral of government securities.

LAF includes Repo rate and Reverse Repo Rate. Marginal Standing Facility is a penal rate through which banks can borrow from RBI over and above the LAF. There are qualitative credit controls as well. These instruments direct or restrict the flow of credit to specified areas of economic activity. Margin requirement refers to difference between the current value of security offered for loan and the value for loans granted. In discriminatory Interest Rates RBI charges different rate of interest from different sectors. RBI regularizes consumer credit**.** This requires that certain percentage of loan taken for purchase of durable goods called the down payment has to be made by the customer in cash. When RBI wants to contract credit it increases the down payment and reduces the number of installment and vice versa. RBI issues periodical letters to commercial banks to exercise control over credit either in general or for particular goods. When persuasion fails, direct action is taken.

The fiscal policy is the revenue and expenditure policy of the Government. In the fiscal policy government makes adjustments in its spending and taxation rates in order to influence the performance of an economy. Through fiscal policy the government increases public expenditure. It leads to capital formation and infrastructural development in a country. More employment is generated in the economy. Government tries to control inflation/deflation with the help of fiscal policy. Fiscal policy aims at removing the disparities between the rich and the poor.

Through the fiscal policy government tries to develop the underdeveloped regions by increasing expenditure in particular regions and also giving tax concessions and exemptions to certain regions. The government uses some instruments in its fiscal policy- Public expenditure refers to the spending made by the government on infrastructural developments, law, order and social security schemes like pension, health, education etc. in a country. Taxes are the financial charges levied on the individuals and the corporate sector. These represent the revenue collected by the Government for undertaking public expenditure. The revenue generated from the taxes may not be sufficient to incur public expenditure, therefore government borrows public debt to finance budget deficit. Deficit financing involves printing of new currency by the Reserve Bank of India to cater to the budget deficit of the government.

9.6. KEY WORDS

1. **Economic Policy**- Economic policy is a “statement of aims and ideals to be achieved through various instruments outlined by the government to guide the process of economic development. In a way, it can be termed as a structural response to correct economic imbalances (and inequality). Government, by manipulating economic and social variables, influences the process of resource allocation to achieve desired level of economic development with social justice and stability”.
2. **Macro-economic policies-** Those policies that control the macro variables, like employment, national output, inflation, saving and investment, exchange rate, money supply etc are the macro- economic policies.

3. **Micro-economic policies-** Those policies that control the micro variables, are called the micro-economic policies. These are sectoral policies address to the growth in the individual sectors of the economy, like agriculture, industry, services, etc.
4. **Monetary Policy**- Monetary policy is defined as a "discretionary act undertaken by the authorities designed to influence (a) the supply of money,

   (b) cost of money or rate of interest and (c) the availability of money for achieving specific objectives."
5. **Expansionary Monetary Policy**- The policy that increases money supply in the economy is the expansionary Monetary Policy..
6. **Contractionary Monetary Policy-** The policy that decreases money supply in the economy is called Contractionary Monetary Policy.
7. **Cash Reserve Ratio-** It refers to the minimum percentage of bank's total demand and time liabilities which it is required to keep with the Reserve Bank of India.
8. **Statutory Liquidity Ratio-** Apart from the Cash Reserve Ratio, the commercial banks have to keep a certain proportion of their time deposits in liquid form, gold and short term securities is known as Statutory Liquidity Ratio (SLR).
9. **Liquidity Adjustment Facility-** Liquidity Adjustment Facility (LAF) allows commercial banks to borrow money from Reserve Bank of India in case of shortage or deposit excess funds in case of excess liquidity on an overnight basis against the collateral of government securities.
10. **Margin Requirement-** The loan is granted against a collateral security. Margin requirement refers to difference between the current value of security offered for loan and the value for loans granted.
11. **Fiscal Policy**- "Fiscal Policy is the policy to achieve full employment level by altering the revenue and expenditure and maintaining equilibrium between effective demand and availability of goods and services".

12. **Deficit Financing**- It is a tool of fiscal policy which involves compensating the budget deficit of the government by printing new currency notes by Reserve Bank of India and giving it to the Government.

9.7. SELF ASSESSMENT TEST

1. What is meant by economic policy? What is the need of economic policy?
2. What is monetary policy? What are its instruments?
3. How does monetary policy help to control credit in the economy?
4. Explain the quantitative and qualitative tools of monetary policy.
5. What is fiscal policy? What is the influence of fiscal policy on business environment?
6. Explain the tools of fiscal policy? How do they help in obtaining desirable economic results?
7. Write notes on-
    a) Features and types of monetary policy.
    b) Quantitative VS Qualitative tools of monetary policy
    c) Repo rate VS Reverse Repo Rate
    d) Types of fiscal policies

9.8. ANSWERS TO CHECK YOUR PROGRESS

1. All of the above
2. Deposited with RBI
3. Increased
4. Deficit Financing
5. pension schemes to the population

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Course: Business Environment	Author: Dr. Aparna Bhatia
Course Code: BCOM 206	Vetter: Prof. Pardeep Kumar Gupta
LESSON: 10 Privatization in India	

STRUCTURE:

10.0. LEARNING OBJECTIVES

After going through this lesson you should be able to know

- the concept of privatization
- the reasons leading to privatization
- the objectives of Privatization

- different ways through which a public sector unit can be privatized
- arguments in favor and arguments against privatization
- the difference between privatization and nationalization
- reforms brought in India

10.1. INTRODUCTION AND MEANING OF PRIVATIZATION

With the passage of time countries restructure their economies for progress and growth. India has been no exception to the phenomenon. At one time India had large public enterprise sector. It consisted of approximately 1300 enterprises which were owned and managed by the governments at central, state and local levels. These included different sectors as power, oil and natural gas, iron and steel, mining, telecommunications, transport and even banking and insurance. Even just prior to the year of liberalization in 1990-91 India had 236 public enterprises. But these were together generating profits of just Rs. 2368 crores as many of these enterprises were loss making. The new economic reforms of 1991 recommended contraction of public sector and expansion of private sector making policy of privatization as the main feature of new economic reforms.

Privatization means opening the gates of public sector to private sector. In other words it is transferring the public sector enterprises to private sector. It is opposite on nationalization. When the government owned undertakings are denationalized and disinvestment is made from public sector enterprises, it is called privatization. Hence, privatization is “the withdrawal of the state in varying degrees from, the economic activities of the nation”. The terminology ‘privatization’ is used in two senses-

Narrow sense- In narrow sense privatization refers to “private ownership of public enterprises.”

Broader sense- In broader sense privatization implies, “transferring the ownership of public sector to private sector or managing and controlling the public sector by private individuals without transferring the ownership.”

Definitions of Privatization

Some of the definitions of privatization given by popular authors are as follows-

According to Barbara Lee -

"Privatization is the general process of involving the private sector in the ownership or operation of state owned enterprise".

According to J N Goodrich-

"Privatization refers to any process that results in the transfer of functions, activities, assets or organization in whole or in part which is owned or controlled either directly or indirectly by the government to a non-government body".

According to Barbara Lee and John Nellis-

"Privatization may be understood as the process whereby activities or enterprises that were once performed or operated by the Government and its employees are now performed, managed or owned by private business and individuals."

"Privatization involves transfer of ownership, direction and effective control to the private sector. It also means the withdrawal of state from an industry or sector, partially or fully."

"Privatization is the general process of involving the private sector in the ownership or operation of a state owned enterprise. Thus, the term refers to private purchase of all or part of a company. It covers contracting out and the privatization of management through management contract, leases or franchise arrangements."

According to V K Ramandhan-

"There are fifteen senses by which this term privatization can be used as the literature ranging from 'transition to private legal form' to 'partial or complete denationalization' of assets".

Since the chapter focuses on 'Privatization in India', so specifically for India privatization refers to any of the following-

i. "Allowing private sector industries to enter into the areas which were once reserved exclusively for the public sector or which were once considered exclusive monopolies of the state."
ii. "Denationalization wherein state ownership of productive assets is transferred to the private sector. In this sense, privatization may be considered as the anti-thesis of nationalization."

iii. “Reducing the scope of the public sector or limiting any more diversification of the existing Public Sector Unit and activities, which were hitherto managed by departments of governments such as railways, post and telegraph to private sector or through Employee Stock Ownership Plan (ESOP). Employee Stock Ownership Plan (ESOP) can take place through different means such as

a. franchising wherein private players would own the enterprise while the public sector will own the brand name and technical know- how which it may provide to the former for a fee,

b. contacting out of government service,

c. leasing out physical facilities to private organizations, d. divesture through equity sale.”

From the above definitions it can be extracted that-

- Privatization is entry of private ownership in public enterprises.
- The takeover may be partial or complete.
- It involves takeover of managerial control of public enterprises by private people.
- Transfer of ownership may or may not be there but it definitely involves transfer of managerial control.
- It can be done through many modes as leases, management contracts, franchise agreements etc.
- It is known by several names as denationalization, disinvestment, asset sale program etc.

Thus, to conclude privatization is a process to transition of private sector into the domain of public sector firms.

Causes of Privatization

In the recent years, privatization is advocated at various levels and platforms. There are several reasons for adoption of privatization. These are explained as below-

11. **Lack of independence of public sector in decision making**- The Public sector enterprises are under bureaucratic control. Decision making is under political influence and pressure. Political leaders and ministers play a critical rule in various decisions. As a result the decision are often delayed and compromised.

12. **Dissatisfaction from socialist economic system-** Capitalist economies allowing private ownership have been seen to develop tremendously as compared to socialist economies. USSR and USA are leading example of same with USSR being a socialistic economy while USA a capitalist one. Taking responsibility of one's own work in terms of profits and losses is seen in capitalism which allows greater freedom, rights and privileges.
13. **Inefficiency of public sector**- In spite of the fact that public sector has full support of the government, it is seen that public sector runs into losses. The major reason is that no one takes ownership of the businesses. People get fixed remuneration irrespective of profits or losses. As a result, there were inefficiencies in public sector enterprises that led to privatization.
14. **Failing fiscal policy**- The government in India is usually in a fiscal deficit where revenue from taxes falls short to cater to public welfare and infrastructural developments in a country. Certain tools like deficit financing which pour new currency into the economy cannot be used often. Hence, to shoulder the responsibility of the government in development of the country private players were allowed.
15. **No ownership of losses**- Losses arising from the business are borne by the Government alone. Government gets heavily burdened with these losses. Government is usually seen in deficit due to nationalization. To avoid the same, the move of privatization was adopted and popularized.
16. **Demonstrative effect**- Other Asian economies like Japan, Korea, and Singapore that followed privatization were seen to develop faster relative to India. So following suit with these economies, the framework of privatization was adopted.
17. **Uneconomic price fixation**- Prices of public sector enterprises as electricity, railways, postage are fixed by the government for the masses. In consideration of its social goals which are backed by political interventions, the prices are kept quite less. The public enterprise is not even able to break even its cost and runs into losses. As a result it favors privatization.
18. **Financial Crisis in India**- In 1990-91 India was caught in debt-crisis. It had exhausted majority of its channels of financing. India was not left with much choice but to let private players enter the commercial market and takeover. Hence since 1991 the move of privatization picked momentum in the country.

19. **Low Industrial Growth-** Promotion of industries by equipping them with latest technologies and know-how is not possible for the government alone. Privatization brings in expertise and remunerates them sufficiently. As a result there is larger growth of industries and development of economy.
20. **Privatization brings globalization**- Foreign companies prefer to come in partnership with private firms due to freedom in working and claim on profits. As a result privatization enhances attraction of foreign firms to come in India and hence encourage globalization.
21. **Increasing Entrepreneurial skills**- With the passage of time, there is enhancement of entrepreneurial skills in the country. People wish to invest in new businesses in lure of profits even if they involve risk. Government projects move with a conservative approach which is not suitable for entrepreneurs. Hence privatization is encouraged in the country.

Objectives of Privatization

Privatization is a major decision for a country like India which has believed in socialism with high dependence on government oriented development. When in 1991 India revised its economic policies to adopt privatization it had specific objectives to achieve. These are discussed as follows-

19. **Increasing competition in the economy**- Public sector enterprises had developed monopolies in the country. As a result there was corruption, favoritism and inefficiencies erupting in the economy. In order to curb the monopolies of public sector it was required that public sector gets competition from other players in the market. Healthy competition leads to more growth. As a result privatization is advocated to put public sector enterprises under pressure to perform well in the market.
20. **Professional Management**- Private Companies are managed by professionals who have taken professional education like MBA. They are well versed with the principle and practices of management. So in order to take the benefit of professional management the government allowed privatization of public sector units.
21. **Efficient utilization of resources-** Privatization was encouraged so that the physical, financial and human resources are utilized in an effective manner. Physical resources are wasted in the economy in the public sector firms. Financial resources are embezzled and drained away by the

bureaucrats. Human resources waste their capabilities. High degree of disguised employment has been witnesses in public sector firms. Privatization was initiated with the object of well utilizing these resources of the economy.

22. **Attracting Foreign Capital-** A country like India usually has deficit balance of payment. It needs foreign capital and resources to correct it. Foreign players prefer to work with private players. Hence in order to attract foreign capital and inflows in the country, privatization was introduced.

23. **Breaking monopolies**- Public sector had full control over production and production units. They were enjoying their monopoly. There was no fear even if the organization was running into losses. So privatization was brought in as a strong competitor for the public sector firms to break their monopolies.

Measures of Privatization

There are three measures of privatization-

1. Ownership measures
2. Organizational measures
3. Operational measures

1. **Ownership measures**- Ownership measures are the measures through which either full or partial ownership of a public sector enterprise is given to the private sector. Shares are sold to private partners. The process is done with the help of consultants. These consultants help to find private partners who may be persons or institutions that are willing to buy the shares of a public sector firm. This method has four forms-

   I. **Transfer of Full Ownership**- In this public sector unit is sold to private sector unit through auction. The private sector acquires complete ownership of the public sector unit. This is also called total denationalization.

   II. **Transfer of Partial Ownership**- In this method some shares of public sector unit are sold to private sector. It results in partnership or joint venture between the two sectors. The proportion of ownership is decided as per government regulations. Partial ownership is transferred to private sector through two modes- Initial Public Offering and Strategic Sale.

Initial Public Offer is a method where shares of a public sector company are offered for sale to the public, employees and institutional investors. When shares are offered for the first time it is called Initial Public Offering (IPO). When subsequent issue is made it is called Follow-on Public Offering (FPO). This method is more popular in countries that have developed capital markets. Majority of the shareholding under this method rests with the government. **Strategic sale** is a method in which government sells the shares of a public sector unit to a strategic partner who is in the private sector. Here private sector buys managerial control from the government. This method is often used when loss making public sector units need strong managerial assistance and control and a share of such units is given to private hands.

III. **Liquidation**- This measure is adopted in case of sick units where partnership or joint venture shall not help to revive the loss making units. Here the assets of a public sector unit are sold to private sector unit though the process of bidding. Once purchased these assets can be utilized by the private sector for the same business or any other business.

IV. **Transfer of Ownership to Employees**- In this public sector units are sold to employees who then become the owners of the unit. The employees form a cooperative society, pool their resources, take loan form bank and purchase to Public Sector Enterprise.

2. **Organizational measures**- Those measures that bring change in the organizational structure of public sector units are called organizational measures. These measures result in reduction of government control of public sector units. Following are the types of organizational measures-

I. **Holding company**- In this form parent subsidiary relationship is established between the public and private sector unit. Public Sector Unit remains the holding company with majority of capital, that is, 51% while private sector holds 49% of the share capital. Thus directors are appointed from the public sector undertaking. Public sector unit hold major role in decision making also.

II. **Leasing-** Leasing refers to giving on rent. Hence here, the public sector unit is given on lease to the private sector for a longer period of time. The private sector manages the public sector unit though the ownership is vested with the government only.

III. **Financial restructuring-** This method is followed for sick public sector units. The losses of these units are taken over by the government and new capita is invested by the private sector to revive these units and improve their financial health.

3. **Operational measures-** As the name is suggesting here changes are made in the operating and working style of public sector enterprises. Public sector enterprises are made to work on the pattern of private sector enterprises. More freedom and autonomy is given in decision making but accountability of the employees is also increased. Capital is allowed to be raised from the capital market. All possible changes are made following the private sector units that can bring operational efficiency in business.

Advantages of Privatization

Privatization of business offers many advantages. These are discussed as follows-

1. **Support to the fiscal deficit of government-** When government alone is not able to recover its fiscal deficit privatization helps to shoulder the financial burden of the government by making investment in the public sector enterprises and contribute to the fiscal deficit.
2. **Optimum utilization of resources-** In public sector units resources belong to the society or the government and not the individuals. As a result, they are wasted and not used judiciously. When private sector takes over the public unit it ensures efficiency in utilization of resources because every rupee saved adds up to the profitability of private sector undertakings.
3. **Benefit of professional management-** When private sector units participate in the working of Public Sector Units professionalism is introduced. Technical and managerial expertise of professional who are holding professional degrees like MBAs is available. PSUs definitely benefit from such expertise.
4. **Healthy competition-** Privatization introduces fear in the minds of public sector units. They are forced to work well. Monopolies of public sector are broken. The stakeholders benefit from such competition in terms of choices of goods, quality of goods, prices etc.

5. **Increase in foreign exchange earnings-** Privatization attracts foreign capital in terms of Foreign Direct Investments. The market gets liberalized and globalization is promoted. Foreigners are lured to join hands with private partners.
6. **Novelty and innovation-** Private sector entrepreneurs add newness into the business. They deploy new technique and bring innovations. Expenditure on research and development is enhanced. New techniques of production are deployed.
7. **Reduced political interference-** Since the enterprises are partially or even fully owned by the private sector, government interference which includes interference from the political leaders is restricted. The work gets expedited.
8. **Increased efficiency-** With privatization efficiency of business increases as there are less wastage, more finances, use of advanced technology, no political interference, collaboration with foreign partners.
9. **Work culture-** Privatization brings a change in work culture. Employees become punctual and dedicated. They believe in achieving targets because non-achievers are penalized in privatization.
10. **Economic development-** The economy as a whole develops with privatization. Government gets more finances and capital formation for the economy. Ultimately all gains are added up to a country's Balance Sheet.

Disadvantages of Privatization

There are many arguments against the move of privatization. These are discussed as below-

1. **Lopsided regional development-** Private sector does not set up its units in the backward areas of the country. The utilities required by the private sector are not readily available in the small or remote areas of the country. Hence private sector installs its units in the developed regions only. As a result, the backward regions are not able to develop even in privatization.
2. **No focus on basic and heavy industries-** Basic and heavy industries of the country require huge capital investment. They also have long gestation periods. The pay- back period is also long. Privatization aims at profit generation and hence they avoid investment in these key industries of the country.

3. **Income inequalities**- The industrialists grow and earn bigger profits in privatized regime while the labor class remains weak and exploited. There is no minimum fixation of salaries or remuneration to people. Hence income inequalities are encouraged in privatization.
4. **Not preferred by employees**- Employees feel exploited in privatized sectors. There is no job security. There are no fixed structures of remuneration. Even the working hours are not fixed. There is culture of hire and fire. As a result, there is less job satisfaction in privatization.
5. **Limited finances**- Entrepreneurs in private sector have limited finances unlike the government. They cannot finance big social project involving larger populations.
6. **Profit orientation**- Privatization has a motive of earning profits. Social welfare and mass welfare are not in the domain of privatization.
7. **Social injustice**- There is class conflict and income inequality in privatization. Rich become richer at the expense of the poor.
8. **Reduced employment**- Privatization is capital intensive. It brings new and advanced techniques which require less number of people. Hence privatization brings a blow to the employment levels in the economy.

10.2. PRIVATIZATION AND NATIONALIZATION

The difference between Privatization and Nationalization is given in Table 1-

Table 1- Privatization and Nationalization

Factors	Privatization	Nationalization
Ownership	Firms owned by the private sector	Firms owned and managed by the government
Incentives	The profit motive acts as an incentive for owners and managers	Workers may feel motivated if they feel that the company belongs to them
Externalities	Private firms may ignore external costs(pollution) and external benefits	The government can put social benefits above the profit motive
Efficiency	Incentive to introduce new technology and increase labor productivity	Nationalized firms may find it hard to sack surplus workers
Knowledge	Private firms employ managers with the best skills	Politicians may interfere based on political motives
Natural monopolies	Private monopolies, e.g., water/trains, may charge high prices	The government can set prices based on social factors
Depends on industry	Worked well for BT and BA	Natural monopolies, like trains/water; non-profit services like health care

Source: *Economic Times*, 12 May 2017.

10.3. PRIVATIZATION IN INDIA

Evolution of Disinvestment Policy in India

The liberalization reforms undertaken in 1991 ushered in an increased demand for privatization/ disinvestment of PSUs.

- “In the initial phase, this was done through the sale of a minority stake in bundles through auction. This was followed by a separate sale for each company in the following years, a method popularly adopted till 1999-2000”.
- “India adopted strategic sale as a policy measure in 1999-2000 with the sale of a substantial portion of government shareholding in identified Central PSEs (CPSEs) up to 50% or more, along with transfer of management control. This was started with the sale of 74 % of the Government’s equity in Modern Food Industries Limited (MFIL)”.
- “Thereafter, 12 PSUs (including four subsidiaries of PSUs), and 17 hotels of Indian Tourism Development Corporation (ITDC) were sold to private investors along with transfer of management control by the Government”.
- “Another major shift in disinvestment policy was made in 2004-05 when it was decided that the government may “dilute its equity and raise resources to meet the social needs of the people”, a distinct departure from strategic sales”.
- “Department of Investment and Public Asset Management (DIPAM) has laid down comprehensive guidelines on “Capital Restructuring of CPSEs” in May 2016 by addressing various aspects, such as payment of dividends, buyback of shares, issues of bonus shares and splitting of shares”.

The Government has been following an active policy on disinvestment in CPSEs through the various modes:

- “Disinvestment through minority stake sale in listed CPSEs to achieve minimum public share holding norms of 25%. While pursuing disinvestment of CPSEs, the Government will retain majority share holding, i.e., at least 51% and management control of the Public Sector Undertakings”.

- “Listing of CPSEs to facilitate people’s ownership and improve the efficiency of companies through accountability to their stakeholders”.
- “Strategic Disinvestment”.
- “Buy-back of shares by large PSUs having a huge surplus”.
- “Merger and acquisitions among PSUs in the same sector”.
- “Launch of exchange-traded funds (ETFs) – an equity instrument that tracks a particular index”.
- “The CPSE ETF is made up of equity investments in India’s major public sector companies like ONGC, REC, Coal India, Container Corp, Oil India, Power Finance, GAIL, BEL, EIL, Indian Oil and NTPC”.
- “Monetization of selected assets of CPSEs to improve their balance sheet/reduce their debts and to meet part of their capital expenditure requirements”.

“NITI Aayog has been mandated to identify PSUs for strategic disinvestment. For this purpose, NITI Aayog has classified PSUs into “high priority” and “low priority”, based on:

- National Security
- Sovereign functions at arm’s length, and
- Market Imperfections, and
- Public Purpose.

“The PSUs falling under “low priority” are covered for strategic disinvestment. To facilitate quick decision making, powers to decide the following have been delegated to an Alternative Mechanism in all the cases of Strategic Disinvestment of CPSEs where Cabinet Committee on Economic Affairs (CCEA) has given ‘in principle’ approval for strategic disinvestment:

- The quantum of shares to be transacted, mode of sale and final pricing of the transaction or lay down the principles/ guidelines for such pricing; and the selection of strategic partner/ buyer; terms and conditions of sale; and

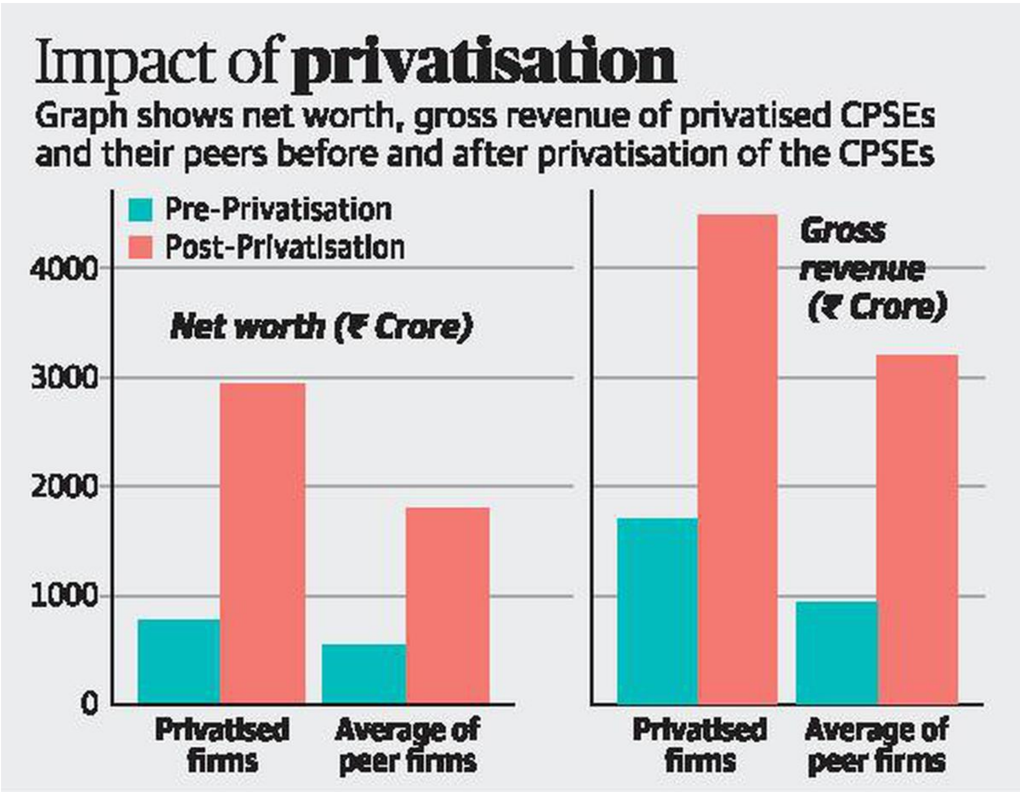
- To decide on the proposals of Core Group of Disinvestment (CGD) with regard to the timing, price, terms & conditions of sale, and any other related issue to the transaction".

In November 2019, "the government announced that full management control will be ceded to buyers of Bharat Petroleum Corporation Ltd. (BPCL), Shipping Corporation of India (SCI) and Container Corporation of India Ltd (CONCOR). In Jan 2020, strategic disinvestment was approved for Minerals & Metals Trading Corporation Limited (MMTC), National Mineral Development Corporation (NMDC), MECON and Bharat Heavy Electricals Ltd. (BHEL)"

(Source- April 8, 2020 Economic Survey)

10.4. IMPACT OF PRIVATIZATION

The impact of privatization has been good on the financial performance in terms of Net worth and Gross revenues of privatized Central Public Sector Enterprises as shown in the following figure-



SOURCE: SURVEY CALCULATIONS BASED ON DATA FROM CMIE PROWESS

(Economic Survey 2020; The Hindu January 31, 2020)

10.5. CHECK YOUR PROGRESS

Choose the correct option-

1. Privatization involves-
   a) Transfer of ownership to private sector
   b) Transfer of managerial control to private sector
   c) Can be both A and B
   d) Neither A nor B
2. Which of the following is a cause of privatization-
   a) Strict government in the country
   b) Boring government in the country
   c) Fashionable population
   d) Inefficiency of Public Sector
3. Measure of privatization preferred for sick units is-
   a) Liquidation
   b) Strategic Sale
   c) Transfer of ownership to employees
   d) Partial transfer of ownership to public
4. Operation measures focus on-
   a) Purchase of machinery as in private sector
   b) Copying working and operating style of private sector
   c) Entering into joint ventures with foreign partners
   d) Having a holding subsidiary relationship
5. As per NITI Aayog which PSUs are covered for strategic disinvestment-
   a) High priority PSUs

b) Medium priority PSUs

c) Low priority PSUs

d) All of the above

10.6. SUMMARY

The new economic reforms of 1991 recommended contraction of public sector and expansion of private sector making policy of privatization as the main feature of new economic reforms. Privatization means opening the gates of public sector to private sector. In other words it is transferring the public sector enterprises to private sector. It is opposite to nationalization. In broader sense privatization implies, “transferring the ownership of public sector to private sector or managing and controlling the public sector by private individuals without transferring the ownership.” There are several reasons for adoption of privatization. There is lack of independence of public sector in decision making and dissatisfaction from socialist economic system. In spite of the fact that public sector has full support of the government, it is seen that public sector runs into losses. The government in India is usually in a fiscal deficit where revenue from taxes falls short to cater to public welfare and infrastructural developments in a country. Government is usually seen in deficit due to nationalization. To avoid the same, the move of privatization was adopted and popularized. Other Asian economies that followed privatization were seen to develop faster relative to India. Prices of public sector enterprises are kept quite less. The public enterprise is not even able to break even its cost and runs into losses. In 1990-91 India was caught in debt-crisis. India was not left with much choice but to let private players enter the commercial market and takeover. Hence since 1991 the move of privatization picked momentum in the country. Foreign companies prefer to come in partnership with private firms. Promotion of industries by equipping them with latest technologies and know-how is not possible for the government alone.

There are three measures of privatization- Ownership Measures, Organizational Measures and Operational Measures. Ownership measures are the measures through which either full or partial ownership of a public sector enterprise is given to the private sector. Those measures that bring change in the organizational structure of public sector units are called organizational measures. In operation measures changes are made in the operating and working style of public sector enterprises. Public sector enterprises are made to work on the pattern of private sector enterprises.

Privatization of business offers many advantages as support to the fiscal deficit of government, optimum utilization of resources and benefit of professional management. Privatization introduces fear in the minds of public sector units. Monopolies of public sector are broken. Privatization attracts foreign capital in terms of foreign direct investments. Private sector entrepreneurs add newness into the business. They deploy new technique and bring innovations. Government interference which includes interference from the political leaders is restricted. With privatization efficiency of business increases as there are less wastage, more finances, use of advanced technology, no political interference, collaboration with foreign partners.

There are many arguments against the move of privatization. The backward regions are not able to develop even in privatization. Privatization aims at profit generation and hence they avoid investment in these key industries of the country. Income inequalities are encouraged in privatization. Employees feel exploited in privatized sectors. Social welfare and mass welfare are not in the domain of privatization. There is class conflict and income inequality in privatization. Privatization brings a blow to the employment levels in the economy.

The liberalization reforms undertaken in 1991 ushered in an increased demand for privatization/ disinvestment of PSUs. The impact of privatization has been good on the financial performance in terms of Net worth and Gross revenues of privatized Central Public Sector Enterprises.

10.7. KEY WORDS

1. **Privatization**- Privatization implies, "transferring the ownership of public sector to private sector or managing and controlling the public sector by private individuals without transferring the ownership."
2. **Ownership Measures**- Ownership measures are the measures through which either full or partial ownership of a public sector enterprise is given to the private sector.
3. **Strategic Sale**- Strategic sale is a method in which government sells the shares of a public sector unit to a strategic partner who is in the private sector. Here private sector buys managerial control from the government. This method is often used when loss making public sector units

4. **Liquidation-** This measure is adopted in case of sick units where partnership or joint venture shall not help to revive the loss making units. Here the assets of a public sector unit are sold to private sector unit though the process of bidding
5. **Organizational measures-** Those measures that bring change in the organizational structure of public sector units are called organizational measures.
6. **Leasing-** Leasing refers to giving on rent. Hence here, the public sector unit is given on lease to the private sector for a longer period of time. The private sector manages the public sector unit though the ownership is vested with the government only.
7. **Operational measures-** Measures in which changes are made in the operating and working style of public sector enterprises. Public sector enterprises are made to work on the pattern of private sector enterprises.
8. **Nationalization-** Nationalization is the process of transforming privately-owned assets into public assets by bringing them under the public ownership of a national government or state.

10.8. SELF ASSESSMENT TEST

1. Define Privatization. Give its measures.
2. Explain the objectives of undertaking privatization.
3. What are the reasons of popularity of the phenomenon of privatization?
4. What are the advantages and disadvantages of privatization?
5. Write a note on privatization in India.
6. Write notes on-
   a) Impact of privatization on the performance of PSUs
   b) Privatization VS Nationalization
   c) Transfer of Full Ownership VS Transfer of Partial Ownership

10.9. ANSWERS TO CHECK YOUR PROGRESS

1. Can be both A and B

2. Inefficiency of Public Sector
3. Liquidation
4. Copying working and operating style of private sector
5. Low priority PSUs

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Course: Business Environment	Author: Dr. Aparna Bhatia
Course Code: BCOM 206	Vetter: Prof. Pardeep Kumar Gupta
LESSON: 11	
Public Sector Enterprises	

STRUCTURE:

11.0. LEARNING OBJECTIVES

After going through this lesson you should be able to know

- the concept and meaning of Public Sector Enterprises and its form of organizations
- the rationale and objectives behind the formation of Public Sector Enterprises
- analyzing performance of Public Sector Enterprises, the causes for poor performance and suggesting remedies to improve the performance.

- The concept of micro small and medium enterprises
- significance, growth, problems and remedial to MSMEs

11.1. MEANING OF PUBLIC SECTOR ENTERPRISES

Public Sector Enterprises are also known as state enterprises and Government enterprises. The main objective of Public Sector Enterprises was to expedite the economic development of the country. According to Bureau of Public Enterprises,

“Public enterprises are born as the outcome of the conscious policy of the government to speed up industrialization of the country with a view to give added impetus to economic growth as well as to achieve certain socio-economic goals as enunciated in the industrial policy resolutions of the Government, these enterprises today cover a wide spectrum of activities in basic and strategic industries like steel, coal, minerals and metals, petroleum, heavy engineering, chemicals, fertilizers and pharmaceuticals etc on the one hand and consumer services, tourist services, financial services, development of small industries etc on the other. While some of the enterprises operate under monopoly/near monopoly conditions, there are others working under competitive conditions. There is yet another segment of public enterprises viz sick enterprises taken over from private sector to protect employment. Thus public enterprises comprise of units engaged in different spheres of industrial and commercial activities, some capital intensive long gestation low profitability enterprises, some sick and hence requiring special treatment while some others are low risk high profitability enterprises. Added to this basic diversity in the composition of the units are the multi-dimensional objectives of Public enterprises in general which is another significant factor to be considered while making any realistic analysis of their performances.”

In brief, Public Sector Enterprise is “an industrial, commercial or other economic activity owned and managed by the Central or State Government or jointly by the both”.

Definitions of Public Sector Enterprises

A comprehensive definition of Public Sector Enterprise given by **International Centre for Public Enterprises (ICPE) Yogoslavia-**

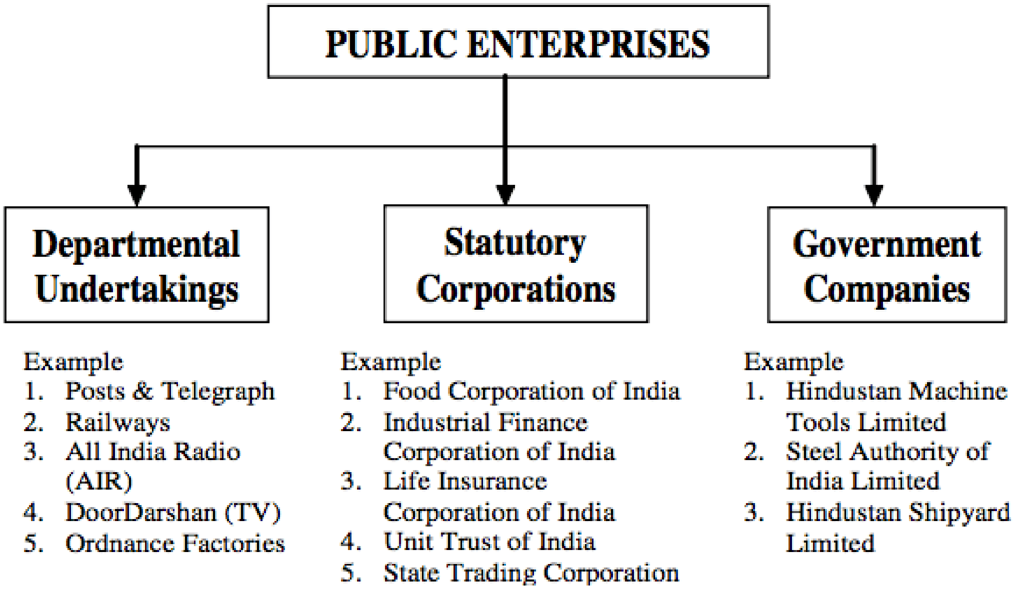
“A Public Enterprise is an organization which is-

- Owned by public authorities including Central, State or local authorities to the extent of 50% or more.
- Is under the top managerial control of the owning public authorities. Such public control including inter-alia, the right to appoint top management and to formulate critical policy decisions.
- Is established for the achievement of a definite set of public purpose, which may be multi-dimensional in nature.
- And is consequently placed under a system of public accountability.
- Is engaged in activities of a business character.
- Involves the basic idea of investment and returns
- That makes the outputs in the shape of goods and services".

Thus, an organization owned by the government is called a public sector enterprise. In India, there are 365 public sector undertakings. Some of these PSUs come under the control of some of the ministers of the Parliament, like the Railways. The people working in these organizations are government employees. PSUs benefit all citizens of India.

Forms of Organization of Public Sector Enterprises

Public Sector Enterprise can be classified into three forms of organization-



These are explained as follows-

1. **Departmental Undertaking-** Departmental Undertaking form of organization is primarily used for provision of essential services such as railways, postal services, broadcasting etc. Department undertakings function under the overall control of a ministry of the Government. These are financed and controlled in the same way as any other government department. These undertakings are under Central or State Government. The rules of Central/State Government are applicable on these organizations.This form is considered suitable for activities where the government desires to have control over them in view of the public interest. These primarily include essential services such as railways, postal services, broadcasting etc.

   Features of departmental undertakings:-

   - They operate under the overall control of one of the ministries of central or state government.
   - They are a part of government only; hence they are not a separate entity.
   - The revenue of departmental undertakings is deposited in the treasury of government.
   - They are financed from the annual budgets of the government.

2. **Statutory Corporation**- Statutory Corporation is a corporate body created by the special Act of Parliament or State Legislature which define its powers, functions and management. Statutory Corporation is also known as Public Corporation. Its capital is wholly financed by the government. Examples of such organizations are Life Insurance Corporation of India, State Trading Corporation etc.

   Features of a public corporation: -

   - It is created by an act of parliament or central or state legislature.
   - The powers, objectives & limitations of a public corporation are defined in the Act only.
   - Operations of public corporations takes place under total control of central or state government
   - a public corporation is a separate legal entity. It gets incorporated automatically when the Act is passed in the parliament.

3. **Government Company**- Government Company refers to a company in which 51 percent or more of the paid up capital is held by the government. It is registered under Companies Act, 2013 and is fully governed by the provisions of the Act. Most business units owned and managed by government fall in this category.

Features of Government Company: -

- The government company gets incorporated under the Companies Act.
- All the provisions of Companies Act are applicable to a government company.
- The government company is wholly or partly owned by the government.
- The government is managed by the board of directors, who are nominated by the government & other shareholders.
- The government has the authority to appoint majority of the directors.

The difference between three forms of organization of Public Sector Enterprises is shown as follows-

Basis of comparison	Departmental organization	Public corporation	Government company
Formation	By order of the ministry	By a Special Act of Parliament or State Legislature	By registration under the Companies Act.
Legal status Ownership	No separate legal entity Wholly owned with Government	Separate legal entity Wholly owned with Government	Separate legal entity At least 51% of the share capital owned by the Govt.
Management	Managed by Government officials	Board of Directors	Board of Directors
Staff	Civil servant - Govt. service	Not Government servants – Contract of service	Not Government servants – Contract of service
Autonomy	No autonomy	Sufficient autonomy	Some autonomy from Government High
Public Accountability Flexibility Financing	Highest No flexibility Funds appropriated from budget	Higher Considerable Provided wholly by Govt.	Moderate Separate financing

(Source- Indian Economy, 2020)

Rationale and Objectives Of Public Sector Enterprises

The rationale behind formation of Public Sector Enterprises was to achieve some specific objectives. These are explained as follows-

1. **Socialistic Society**- A socialistic pattern of society offers some advantages to the society in terms of income equalities, dissemination of economic power, generation of employment, upliftment of the weaker section of the society etc. These are not the objectives of a private sector enterprise that has prime motive of profit earnings.
2. **Developing public utilities**- Public utilities as roads, railways, sanitation, electricity postage etc. that cater to the needs of mass public are provided by the government at reasonable and affordable prices. These services also help in the development of key sectors of economy like agriculture and industries.
3. **Support to key and basic industries -** Key and basic industries include iron and steel, electrical, machinery, chemical, fertilizers etc. These industries are the infrastructural backbone of a developing nation. These industries require huge capital. These industries also provide basic raw material for other industries to grow in the economy. Hence, government support is required for these industries. The development of these industries would lead to the progress of whole economy rather than few individuals as in private sector.
4. **Capital formation**- Sectors like Railways, energy etc require massive capital. The profits that are generated from these sectors are ploughed back in these sectors only that results in capital formation in the country. With respect to private sector the profits are taken away by few individuals and may not be deployed back.
5. **Removing regional disparities**- Government aims at holistic development of the country. It tries to open industries even in remote and backward areas so that there is growth in those areas. Private sector would never open ventures in such regions that lack ancillary services. The concentration of private sector firms remains in the already developed areas and hence the under developed regions remain in the same state under privatization.
6. **Development of small scale industry**- The government ensures that small businessman that have relatively less capital also finds space to grow. Government grants several concessions and subsidies for the growth of industries in the small scale sector. For instance certain industries as khadi industry do not get focus under the privatized regime.
7. **Growth of Private sector enterprises**- When industries are opened in the public sector, the

private sector also grows. First, private sector firms acquire requisite technology and instrumentation from the public sector enterprises. Also public sector firms usually are formed with huge capital invested by the government. They require ancillary industries for their support. This can be catered to by the private sector. Hence there is growth in the private sector as well.

8. **Development of industries with long gestation periods**- There are industries that take long time to start as the mining industry, oil exploration industry, irrigation projects. As a result these industries take longer time to pay back. Private entrepreneurs usually have less interest in such industries. So, the government invests and develops these sectors of the economy.
9. **Development of defence related industries-** Defence related industries deal with the manufacturing of arms and ammunition, atomic energy, nuclear energy. Such matters concerning national security cannot be given in the hands of few individuals and hence fall in the scope of public sector enterprises only.
10. **Providing social goods**- There are certain goods which are required by every unit of society. All units of population do not have same affordability. Hence the responsibility of providing basic amenities of life like water, sanitation, power, electricity, roads, transportation facilities etc are to be provided by the public sector enterprises operating under government control and supervision.

Growth of Public Sector Enterprises

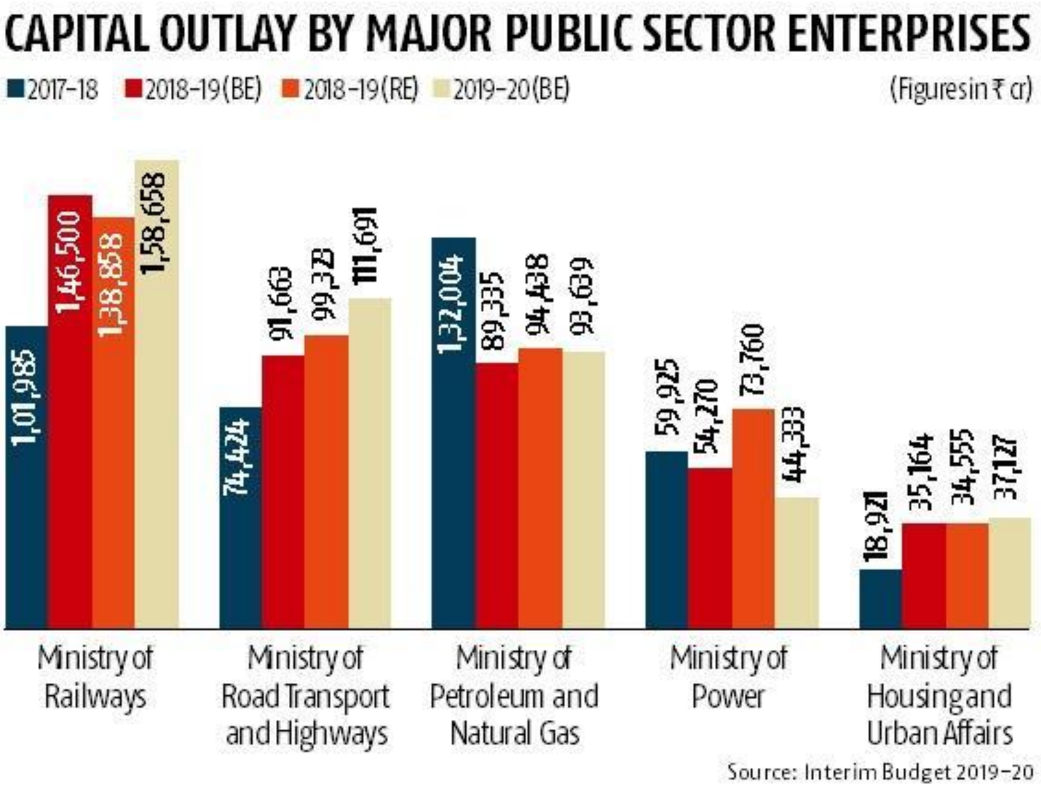
Some available statistics are given as follows to gauge the growth of Public Sector Enterprises in India. The capital invested by Central Public Sector Enterprises has been growing tremendously over decades. The data available from 1951 till 2012 as shown in the following Table 1 shows the same as follows-

Table 1- Growth of Central Public Sector Enterprises

As at End of March	No. of Total Units	Cumulative Investment (₹ Crore)
1951	5	29
1961	47	950
1980	179	18,150
1990	244*	99,330
2000	240*	252,745
2001	242*	274,114
2005	237	357,849
2007	244	421,089
2008	242	4,55,409
2010	217	5,79,920
2012	200**	—

(Source- https://www.economicsdiscussion.net/)

Similarly, the Government has the responsibility of providing public utilities and hence focuses on the development of key and basic industries of the country. The following figure shows the contribution of Public Sector Enterprises in the basic industries of the country over recent years as follows-



(Source- Business Standard)

The financial perforamnce of Public Sector enterprises over different five year plans can also be seen from Table 2. Table 2 presents the data till 10th five year plan. Now the Planning commission in India has replaced five year plans with NITI Aayog. The figures are presented as follows in Table 2-

Table 2- Indicators of Financial Performance of Central Public Sector Enterprises

₹ *Crores*

	No. of Operating Enterprises	*Capital Employed*	*Gross Profit before Interest & Tax*	*Net Profit before Tax*	*Net Profit after Tax*	*Rate of return* Gross Profit to Capital Employed (%) $6 = \frac{3}{2} \times 100$	Net Profit After Tax to Capital Employed (%) $7 = \frac{5}{2} \times 100$
	1	**2**	**3**	**4**	**5**	**6**	**7**
SIXTH PLAN							
1980-81	168	18.207	1,418	19	–203	7.8	–1.1
1981-82	188	21,935	2,654	1,025	446	12.1	+2.0
1982-83	193	26.590	3,469	1,547	618	13.1	+2.3
1983-84	201	29,856	3,564	1,480	240	11.9	+0.8
1984-85	207	36,382	4,628	2,099	909	12.7	+2.5
SEVENTH PLAN							
1985-86	211	42,965	5,287	2,173	1,172	12.3	+2.8
1986-87	214	51,835	6,521	3,101	1,771	12.6	+3.4
1987-88	220	55,617	6,940	3,353	2,030	12.5	+3.6
1988-89	226	67,629	8,572	4,404	2,993	12.7	+4.4
1989-90	233	84,760	10,622	5,293	3,789	12.5	+4.5
1990-91	236	1,01,702	11,359	3,820	2,368	11.2	+2.3
1991-92	237	1,17,991	13,675	4,003	2,355	11.6	+2.0
EIGHTH PLAN							
1992-93	239	1,40,110	15,957	5,076	3,271	11.4	+2.3
1993-94	240	1.59,836	18,555	6,654	4,544	11.6	+2.8
1994-95	241	1,62,451	22,630	9,768	7,187	13.9	+4.4
1995-96	239	1,73,948	27,587	13,621	9,574	15.9	+5.5
1996-97	236	2,31,178	30,915	15,378	10,188	13.4	+.44
NINTH PLAN							
1997-98	236	2,49,855	37,206	19,216	13,582	14.9	5.4
1998-99	235	2,65,093	39,727	19,702	13,203	15.0	5.0
1999-00	232	3,02,947	42,270	22,037	14,331	13.9	4.7
2000-01	234	3,31,372	48,767	24,967	15,653	14.7	4.7
2001-02	231	3,89,934	63,190	38,233	25,978	16.2	6.7
TENTH PLAN							
2002-03	226	4,17,160	72,539	48,616	31,119	17.4	7.5
2003-04	230	4,52,336	95,039	71,144	49,010	21.0	10.8
2004-05	227	5,04,407	1,08,420	85,550	63,889	21.5	12.7
2005-06	226	5,85,484	1,14,422	90,714	66,344	19.5	11.3
2006-07	217	6,61,338	1,39,008	1,11,527	77,175	21.0	11.7
2007-08	214	7,24,009	1,52,579	1,20,453	79,704	21.1	11.0
2008-09	213	7,92,232	1,42,395	1,03,095	69,267	18.0	8.7
2009-10	217	9,08,842	1,59,846	1,24,126	84,119	17.6	8.7

(Source- https://www.economicsdiscussion.net)

Some key indicators of performance of Public Sector Enterprises for the recent data available are presented in comparative form in the following Table 3 as follows-

Table 3- Key indicators of financial perforamnce of Public Sector Enterprises

Sl.No.	Particulars	2009-10 (in ₹ crore)	2008-09	% Change over previous year
1.	Investment (long-term loan + equity)	579,920	513,532	12.93
2.	Capital employed (net fixed assets + working capital)	910,120	793,240	14.73
3.	Total turnover	1,235,060	1,271,529	–2.87
4.	Profit of Profit Making CPSEs	108,435	98,488	10.10
5.	Loss of Loss Making CPSEs	15,842	14,621	8.35
6.	Net worth	660,245	665,686	–0.82
7.	Dividend declared	33,223	25,501	30.28
8.	Corporate tax	119,529	131,583	–9.16
9.	Interest paid	35,720	39,300	–9.11
10.	Contribution to Central Exchequer	139,828	151,529	–7.72
11.	Foreign Exchange Earnings	77,745	74,206	4.77
12.	Foreign Exchange Outgo	420,415	433,332	–2.98

(Source- https://www.economicsdiscussion.net)

Reasons for Poor Performance Of Public Sector Enterprises

Public sector enterprises run on government finances which have multiple and huge sources of collection. Still it is seen that the performance of public sector often lags behind than the expectation and requirement. There are various reasons for the same. These are discussed as follows-

1. **Disguised Employment**- Public sector enterprises witness the problem of disguised employment. This refers to a "situation where labor that is employed in a job is not actually utilized for the production of goods and services. In other words, such employment does not contribute to the output of an economy and is thus akin to a form of unemployment". Hence productivity is constant but costs associate increase because of large number of people in employment.
2. **Excess capacity**- Public sector enterprises tend to open many ventures even in the rural, remote and backward areas. Huge investment is made in such ventures. But these enterprises are seen to be running at less capacity. The excess capacity increases the cost per unit of production. There

is under utilization of machinery and infrastructure because of which the cost becomes uncompetitive and the public sector units are not able to compete and sustain in the long run,

3. **Political interference**- Public sector enterprises are primarily government owned. Hence there is lot of interference from politician and bureaucrats. Such interference leads to inefficiencies and delays. There is lack of autonomy in operations. Decisions become unfair which in the long run hamper efficiency of public sector enterprises.
4. **Lack of Power**- Public sector enterprises usually deal in heavy and capital intensive projects. This requires constant supply of electricity and power. Many states in India have power cuts and power shortages. Consequently the production suffers leading to inefficiencies in the system.
5. **Poor locations of project**- In order to ensure regional balanced development public sector enterprises many a times tend to start businesses in location which are inappropriate for commercial set ups. There is lack of means of production and ancillary services in such locations. The transportation cost of bringing those resources is very high. As a result either the production stops or the finished product tends to be very costly. Hence public sector enterprises in either case incur losses.
6. **Lack of inspection**- There is no proper monitoring or inspection of public sector units. They are usually controlled by government officials, politicians and bureaucrats. If there is corruption at these levels, the ventures fail and become cost ineffective.
7. **Monopoly of public sector-** Due to varied reasons there are certain sectors as defence, railways, electricity, postage which are reserved for the public sector only. Hence public sector has monopoly over these sectors. There is no competition from anywhere. Consumer does not have any choice but to depend upon the public sector for these goods and services. As a result public sector does not endeavor to bring many improvements in these sectors and continue to enjoy their monopolies in these sectors.
8. **Overcapitalization-** Usually Government invests heavily in public sector enterprises. Since it is the government's money that is being deployed, so in spite of the tenders received due to certain political interferences or lack of interest equipment and machinery is purchased at exorbitant

prices. The return from this investment falls short in the long run due to overcapitalization. Consequently, public sector firms incur losses.

9. **No personal stake**- In the public sector enterprises it is the money of the government that is put at stake. No individual is responsible for the losses and the risk. As a result there is no personal interest in achieving targets and efficiencies.
10. **Lack of professional management**- In the contemporary times people who take professional education are more interested in joining private sector organization due to lucrative packages offered by the private sector. Since professionals do not prefer to join the public sector so public sector is not able to avail the benefit of professional management.

Suggestions to Improve Public Sector Enterprises

There are few suggestions to improve the performance of Public Sector Enterprises. These are discussed as follows-

1. The interference of Government in day to day working of Public Sector Enterprises should be reduced. Holding companies should be formed for Public Sector Enterprises and the management should be left to them.
2. The political interference in appointments of personnel, approval of tenders, hiring policies etc should be minimized so that a rule based system prevails in the Public Sector Enterprises rather than the relation based system.
3. Remuneration and pay packages should be set at par with the firms in the private sector so that young people with professional outlook and qualifications prefer to join public sector jobs.
4. There should be a proper balance between autonomy and accountability. Memorandum of Understandings (MOUs) should be signed between the Government and Public Sector Enterprises to define these roles clearly.
5. Certain enterprises which are running into losses since years and have become sick units should either be closed or handed over to the private sector to reduce aggregate losses.
6. Continuous Government Audits should be encouraged to gauge the activities of Public Sector Enterprises.

7. Establishment of Public Sector Enterprises should be encouraged in sectors where these are desired and where the private sector does not invest. Investment should not be wasted in consumer durable products by the public sector.
8. More policies and reforms should be brought to up lift the micro small and medium scale industries falling in the preview of Public Sector Enterprises.

11.2. MICRO SMALL AND MEDIUM ENTERPRISES-INTRODUCTION

"The Micro, Small and Medium Enterprises (MSME) sector has emerged as a highly vibrant and dynamic sector of the Indian economy over the last five decades. It contributes significantly in the economic and social development of the country by fostering entrepreneurship and generating large employment opportunities at comparatively lower capital cost, next only to agriculture. MSMEs are complementary to large industries as ancillary units and this sector contributes significantly in the inclusive industrial development of the country. The MSMEs are widening their domain across sectors of the economy, producing diverse range of products and services to meet demands of domestic as well as global markets". (msme.gov.in)

"Ministry of Micro, Small & Medium Enterprises (M/o MSME) envisions a progressive MSME sector by promoting growth and development of the Sector, including Khadi, Village and Coir Industries, in cooperation with concerned Ministries/Departments, State Governments and other Stakeholders, through providing support to existing enterprises, adopting cutting edge technologies and encouraging creation of new enterprises". (msme.gov.in)

"A number of statutory and non-statutory bodies work under the aegis of the Ministry of MSME. These include the Khadi and Village Industries Commission (KVIC) and the Coir Board besides National Small Industries Corporation (NSIC), National Institute for Micro, Small and Medium Enterprises (NIMSME) and Mahatma Gandhi Institute for Rural Industrialisation (MGIRI)". (msme.gov.in)

"The Ministry of MSME runs various schemes aimed at financial assistance, technology assistance and upgradation, infrastructure development, skill development and training, enhancing competitiveness and market assistance of MSMEs". (msme.gov.in)

11.3. MICRO SMALL AND MEDIUM ENTERPRISES- MEANING AND DEFINITION

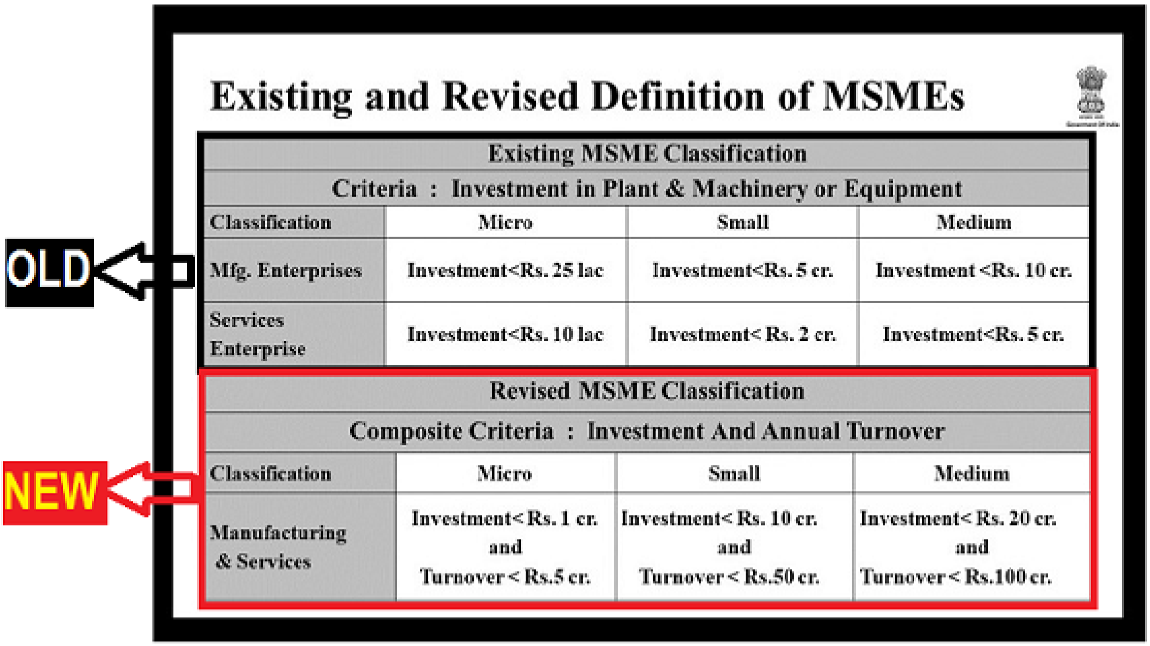
In accordance with the provision of Micro, Small & Medium Enterprises Development (MSMED) Act, 2006 the Micro, Small and Medium Enterprises (MSME) are classified as below:

(i) "a micro enterprise, where the investment in plant and machinery or equipment does not exceed one crore rupees and turnover does not exceed five crore rupees;

(ii) a small enterprise, where the investment in plant and machinery or equipment does not exceed ten crore rupees and turnover does not exceed fifty crore rupees; and

(iii) a medium enterprise, where the investment in plant and machinery or equipment does not exceed fifty crore rupees and turnover does not exceed two hundred and fifty crore rupees".

"The new classification has come into effect from 1st July, 2020. The earlier criteria of classification of MSMEs under MSMED Act, 2006 were based on investment in plant and machinery / equipment. It was different for manufacturing and service units. It was also very low in terms of financial limits. Since then, the economy has undergone significant changes. A revision in MSME criteria of classification was announced under Aatma Nirbhar Bharat package on 13th May, 2020. This has been done in order to be realistic with time and to establish an objective system of classification and to provide ease of doing business. The old and new definition of MSMEs is clear from the following-



Existing and Revised Definition of MSMEs

Existing MSME Classification			
Criteria : Investment in Plant & Machinery or Equipment			
Classification	Micro	Small	Medium
Mfg. Enterprises	Investment<Rs. 25 lac	Investment<Rs. 5 cr.	Investment <Rs. 10 cr.
Services Enterprise	Investment<Rs. 10 lac	Investment< Rs. 2 cr.	Investment<Rs. 5 cr.

Revised MSME Classification			
Composite Criteria : Investment And Annual Turnover			
Classification	Micro	Small	Medium
Manufacturing & Services	Investment< Rs. 1 cr. and Turnover < Rs.5 cr.	Investment< Rs. 10 cr. and Turnover < Rs.50 cr.	Investment< Rs. 20 cr. and Turnover < Rs.100 cr.

(Source- Business Standard)

Now, there will be no difference between manufacturing and service sectors. Also, a new criterion of turnover has been added in the previous criterion of classification based only on investment in plant and machinery. The new criteria are expected to bring about many benefits that will aid MSMEs to grow in size. It has also been decided that the turnover with respect to exports will not be counted in the limits of turnover for any category of MSME units whether micro, small or medium. This is yet another step towards ease of doing business. This will help in attracting investments and creating more jobs in the MSME sector. The change in criteria of classifying the MSMEs is set to offer major relief to the exporters.

The primary responsibility of promotion and development of MSME is of the State Governments. However, the Government of India, supplements efforts of the State Governments through various initiatives. The role of the Ministry of MSME and its organisations is to assist the States in their efforts to encourage entrepreneurship, employment and livelihood opportunities and enhance the competitiveness of MSMEs in the changed economic scenario". (MSMEs Annual Report 2020-21)

Significance of Micro, Small & Medium Enterprises (MSMES)

The micro, small & medium enterprises (MSMEs) have been contributing significantly to-

1. The expansion of entrepreneurial endeavors through business innovations. it is seen from the total number of MSMEs in rural and urban areas as given in Table 4-

Table 4- Estimated number of MSMES (Activity Wise)

Activity Category	Estimated Number of Enterprises (in lakh)			Share (%)
	Rural	Urban	Total	
(1)	(2)	(3)	(4)	(5)
Manufacturing	114.14	82.50	**196.65**	**31**
Electricity*	0.03	0.01	**0.03**	**0**
Trade	108.71	121.64	**230.35**	**36**
Other Services	102.00	104.85	**206.85**	**33**
All	**324.88**	**309.00**	**633.88**	**100**

**Non-captive electricity generation and transmission*

(Source- Annual Report MSMEs 2020-21; NSS Round 2015-16)

2. There is overall development of business in the country. The percentage share of various states depicts the same. Below table 5 shows the comparative distribution of MSMEs in the top 10 States in percentage.

Table 5- Distribution of MSMEs across states

Sl. No.	State/UT	NSS 73rd round*		Fourth All India Census of MSME and Fifth Economic Census**	
		Number (in lakh)	Share (%)	Number (in lakh)	Share (%)
1	Uttar Pradesh	89.99	14	44.03	12
2	West Bengal	88.67	14	34.64	10
3	Tamil Nadu	49.48	8	33.13	9
4	Maharashtra	47.78	8	30.63	8
5	Karnataka	38.34	6	20.19	6
6	Bihar	34.46	5	14.70	4
7	Andhra Pradesh***	33.87	5	25.96	7
8	Gujarat	33.16	5	21.78	6
9	Rajasthan	26.87	4	16.64	5
10	Madhya Pradesh	26.74	4	19.33	5
11	**Total of above ten States**	**469.4**	**74**	**261.04**	**72**
12	**Other State/UTs**	164.5	26	100.72	28
13	**All**	**633.9**	**100**	**361.76**	**100**

**NSS 73rd Round, 2015-16, ** Fourth All India Census of MSME, 2006-07 (Unregistered sector) and Fifth Economic Census, ***Including Telagana in Fourth All India Census of MSME*

3. The MSMEs in India are playing a crucial role by providing large employment opportunities at comparatively lower capital cost than large industries as well as through industrialization of rural & backward areas, inter alia, reducing regional imbalances. As per the National Sample Survey (NSS) 73rd round conducted during the period 2015-16, MSME sector has been creating 11.10 crore jobs (360.41 lakh in Manufacturing, 0.07 lakh in Non-captive Electricity Generation and Transmission, 387.18 lakh in Trade and 362.82 lakh in Other Services) in the rural and the urban areas across the country. Table 6 shows the distribution of MSMEs activity wise.

Table 6- Estimated employment in MSMEs

Broad Activity Category	Employment (in lakh)			Share (%)
	Rural	Urban	Total	
(1)	(2)	(3)	(4)	(5)
Manufacturing	186.56	173.86	360.41	32
Electricity*	0.06	0.02	0.07	0
Trade	160.64	226.54	387.18	35
Other Services	150.53	211.69	362.22	33
All	**497.78**	**612.10**	**1109.89**	**100**

**Non-captive electricity generation and transmission*

Micro sector with 630.52 lakh estimated enterprises provided employment to 1076.19 lakh persons that in turn accounts for around 97% of total employment in the sector. Small sector with 3.31 lakh and Medium sector with 0.05 lakh estimated MSMEs provided employment to 31.95 lakh (2.88%) and 1.75 lakh (0.16%)persons of total employment in MSME sector, respectively. the following table 7 shows the distribution of employment sector wise in Rural and Urban Areas.

Table 7- Distribution of employment sector wise in Rural and Urban Areas

(Numbers in lakh)

Sector	Micro	Small	Medium	Total	Share (%)
Rural	489.30	7.88	0.60	**497.78**	**45**
Urban	586.88	24.06	1.16	**612.10**	**55**
All	1076.19	31.95	1.75	**1109.89**	**100**

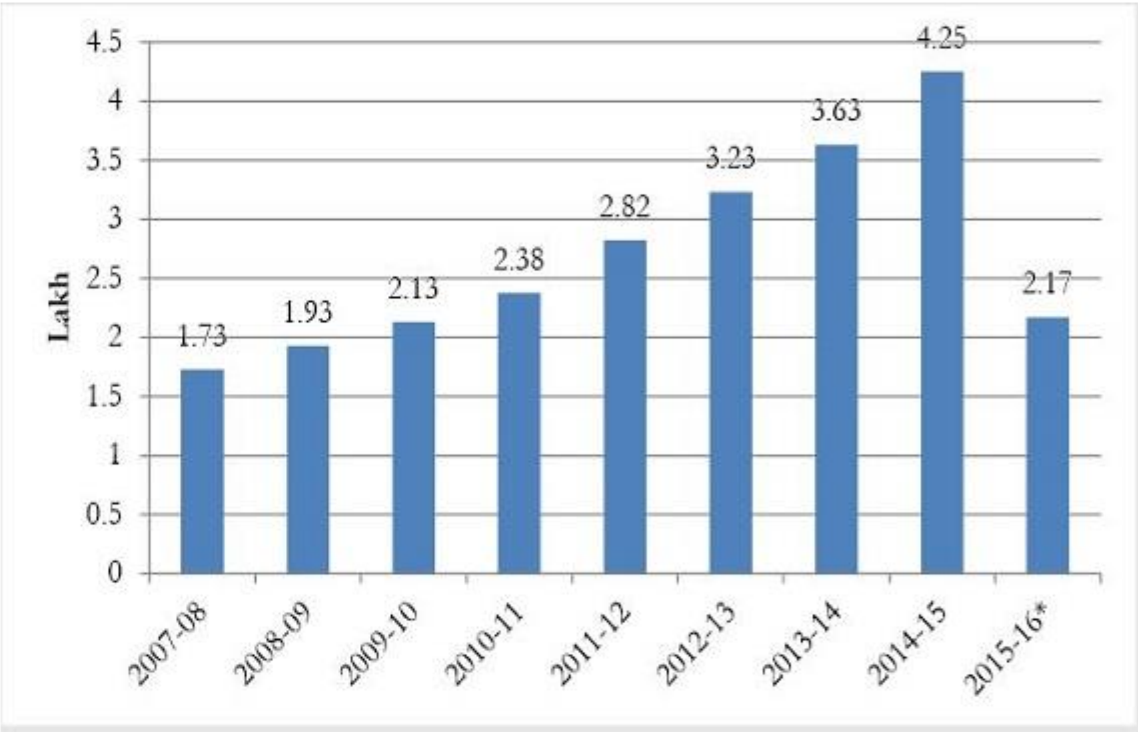
4. The MSMEs are widening their domain across sectors of the economy, producing diverse range of products and services to meet demands of domestic as well as global markets.
5. Assuring more equitable distribution of national income and wealth.

Growth of Micro, Small & Medium Enterprises (MSMEs)

MSME's in India contribute nearly 8% of the country's GDP, approximately 45 % of manufacturing output, and 40% of exports. It would not be incorrect to call them the "backbone of the country". In accordance with the Micro, Small, And Medium Enterprises Development Act of 2006, the Government of India established MSMEs. These businesses are primarily involved in the production, manufacturing, processing, or storage of goods as well as commodities.

The growth of MSMEs can be gauged as follows from Figure 1-

Figure 1-Growth of MSMEs.



The investment and employment growth generated by MSMEs can be gauged from the following Table 8-

Table 8- Investment and Employment Trend of MSMEs

S.No	Year	Number of total MSMEs (in lakhs)	Fixed Investment (Rs.Crores)	Employment (Lakh Persons)	Average investment	Average Employment
1	2000-01	101.1	27279	238.73	2.70	2.36
2	2001-02	105.21	154389	249.32	1467.44	2.37
3	2002-03	109.49	162317	260.21	1482.48	2.38
4	2003-04	113.95	170219	271.42	1493.80	2.38
5	2004-05	118.59	178699	282.57	1506.86	2.38
6	2005-06	123.42	188113	294.91	1524.17	2.39
7	2006-07	261.01	500758	805.23	1918.54	3.09
8	2007-08	272.79	558190	626.34	2046.23	2.30
9	2008-09	285.16	621753	659.35	2180.37	2.31
10	2009-10	298.1	693835	695.38	2327.52	2.33
11	2010-11	428.73	1105934	965.15	2579.56	2.25
12	2011-12	447.64	1182757	1011.69	2642.21	2.26
13	2012-13	467.54	1268763	1061.4	2713.70	2.27
14	2013-14	488.46	1363700	1142.29	2791.84	2.34
15	2014-15#	510.57	1471912	1171.32	2882.88	2.29
MEAN		275.45	641440.79	649.02		

- Projected Source: MSMEs Annual Report 2015-2016

Hence, Micro Small and Medium Enterprises are the backbone of a developing nation like India.

Problems and Remedies of Micro, Small & Medium Enterprises (MSMEs)

The following are a few primary challenges facing MSMEs that affect their growth prospects**.**

1. **Financial Issues-** The owners of MSMEs in India are often less educated and come from rural areas. They are less familiar with the availability of financial privileges available in the country. Hence they face financial difficulties and sometimes take bad financial decisions. Furthermore, MSME firms in India have less creditworthiness due to non- availability of collaterals to offer against loans. As a remedy many banks have introduced easy finance and credit schemes to help MSMEs avail capital without any hassles.

2. **Lack of Professional Skills-** The owners of MSMEs belong to rural areas with less educational backgrounds. They do not have professional skills of management, control and administration. As a result there are managerial and administrative difficulties. Some technology companies have launched tailor-made products, services and solutions for MSMEs. There is "Assistance to Training

Institutions Scheme", which provides financial assistance to national level training institutions operating under the Ministry of MSME. Besides, the corporate sector is doing their bit to give a push to the MSME sector.

3. **Unskilled labor**- The labor available with MSMEs is also not much skilled. They are primarily informal workers who lack technical skills. They are also under paid. It impacts the quality and growth prospects of MSMEs. The ministry conducts a large number of short term as well as long term courses in order to trained the youth to encourage self- employment and provide necessary skill to the youth to make them eligible for wage employment and also upgrade the skill level of existing workers and entrepreneurs of MSMEs sector.
4. **Dearth of Technology**- MSMEs work with basic tools and equipments. They do not have much access to the latest techniques and innovations.
5. **Marketing Challenges**- MSMEs do not have knowledge of boosting their sales. They are not familiar with the techniques of marketing their produce. MSMEs should seek help from Non-Government Organizations and the Governmental marketing agencies.

11.4. CHECK YOUR PROGRESS

Choose the correct option-

1. In a Government Company, the stake of government is atleast-
   a) 51%
   b) 50%
   c) 49%
   d) 75%
2. Public Corporation are framed by-
   a) RBI
   b) SEBI
   c) Special Act of Parliament
   d) The Prime Minister
3. In India stake of private sector is not allowed in-

   a) Defence
   b) Railways
   c) Electricity
   d) All of the above

4. The basis for classification into micro, small and medium enterprises is-
   a) Investment in real estate
   b) Investment in shares
   c) Investment in plant and machinery
   d) All of the above

5. An enterprise to be classified as a Small enterprise -
   a) Must have investment in plant and machinery or equipment upto ten crore rupees and turnover upto fifty crore rupees
   b) Must have investment in plant and machinery or equipment upto one crore rupees and turnover upto five crore rupees
   c) Must have investment in plant and machinery or equipment upto twenty crore rupees and turnover upto fifty crore rupees
   d) Must have investment in plant and machinery or equipment upto fifty crore rupees and turnover upto ten crore rupees

11.5. SUMMARY

Public sector enterprises are also known as state enterprises and government enterprises**.** Public Sector Enterprise is “an industrial, commercial or other economic activity owned and managed by the Central or State Government or jointly by the both”. The main objective of public sector enterprises was to expedite the economic development of the country. Public Sector Enterprise can be classified into three forms of organization-Department Undertaking form of organization is primarily used for provision of essential services such as railways, postal services, broadcasting etc. Department undertakings function under the overall control of a ministry of the government. Statutory Corporation is a corporate body created by the special act of parliament or state legislature which define its powers, functions and management. Statutory Corporation is also known as Public Corporation. Its capital is wholly financed by the government. Government Company refers to a company in which 51 percent or more of the paid up capital is held by the government. It is registered under Companies Act, 2013 and is fully governed by the provisions of the act.

The rationale behind formation of public sector enterprises was to achieve some specific objectives as a socialistic society, developing public utilities, providing support to key and basic industries, capital formation, removing regional disparities, development of small scale industry, growth of private sector enterprises, development of industries with long gestation periods as the mining industry, oil exploration industry, irrigation projects etc., development of defence related industries, providing social goods which are required by every unit of society. All units of population do not have same affordability. Hence the responsibility of providing basic amenities of life likes water, sanitation, power, electricity, roads, and transportation facilities is with the public sector enterprises. It is seen that the performance of public sector often lags behind than the expectation and requirement. Public sector enterprises witness the problem of disguised employment. There is excess capacity that increases the cost per unit of production. There is lot of interference from politician and bureaucrats. Many states in India have power cuts and power shortages. Consequently the production suffers leading to inefficiencies in the system. The location of projects is poor. There is no proper monitoring or inspection of public sector units. There are monopolies of public sector in defence, railways, electricity, postage etc. Usually Government invests heavily in public sector enterprises. The return from this investment falls short in the long run due to overcapitalization. No individual is responsible for the losses and the risk. Professionals do not prefer to join the public sector so public sector is not able to avail the benefit of professional management.

11.6. KEY WORDS

1. **Public Sector Enterprise-** Public Sector Enterprise is “an industrial, commercial or other economic activity owned and managed by the Central or State Government or jointly by the both”.

2. **Departmental Undertaking**- Departmental Undertaking form of organization is primarily used for provision of essential services such as railways, postal services, broadcasting etc. Department undertakings function under the overall control of a Ministry of the Government
3. **Statutory Corporation-** Statutory Corporation is a corporate body created by the special Act of Parliament or State Legislature which define its powers, functions and management.
4. **Government Company**- Government Company refers to a company in which 51 percent or more of the paid up capital is held by the government. It is registered under Companies Act, 2013 and is fully governed by the provisions of the Act.
5. **Micro enterprise**- A micro enterprise is, where the investment in plant and machinery or equipment does not exceed one crore rupees and turnover does not exceed five crore rupees;
6. **Small Enterprise**- A small enterprise is, where the investment in plant and machinery or equipment does not exceed ten crore rupees and turnover does not exceed fifty crore rupees; and
7. **Medium enterprise-** A medium enterprise is, where the investment in plant and machinery or equipment does not exceed fifty crore rupees and turnover does not exceed two hundred and fifty crore rupees.

11.7. SELF ASSESSMENT TEST

1. Define Public Sector Enterprises. Give their forms of organization.
2. Explain the features of Departmental undertakings, Statutory Corporations and Government Companies. Also distinguish between the three forms of organization.
3. What are the objectives of Public Sector Enterprises? Are they able to achieve these?
4. What is the growth in Public Sector Enterprises? What are the reasons for poor growth? What are the remedies for the same?
5. How has the definition of MSMEs undergone a change? Explain the significance and growth of MSMEs.
6. Write notes on-

   a) Problems of MSMEs

b) Remedies to the problem of MSMEs

11.8. ANSWERS TO CHECK YOUR PROGRESS

1. 51%
2. Special Act of Parliament
3. All of the above
4. Investment in Plant and Machinery
5. Must have investment in plant and machinery or equipment upto ten crore rupees and turnover up to fifty crore rupees

11.9. REFERENCES/SUGGESTED READINGS

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Course: Business Environment	Author: Dr. Aparna Bhatia
Course Code: BCOM 206	Vetter: Prof. Pardeep Kumar Gupta
LESSON: 12 Social Responsibilities of Business and Social Audits	

STRUCTURE:

12.0. LEARNING OBJECTIVES

After going through this lesson you should be able to know

- the concept of social responsibility and the models of social responsibility
- reasons for undertaking social responsibility and arguments against social responsibility of business

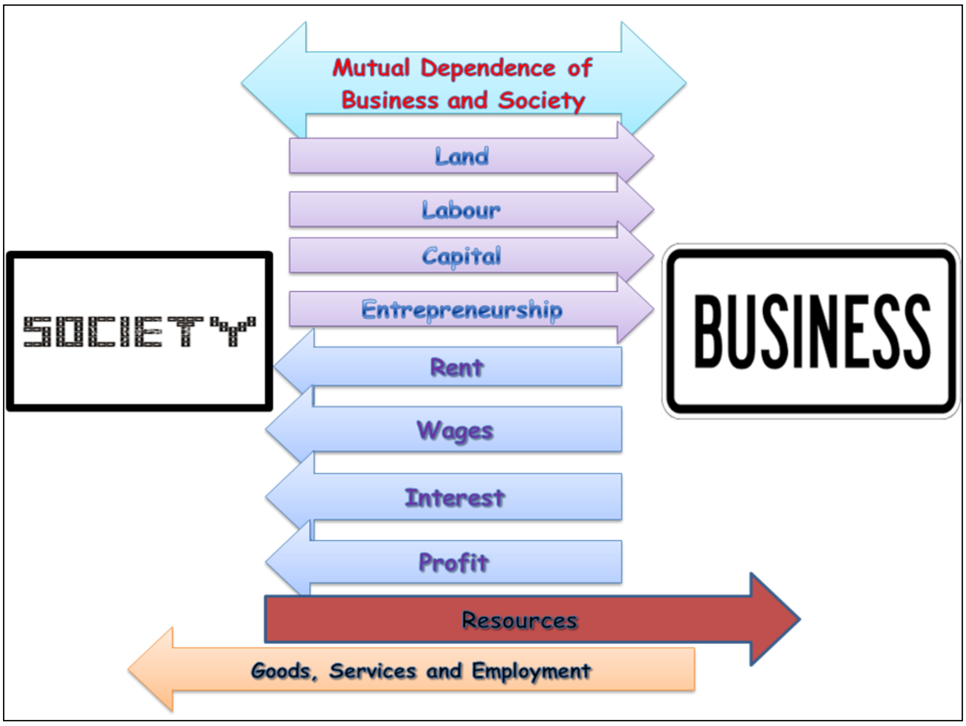
- scenario of social responsibility of business in India with special reference to Companies Act 2013.
- Concept of social audit and its types
- Social audit undertaken by Indian companies

12.1. INTRODUCTION TO SOCIAL RESPONSIBILITY OF BUSINESS

Economic performance, social performance and corporate governance are the three pillars of sustainable growth and hence economy of any country. The goal of sustainable development is to "meet the needs of the present without compromising the ability of future generations to meet their own needs" (Global Reporting Initiative, 2006, G3). The effectiveness of an organization nowadays depends on its ability to develop itself into a social organization. This is because corporate responsibility and accountability are developing as the building blocks for any organization.

Social responsibility (CSR) is a concept whereby organizations not only consider their profitability and growth, but also the interest of society and the environment by taking responsibility for the impact of their activities on stakeholders, employees, shareholders, customers, suppliers and civil society represented by NGOs. The mutual dependence of business and society is established since times immemorial. The same can be explained with the help of following figure 1-

Figure 1- Mutual dependence of business and society



Thus, society gives resources and means of production to the business in terms of land, labor, capital and organization while business gives goods and services and employment to the society and adequate compensation to the means of production.

Carroll (1991) organized different corporate social responsibilities as a four-layered model and called it the pyramid of responsibilities. The four different responsibilities - economical, legal, ethical and philanthropic are the layers of the pyramid. Economic responsibilities are the ones which a business "must do" and require that the business should be profitable. It should be able to utilize the resources of the society in the most optimum manner. Legal responsibilities are the ones that the business "has to do" and require that business should obey the law. Ethical responsibilities are the ones that a business "should do". These are not required but expected by the society. These go beyond the minimum legal requirements. Philanthropic responsibilities are at the top of the pyramid. These are the ones that the business "might do" for the society. Philanthropy is discretionary in nature. Society expects business to be a good corporate citizen and improve the quality of life for the society. It should practice social responsibilities voluntarily for the support of the community, eradication of hunger and poverty, education of the masses etc. The Carroll's Approach of CSR is presented in Figure 2 as follows:

Figure 2: Carroll's four responsibilities of Business

Source: Based on A. B. Carroll, "A Three Dimensional Conceptual Model of Corporate Performance," Academy of Management Review (October 1979), pp. 497–505; A. B. Carroll, "Managing Ethically with Global Stakeholders: A Present and Future Challenge," Academy of Management Executive (May 2004), pp. 114–120; and A. B. Carroll, "The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders," Business Horizons (July–August 1991), pp. 39–4

Definitions

Some of the definitions of Social Responsibility given by popular authors are as follows-

Definitions of Social Responsibility of Business

According to Business for Social Responsibility,

CSR is defined as "achieving commercial success in a way that honor ethical values and respect people, communities and natural environment."

According to McWilliams and Seigal-

Social responsibility of business refers to, "actions that appear to further some social good, beyond the interest of the firm and that which is not required by law."

According to N R Murthy-

Social responsibility of business is "ensuring that the company can grow on a sustainable basis, while ensuring fairness to all stakeholders".

According to European Commission-

Social responsibility of business is "A concept whereby companies decide voluntarily to contribute to a better society and a cleaner environment."

According to Prince of Wales Business Leader Forum-

Social responsibility of business refer to, “Open and transparent business practices that are based on ethical values and respect for employees, communities and the environment. It is designed to deliver sustainable value to society at large, as well as to shareholders”.

According to World Business Council for Sustainable Development-

Social responsibility of business “is the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well of the local community and society at large.”

In brief, Social responsibility of business is about business giving back to society. In fact, CSR is doing the right thing even when no one is looking. Thus, it can be said that, CSR is a comprehensive set of policies, practices and programs that are integrated into business operations, supply chains and decision making process throughout the company and usually include issues related to business ethics, community investment**,** environmental concerns, governance, human rights, the market place as well as the work place.

To conclude business interacts with its environment. It can neither escape it nor ignore it.

Why Social Responsibility of Business

1. Business is a part of society. It takes its raw material and supplies from society.
2. Business gets the means of production, that is, land, labor, capital and entrepreneurship from society.
3. It improves reputation and goodwill of the business.
4. It earns customer loyalty and employee satisfaction.
5. There are no allegations from the media and the Non-Governmental Organizations.
6. Enterprises are perceived as good corporate citizens.
7. It gets easy to get credit from the banks and financial institutions.
8. The credit ratings of an organization improve with participation in social responsibility of business.
9. Companies earn good name even in the international market.
10. It becomes easy for companies for raise new capital from the market.

11. In India, it is mandatory to undertake social responsibility of business.

Why Not Social Responsibility of Business

1. It is costly.
2. The resources get drained away in non-core activities of business.
3. The money used in conduct of social responsibilities of business actually belongs to shareholders and investors.
4. The benefits received from conduct of social responsibility are intangible.
5. The pay back of expenditure on social responsibility is very slow and gradual.
6. Social responsibility is first the responsibility of the government and not the corporate.
7. Business already pays corporate tax to the government. Government has to make public expenditure out of the tax collected from the society.

Models of Social Responsibility Of Business

The following are the models of social responsibility of business-

1. **The Trusteeship Model**- Trusteeship model is given by Mahatma Gandhi he believed that, "the wealth one creates has to be ploughed back to the society. CSR may be defined as achieving commercial success in ways that honour ethical values and respect people, communities and the natural environment". It is the responsibility of the rich to use their wealth for the benefit of the under-privileged. It is in the enlightened interest of businesses to strengthen the societies they operate in. The Gandhian model of Trusteeship provides a "means of transforming the present unequal order of society into an equal one. Along with the principle that surplus wealth needs to be kept in trust for the common good and welfare of others, it also specifies that everything we do must be economically viable as well as ethical – at the same time making sure we build sustainable livelihoods for all".
2. **Shareholder's Model:** The shareholder's Model was proposed by Milton Friedman (1970) and is amongst the most traditional theories of CSR. The model advocates that "the business of a business is to do business only". There is one and only one social responsibility on business-to use its resources and engage in activities designed to increase its profits so long as it stays within

the rules of the game, which is to say, engage in open and free competition without deception or fraud'. The business has a sole purpose of maximizing the profits of shareholders while obeying the law and ethical customs of the society. Managers are the hired agents of shareholders and hence it is their duty to work in the interest of their principal only. Shareholder theory negates the interest of other stakeholders and thus becomes very narrow in giving the concept of CSR. The theory even leads to manipulation of accounts in order to window dress the financial statements in the eyes of the shareholders; as long as it remains within the legal and ethical limits.

3. **Stakeholder's Model:** The Stakeholder's Model was given by Edward Freeman (1984). The model states that business owes responsibility to a wider group of people rather than just the shareholders. A stakeholder is "a person/ group who can affect or be affected by the actions of a business". Stakeholders may include employees, customers, suppliers, creditors, community and competitors. Thus CSR activities should extend towards all these groups who contribute either directly or indirectly towards the success of the business. The purpose of CSR is to serve broads societal interests rather than just focusing on the value creation of shareholders. Stakeholders are typically analyzed into primary and secondary stakeholders. Primary stakeholder refers to a group as "one without whose continuing participation the corporation cannot survive as a going concern" – with the primary group including "shareholders and investors, employees, customers and suppliers, together with what is defined as the public stakeholder group: the governments and communities that provide infrastructures and markets, whose laws and regulations must be obeyed, and to whom taxes and obligations may be due". The secondary groups are defined as "those who influence or affect, or are influenced or affected by the corporation, but they are not engaged in transactions with the corporation and are not essential for its survival". Thus, the view based on stakeholder theory, holds that companies have a social responsibility that requires them to consider the interests of all parties affected by their actions. Stakeholder's theory answers the question "to whom" is the business responsible. Mitchell Agle and Wood (1997) developed the model of stakeholder identification. A stakeholder possessing one or more of the three attributes, namely, power, legitimacy and urgency shall be covered in the domain of social

responsibility. The stakeholder theory is also criticized on the ground that it fails to focus on profitability which is the first and foremost objective of a business organization.

4. **Legitimacy Model:** ‘‘Legitimacy Model suggests the existence of an implicit social contract in which business is accountable to society’s expectations or demands Legitimacy is defined as ‘a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs and definitions’. Society grants legitimacy and power to business. In the long run, those who do not use power in a manner which society considers responsible will tend to lose it’. The concept of legitimacy is a condition that prevails when there is congruence between the organization’s activities and society’s expectations. Legitimacy is derived from ‘Social Contract Theory’ (Locke, 1620) that describes society as ‘a series of social contracts between members of society and society itself’. In the context of CSR, an alternative possibility is not that business might act in a responsible manner because it is in its commercial interest, but because it is part of how society implicitly expects business to operate. The company tends to project favorable image towards the society knowing that it is utilizing its resources to benefit the society as a whole, not only its stockholders. Otherwise, there is likelihood that organization will bear political costs, inflicted on it on account of its actions.

5. **Institutional Model**: The Model states that business practices are contextualized by the country’s institutional framework in which they function. It provides theoretical framework for understanding the influence of institutions on social responsibility engagement of firms. Political, cultural, social and economic conditions prevailing in particular institutional environment determine the extent of adoption of social responsibilities by country’s organizations. The institutional environment comprise of institutions such as social norms, values, culture, regulations and incentives within specific country context and assumes that actors exhibit appropriate behavior considering cultural framework, rules and norms. They stimulate orderly behavior that leads to stable society. For instance, institutional factors that engage organizations to engage in socially responsible behavior includes state regulations, peer pressure, media attention, industrial self-regulation, pressure from NGOs and institutional investors. The companies operating in particular institutional environment are subject to

regulative, normative and cognitive forces that shape the development of CSR. The regulative forces refer to organization engagement into social responsibility as a result of enforcement of rules and regulations. However, degree of compliance by companies depends upon the efficiency of the legal system and regulatory framework. The organizations are bound to confirm to these social values set out by multitude of social actors' such as NGOs, media, institutional investors, educational and other professional institutions to legitimate their business practices. These social actors exercise pressure on firms to adopt certain structures and practices that deemed to be socially responsible. These forces bring standardization in social responsibility practices amongst companies operating in different industries and across national boundaries. Therefore, these institutional processes plays influential role in affecting adoption of CSR practices.

6. **Model of Enlightened Self interest**: The model focuses on the benefits that a firm derives from fulfillment of social responsibility activities. These benefits may be through enlarged market share, better employee retention, creating shareholder value, improving public image, reputation and brand name. From the strategic perspective model sees the underlying strategic intent of a business in doing society related activities. Business is an economic entity. It would be reluctant to undertake any activity that is not viable commercially. Social activities generate economic benefits in the long run and hence must be undertaken. For instance: Project Shakti of HUL endeavors to empower women in the rural areas by granting them identity and self-sustenance. But HUL through this project not only improves its CSR profile but also manages to penetrate the rural marketplace. Thus, the theory believes that the social role of the business must contribute to the continuing health and growth of the business.

12.2. SOCIAL RESPONSIBILITY OF BUSINESS IN INDIA

Social Responsibility is a part of Indian cultural heritage since times immemorial. 'Dasvand' which means donating one tenth part of one's harvest is a time old tradition followed in India. Even in the corporate world, economic performance along with social performance is considered as the two strong pillars of sustainable corporate growth. The effectiveness of an organization nowadays depends on its ability to develop itself into a social organization. Corporate Social Responsibility (CSR) has always been personal and voluntary in nature.

But the sanctity of the concept of social responsibility has been questioned many a times in the past specifically in Indian corporate sector. The world's worst industrial disaster- The Bhopal Gas Tragedy that took place in December, 1984 still has an unfinished story. Due to utter negligence of Union Carbide India Ltd. a lethal gas, methyl isocyanate leaked from the pesticide manufacturing plant killing over 500,000 people in Bhopal. Those who died were fortunate than those who survived this fatal disaster. There have been many such industrial disasters prior to this, as Bombay Dock Explosion, 1944 and many even after, as Jaipur Oil Depot fire, 2009; Korba Chimney Collapse, 2009; Mayapuri Radiological Incident, 2010.

But for these evident damages by these identified companies there are other damages that are being caused by industrial pollution. India's white marvel, The Taj Mahal, is turning brownish yellow due to deposition of carbon released from industries (Time of India, 2 January, 2015). Ganges, the sacred river of India is loaded with deposition of heavy metals from industries. Thus, companies are damaging the consumers, the human resource, the environment, the society and even our heritage.

Corporate Social Responsibility and Companies Act, 2013

Companies Act 2013 has changed the provisions of CSR in India and made performance of social responsibility mandatory for the India corporate sector since 1st April, 2014. As per Companies Act, 2013, companies with

net worth of Rs. 500 crore or more,

turnover of Rs 1,000 crore or more or

net profit of Rs 5 crore or more during any financial year

have to compulsorily spend at least 2% of average net profits (net profits before tax calculated as per section 198 of the Indian Companies Act, 1956 but exclude the profits from businesses outside India) of preceding three financial years in CSR activities. Though the threshold limit of net worth and turnover has been kept high, but the threshold limit of profits will bring majority of Indian Companies under the CSR net.

The qualifying company has to form a CSR committee of board members consisting of 3 or more directors out of which one should be an independent director. It will formulate a CSR policy, recommend the amount of expenditure to be incurred on CSR activities and monitor the CSR policy from time to time. The companies are to spend the CSR amount on the development of local areas and around where it operates. The amount to be spent on the CSR activities will not be used exclusively for the benefits of employees and their family members.

Further, the CSR policy is to be disclosed by the qualifying company in the Director's report and on its website. Baselines surveys, social impact assessment and meticulous evaluation including documentation are mandatory along with training and re orientation of the staff. The CSR amount unused in a particular year will be carried forward to the following year. CSR budget itself hence is non lapsable. With regard to failure to spend the requisite amount, the Act states that the company shall have to provide sufficient reasons for not spending the allocated CSR budget.

Section 21 of the Companies (Amendment) Act, 2019 requires companies to transfer unspent CSR funds into a special account named 'Unspent CSR Account' within 30 days from the end of the financial year and the amount has to be utilised within 3 financial years from the date of transfer. The unutilised funds within the stipulated time period will then have to be transferred to a fund specified under Schedule VII of the CA, 2013.

The amendments in the Act also criminalises the contravention to spend on CSR by including a penal liability of up to Rs. 25 lakh and imprisonment of the defaulting officer for up to 3 years, for non-compliance with the funds related provisions.

Mandatory disclosure items as per the revised provisions of schedule VII of Companies Act 2013

Sr. No.	Mandatory disclosure items as per the revised provisions of schedule VII of companies act 2013
1	Eradicating hunger, poverty and malnutrition; promoting preventive health care
2	Improved sanitation facilities and safe drinking water.
3	Promoting education.

4	Enhancing vocational skills among children, women, elderly and differently able; increasing employment and livelihood enhancement projects.
5	Empowering women; promoting gender equality; setting up homes and hostels for women and orphans.
6	Old age homes; day care centers; facilities for senior citizens.
7	Measures for reducing inequalities faced by socially and economically backward groups.
8	Ensuring environmental sustainability and ecological balance; conservation of natural resources; maintaining quality of soil, air and water.
9	Protection of flora and fauna; animal welfare; agro forestry.
10	Protection of national heritage, arts and culture, including', restoring building and sites of historical importance and works of art, promotion and development of traditional art and handicrafts, setting up of public libraries
11	Welfare of armed forces including veterans, war widows and other dependents
12	Training to promote rural, nationally recognized sports, paralympics or olympic sports
13	Contribution to the prime minister's national relief fund or any other fund set up by the central government for socio-economic development and relief and welfare of the scheduled caste&, the scheduled tribes, other backward classes, minorities and women;
14	contributions to technology incubators located within academic institutions approved by central government
15	Rural development projects and social business projects
16	Covid relief
17	Others

Thus, from the trusteeship model to the shareholder’s, stakeholder’s approach, social responsibility is backed by institutional model in the country where Ministry of Corporate Affairs (MOCA) has mandated the provisions of social responsibility.

12.3. SOCIAL AUDIT

Social Audit is a tool for evaluating, verifying and reporting the performance of a firm in the sphere of social responsibility. It is a "formal review of a company's endeavors, procedures, and code of conduct regarding social responsibility and the company's impact on society". It is an "assessment of how well the company is achieving its goals or benchmarks for social responsibility". It is a "way of measuring, understanding, reporting and ultimately improving an organization's social and ethical performance. A social audit helps to narrow gaps between vision/goal and reality, between efficiency and effectiveness. It is a technique to understand, measure, verify, report on and to improve the social performance of the organization". It is a "systematic and comprehensive evaluation of an organization's social performance which is interpreted as organizational efforts in enriching the general welfare of the whole community and the whole society". In brief it is an essential assessment of how well a company has discharged its social obligations.

Features of Social Audit-

1. It is audit of social responsibilities performed by a business.
2. It is a formal process.
3. It may include any parameter of social responsibility as environment, customer, labor relations etc.
4. It is usually an internal evaluation but may also be conducted externally.
5. It can evaluate only an organization's input in the sphere of social responsibility but not the output.
6. It uses both quantitative and qualitative data.
7. It is a tedious process especially when the review is non quantitative.

Types of Social Audit

There are different types of social audit. These are explained as follows-

1. **Social Process Audit-** It tries to measure the "effectiveness of those activities of the organization which are largely taken up to meet certain social objectives. Corporate executives in this case try to examine what they are doing and how they are doing". The method involves the following steps:

2. **Financial Statements Format Social Audit**- Here it is seen if financial statements show traditional financial information plus information regarding social activities like the balance sheet should show a list of social assets on one side and social liabilities and equity on other side. The income statement should reveal social benefits, social costs and the net social income provided by the company operations to the staff community, general public and clients.

Income statement

	Particulars	
1	Social Benefits	
a	Products and services provided	XXXXX
b	Payment to other elements of the society	XXXXX
i	Employment provided	________
ii	Taxes paid	________
iii	Dividend and interest paid	________
iv	Contribution (S-V); lower cost	________
v	Services to employees	________
vi	Improvement in environment	________
vii	Staff services donated to others	________

viii	Equipment and facility services donated	_________
ix	Other benefits	_________
x	TOTAL SOCIAL BENEFITS	XXXXXXXX
1	Social costs	_________
A	Human services used not paid	_________
B	Raw material purchased	_________
i	Building and equipment purchased	_________
C	Payments to other elements of society	_________
i	Additional capital investment	_________
ii	Loans	_________
D	Environmental damage	_________
i	Air/water/ noise/visual/soil pollution	_________
E	Public services used	_________
F	Work related injuries	_________
G	others	_________
	TOTAL SOCIAL COSTS	XXXXXXXX

Balance Sheet

1	Liabilities	_________
A	Organisational equity	_________
B	Social equity	_________
	TOTAL	_________
2	Assets	XXXXXXXX
A	Land	_________
B	Residential and other buildings	_________
C	Roads and bridges	_________
D	Electrification	_________

E	**Water supply and sewerage**	_________
F	**Furniture and fittings**	_________
G	**Human resources**	_________
H	**Other Business Assets**	
	TOTAL	**XXXXXXXX**

3. **Macro-Micro Social Indicator Audit**- This type of audit evaluates company's performance in terms of "social measures (micro indicators) against macro social measures". The macro social factors include "the social goals expected by society in terms of health, safety, education, housing, accidents, pollution control measures, etc. The micro social indicators are measures of the performance of the company in those areas measured by macro social indicators".
4. **Social Performance Audit**- In this audit companies are ranked on the basis of their social performance by opinion polls from various stakeholders as the universities, church groups, consumer activists, NGOs etc. This type helps companies to earn goodwill in the society.
5. **Partial Social Audit**- In this audit only specific area of social performance is evaluated as the energy sector, environment, employee etc. Hence this audit may take the following forms-

   Environmental Audit- When audit is conducted with respect to matters as pollution checks, installation of pollution devices, protection of flora and fauna, rain water harvesting, global warming, carbon emissions, recycling etc. it is environmental audit.

   Energy Audit: An audit to check conservation of energy sources, to investigate how energy is obtained, consumed and preserved.

   Human Resource Audit- The audit that monitors the investment in acquiring, training, and developing human resources as an asset is called Human Resource Audit.
6. **Comprehensive Audit**- The audit that tries to "measure, verify and evaluate the total performance of the organization including its social responsibility activities. It focuses mainly on management systems rather than on the actions or events which are not so important. It aims at evaluating the quality of processes and the information on which organizational decisions are taken".

Advantages of Social Audit

Social audit leads to many advantages as follows-

1. Monitors performance of companies.
2. Develops neglected stakeholders of companies as the human resources and environment.
3. Enlightens local community about the concept of social responsibility.
4. Encourages local democracy.
5. Recognizes importance of different stakeholders in an organization.
6. Beneficial to the disadvantages group of stakeholders.

12.4. SOCIAL AUDIT IN INDIA

The Tata Iron & Steel Co. Ltd. (TISCO) is the first company in India to initiate Social Audit. A resolution was passed on 22nd May 1979 where the Board of Directors of TISCO approved the proposa1 to appoint a committee to go into the question "whether and to what extent the company had fulfilled its obligations under the broad head of social and mora1 responsibilities under Article 3A of its Articles of Association".

The Committee, subsequently appointed in October 1979, consisted of three persons as follows:-

Mr Justice S. P. Kotva1-Chairman

Prof Rajni Kothari

Prof P. G. Mavalankar

Article 3A was added to the Articles of Association of the Company by a special resolution passed on 28th January 1970. While it speaks of a number of subjects, the Committee was entrusted with seeing whether the Company had fulfilled a limited part of its provisions, as set forth in the following terms of reference:

"To ex-amine and report whether, and the extent to which the Company has fulfilled the objectives contained in Clause 3A of its Articles of Association regarding its social and moral responsibilities to the consumers, employees. Shareholders, Society and the Local community." To be specific responsibility towards five spheres were covered under the audit as –

(i) to the consumers,

(ii) to the employees,

(iii) to the shareholders,

(iv) to society, and

(v) to the local community.

The committee reported the following inadequacies-

1. “At the time of allocation of funds towards the various items of social welfare, the allocating authority should call for greater details of each head of demand and determine the estimated benefits therefrom. This should be stated in the budget so as to be useful when the next yearly accounting and budgeting comes around. Merely stating, heads of grants is not enough.”
2. “When the next annual budget is prepared previous years’ performance in comparison to the expectations and detail of expenditure should be closely scrutinized in order to enable the allocating authority to determine if the aid had reached the persons it was meant for and if the allocations among different items require any change.”
3. “A large allocation towards education of children, particularly girls and tribal, is of vital importance. Such education should be carried to the village folk within the area set apart by the company for its effort.”
4. “In allocating funds care should be taken for faster self-reliance in the community and priority to more critically felt needs of the community should be given.”
5. “There was problem in the pollution from chimneys which requires to be controlled, if possible eliminated. Since the cost is high, the effort may be spread over number of years.”
6. “The dividends paid in the past few years appear to be meager and since the company is constrained by executive instructions to limit them, the company should make the necessary application to the government to be allowed to increase it.”

   Subject to the above inadequacies, the committee reported that, “the social performance of the company has been of high order, and in its magnitude, perhaps unequalled to India.

After TISCO, Unit Trust of India (UTI) planned its social audit in 1993-94. Many other later followed suit as Steel Authority of India Ltd. (SAIL), National Thermal Power Corporation (NTPC), Escorts, J K Synthetics, National Fertilizers Ltd. (NFL) etc.

12.5. CHECK YOUR PROGRESS

Choose the correct option-

1. Stakeholders do not include-
   a) Employees
   b) Customers
   c) Government
   d) Livestock
2. According to Companies Act 2013, which of the following is not a beneficiary of social funds-
   a) Environment
   b) Employees
   c) Heritage
   d) Community
3. The minimum turnover threshold fixed by Companies Act that mandate CSR spending for companies in India is-
   a) Rs. 1 crore
   b) Rs.10 crore
   c) Rs.100 crore
   d) Rs.1000 crore
4. Which type of social audit involves specific stakeholder of business-
   a) Social Performance Audit
   b) Partial Social Audit
   c) Comprehensive Social Audit

d) Micro-Macro Social Audit

5. Which if the first Indian company to get the social audit done -

a) BHEL Ltd

b) HDFC Ltd

c) TISCO

d) HUL

12.6. SUMMARY

Social responsibility (CSR) is a concept whereby organizations not only consider their profitability and growth, but also the interest of society and the environment by taking responsibility for the impact of their activities on stakeholders, employees, shareholders, customers, suppliers and civil society represented by NGOs. They honor the mutual dependence between business and society. Social responsibility of business refers to, “open and transparent business practices that are based on ethical values and respect for employees, communities and the environment. It is designed to deliver sustainable value to society at large, as well as to shareholders”. Business must serve the society as it is a part of society. It takes its raw material and supplies from society. it gets the means of production, from society. It improves reputation and goodwill of the business and earns customer loyalty and employee satisfaction. There are no allegations from the media and the Non-Governmental Organizations. Enterprises are perceived as good corporate citizens. It gets easy to get credit from the banks and financial institutions. The credit ratings of an organization improve with participation in social responsibility of business. It becomes easy for companies for raise new capital from the market. Companies earn good name even in the international market.

But conduct of social responsibilities is costly. The resources get drained away in non-core activities of business. The money used in conduct of social responsibilities of business actually belongs to shareholders and investors. The benefits received from conduct of social responsibility are intangible. The pay back of expenditure on social responsibility is very slow and gradual. Social responsibility is first the responsibility of the government and not the corporate.

There are different models of social responsibility. Trusteeship model is given by Mahatma Gandhi he believed that, "the wealth one creates has to be ploughed back to the society. The shareholder's Model states that business has a sole purpose of maximizing the profits of shareholders while obeying the law and ethical customs of the society. The Stakeholder's Model states that business owes responsibility to a wider group of people rather than just the shareholders. ''Legitimacy Model suggests the existence of an implicit social contract in which business is accountable to society's expectations or demands. The Model states that business practices are contextualized by the country's institutional framework in which they function. It provides theoretical framework for understanding the influence of institutions on social responsibility engagement of firms.

Sanctity of the concept of social responsibility has been questioned many a times in the past specifically in Indian corporate sector. Companies Act 2013 has changed the provisions of CSR in India and made performance of social responsibility mandatory for the India corporate sector since 1st April, 2014. As per Companies Act, 2013, companies with a net worth of Rs. 500 crore or more, a turnover of Rs 1,000 crore or more or a net profit of Rs 5 crore or more during any financial year have to compulsorily spend at least 2% of average net profits (net profits before tax) calculated as per section 198 of the Indian Companies Act, 1956.

Social Audit is a tool for evaluating, verifying and reporting the performance of a firm in the sphere of social responsibility. It is a "formal review of a company's endeavors, procedures, and code of conduct regarding social responsibility and the company's impact on society". There are different types of social audit as Social Process Audit, Financial Statements Format Social Audit, Macro-Micro Social Indicator Audit, Social Performance Audit, Partial Social Audit and Comprehensive Audit. Social audit leads to many advantages as it monitors performance of companies, develops neglected stakeholders of companies as the human resources and environment, enlightens local community about the concept of social responsibility, encourages local democracy, recognizes importance of different stakeholders in an organization.

The Tata Iron & Steel Co. Ltd. (TISCO) is the first company in India to initiate Social Audit. The committee reported that, "the social performance of the company has been of high order, and in its magnitude, perhaps unequalled to India.

12.7. KEY WORDS

1. **Social responsibility**- Social responsibility of business refer to, "Open and transparent business practices that are based on ethical values and respect for employees, communities and the environment. It is designed to deliver sustainable value to society at large, as well as to shareholders".
2. **Legitimacy** - Legitimacy is defined as 'a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs and definitions'.
3. **Trusteeship-** It says that "the wealth one creates has to be ploughed back to the society. The model was given by Mahatama Gandhi in which Trusteeship provides a "means of transforming the present unequal order of society into an equal one.
4. **Institutional Model**- The Model states that business practices are contextualized by the country's institutional framework in which they function. Political, cultural, social and economic conditions prevailing in particular institutional environment determine the extent of adoption of social responsibilities by country's organizations.
5. **Social Audit**- It is a "formal review of a company's endeavors, procedures, and code of conduct regarding social responsibility and the company's impact on society".

12.8. SELF ASSESSMENT TEST

1. Define social responsibility. Why should companies go in for CSR?
2. Give arguments in favor and against the practice of corporate social responsibility.
3. Explain various models of social responsibility
4. Is social responsibility mandatory in India? Discuss the provisions of Companies Act 2013 with respect to social responsibility.
5. What is social Audit? Give its advantages.
6. Discuss various types of social audit.
7. Explain the social audit conducted at TISCO.
8. Write notes on-

a) Definitions of social responsibility of Business.

b) Corporate Social Responsibility and India

c) Institutional Model of Social Responsibility

12.9. ANSWERS TO CHECK YOUR PROGRESS

1. Live stock
2. Employees
3. Rs. 1000 crore
4. Partial Social Audit
5. TISCO

12.10. REFERENCES/SUGGESTED READINGS

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Course: Business Environment	Author: Dr. Aparna Bhatia
Course Code: BCOM 206	Vetter: Prof. Pardeep Kumar Gupta
LESSON: 13 Ethics and Corporate Governance	

STRUCTURE:

13.0. LEARNING OBJECTIVES

After going through this lesson you should be able to know

- the concept of ethics and application of ethics to business
- the nature of ethics and the sources from where ethics emerge
- the scope and significance of following ethics in business
- Understanding corporate governance and its legal framework.

13.1. INTRODUCTION TO ETHICS

The term ‘ethics’ is derived from the Greek word ‘ethos’ which means ‘character’. Ethics are the “principles of conduct governing an individual or a group”. Ethics concerns attempts to distinguish ‘right’ from ‘wrong’, ‘good’ from ‘bad’ and constitution of desirable conduct in a particular set of social circumstances. Ethics consists of the “standards of behavior to which we hold ourselves in our personal and professional lives. It establishes the levels of honesty, empathy, and trustworthiness and other virtues by which we hope to identify our personal behavior and our public reputation. In our personal lives, our ethics sets norms for the ways in which we interact with family and friends. In our professional lives, ethics guides our interactions with customers, clients, colleagues, employees, and shareholders affected by our business practices”.

Ethics is a “consideration and application of frameworks, values and principles for developing moral awareness and guiding behaviour and action”. Commonly, ethics is also referred to as “moral, good, right, just and honest. Ethical standards are referred to as the principles or ideals of human conduct.” Thus, ethics implies “good character and morality and refers to generally accepted human character and behaviour considered as a desirable by contemporary society”.

Ethics can be classified as-

1. Personal ethics
2. Professional ethics
3. Business ethics

1. **Personal ethics** are “the conception of what an individual or a group regards as desirable”. These are values which are applicable to everything an individual does. These are the values that an individual tries to inculcate in his children and expect from one another without explicitly stating them or making them a formal matter. These are the courtesies or moralities expected and displayed in ones daily life. Personal ethics may include- i. trust and honesty ii. Concern for others and their welfare iii. Fairness iv. Being just v. being lawful vi. Being benevolent vii not harming others etc. Personal ethics emerge from the following-

i. Individual's conscience- This refers to one's inner self which is natural or imbibed in one's upbringing.

ii. Societal behavior- This refers to the basic norms of living in a society which includes that an individual shall not harm others.

iii. Legal statutes- Every individual is bound by law. There are certain norms which have to be followed because the statutes enforce them.

2. **Professional ethics** refer to the norms and behavior that an individual follows in his professional career. These include impartiality, objectivity, full disclosure, benevolence, trust, confidentiality, due diligence, avoiding conflicts etc.

3. **Business ethics** is the "application of general ethical ideas to business behavior. Ethical business behavior is expected by various stakeholders who are directly or indirectly attached to the business. Business is a part of the society and in fact every unit of society is the stakeholder of the business. These may be the primary stakeholders as shareholders, debenture holders, employees, customers, suppliers etc or the secondary stakeholders as the potential investors, NGOs, environmentalists, media etc. To be precise, business ethics "is the art and discipline of applying ethical principles to examine and solve complex moral dilemmas". These prove that a business can be honest and still be profitable.

13.2. MEANING AND DEFINITIONS OF BUSINESS ETHICS

Business ethics "is that set of principles or reasons which should govern the conduct of business whether at the individual level or collective level". These are the "moral principles and rule of conduct applied to a business". A business should not be conducted in a manner that it becomes detrimental for other businesses and the society. A business is said to be ethical if it is able to achieve a "trade off" between its economic and social objectives. Profitability is the prime objective of a business but when a business deploys part of profit for the welfare of the society, it becomes ethical. Business ethics are based on principle of integrity and fairness and must benefit all the stakeholders, whether internal or external.

"Premium non nocere" meaning "not knowingly doing harm" is the principle underlying business ethics. This refers to the conduct of a business where a professional evaluates that his decisions and actions do not produce negative effects for the society. Unethical Business practices usually include the following-

- Indulging in black marketing and hoarding of goods.
- Cheating and deceiving the customer by selling bad quality or sub standard goods.
- Trying to distort competition and create monopolies
- Staining the image of competitors by unfair means.
- Window dressing and manipulating the business records to dupe authorities.
- Wrong labeling and packaging
- Evading taxes
- Unfair wages and unfair treatment to employees.

Thus, **"**Business ethics means the behavior of a businessman while conducting a business, by observing morality in his business activities. The behavior of a businessman has more impact within the business organization than outside. So, he should obey the laws even though he may personally believe them to be unjust or immoral. If the businessman feels that the provisions of laws are unjust, he can take steps to change the provisions instead of disobeying them".

Definitions of Business Ethics

Some of the definitions of business ethics given by popular authors are as follows-

According to Churchill

"Ethics are the application of moral values or codes to complex problems using a rational decision making process.

According to Andrew Crane,

"Business ethics is the study of business situations, activities, and decisions where issues of right and wrong are addressed."

According to Raymond C. Baumhart,

"The ethics of business is the ethics of responsibility. The business man must promise that he will not harm knowingly."

According to Wikipedia,

“Business ethics (also corporate ethics) is a form of applied ethics or professional ethics that examines ethical principles and moral or ethical problems that arise in a business environment. It applies to all aspects of business conduct and is relevant to the conduct of individuals and entire organizations.”

According to Baumhart,

"The ethics of business is the ethics of responsibility. The business man must promise that he will not harm knowingly."

According to Garett

“Business Ethics is primarily concerned with the relationship of business goals and techniques to specific human needs”.

To conclude business ethics are the norms, principles and values of a businessman that he displays while carrying on the business.

Features of Business Ethics

The features of business ethics are explained as follows-

1. **Code of conduct**- Business ethics is a code of conduct. They define a framework of business operations which is limited by morality and professional behavioral norms.
2. **Implied codes of conduct-** Many rules and norms that a business needs to follow are implicit in nature. For instance- business shall not cheat customers. This norm is not written anywhere but it is very much imbibed in the conduct of a business.
3. **Expressed code of conduct**- As and when required the code of conduct may be expressed through statutes in a business. For instance- The Minimum Wage Act expressly prohibits exploitation of workers by underpayment to them.
4. **Based on moral and social values**- Business ethics consist of moral values of honesty, integrity, sincerity, trust etc. These are also based on and social principles for doing business as consumer protection, societal welfare, investor protection, fair treatment to workers etc.
5. **Protection to stakeholders**- Business ethics give protection to different stakeholders such as consumers, employees, suppliers, competitors, government, shareholders, creditors, etc.

6. **Setting of limits**- Business ethics set limits for doing business. It gives social cultural, economic, legal and other limits to a business. Business must be conducted within these limits.
7. **Source of business ethics**- Business ethics emerge from one's upbringing, education, relationships, friendships, social culture and also circumstances. They depend upon one's cultural conditioning and also situations that life offers.
8. **Role of authoritative bodies**- Business bodies, Trade Associations and Chambers of Commerce must also play an active role in setting of business ethics.
9. **Relative Term**- Business ethics is a relative term that is, subjective and changes from person to person and situation to situation. These ethics also change and differ from country to country. What is considered good in one situation, or by one person or in one country may be bad in another situation, for another person or in another country. That is, it changes from one business to another. It also changes from one country to another. What is considered as good in one country may be taboo in another country.
10. **Contemporary emergence**- The emergence of term "Business ethics" is recent. It is often used in developed nations. Gradually it is also being formally used in developing countries. From the implied behavior business ethics are shifting to an expressed form of obedience and compliance to norms of behavior.
11. **Art and science**- Business ethics have certain explicit rules and principles which refer to the 'science' of business ethics. But these rules and principles can be applied differently in different situations and to different people. This application of science which is relative and subjective makes business ethics an 'art'.
12. **Related to social responsibility**- Directly or indirectly business ethics focus on fulfillment of the obligations of business towards the society in which it operates. Business is responsible for the welfare of the society and its stakeholders.

Determinants of Business Ethics

Several factors lead to establishment of behavior, culture and values. When a child is born the parents imbibe certain values in the child. These become the foundations of a child's life. Parents no doubt are the first teacher to the child. When an individual is school going the teacher and the books teach him certain values of life. Gradually as he grows up the place of work, friends, colleagues and other associated people affect an individual. Hence, there are different factors that become the source of ethics. Some prominent determinants of ethics are discussed as follows-

1. **Family and School-** The formation of ethics begins early in life. As a child one learns about what is good and bad from one's parents. Parents are the first tutors who imbibe moralities while upbringing a child. Teachers come next to parents. The school teaches value of time, discipline, punctuality, honesty and integrity to children. Education helps to distinguish between right and wrong. Different subject are taught like History, Social Science, Moral Studies, 'Dharam Shiksha', Literature etc. Various incidents, stories and anecdotes in these subjects affect children to follow or not to follow certain norms and values in life.
2. **Religion-** All religions teach good values only. The scriptures inspire individuals to be close to God through good deeds. As a result religion which is motivated by God and Godliness become a source of values and ethics.
3. **Friends, Peers, Colleagues and Superiors**- Company of friends affect individual's development. Either in the company of others child learns to be honest, truthful, helpful, courteous and disciplined or the child may learn untruthfulness, dishonesty, cheating and other form of misbehavior. Children unconsciously imitate people they interact with. The transmission of behavior and values is gradual and unseen. But it transmits very quickly form one person to another. Hence the people who you deal with become strong determinants of one's ethics in life and business.
4. **Experiences in Life**- Experiences in life teach many lessons. These could be bitter or sweet. If one sees that 'honesty pays', one is motivated to become honest. But if one sees that dishonesty and lies succeed, one is forced to follows the path of untruthfulness. Many good people become bad and vice versa because of one's personal experiences.
5. **Threatening Situations-** Fear of a situation affects one's norms and values. Sometimes there are situation where one feels that being unethical would save us than being ethical; self defence forces one to give up values of truthfulness and honesty.

6. **Profession-** There are situations where one's profession demands one to be unethical within limits. Though these limits cannot be defined but sometimes it can be for some good also. Rules should be followed in spirit and not letter. For instance when a doctor for patient's morale boosting hides the seriousness of his disease, it is being unethical for someone's good. Similarly, an advocate sometimes has to manipulate the truth to claim justice from the law.
7. **Legislation:** Law also becomes the determinant of ethical behavior. Disobedience of law attracts punishment and penalties. So fear of the same make people ethical. In business also, law forces businessmen to follow certain guidelines in relation to workers, female employees, trade unions, and environment. Hence ethics are derived from law as well.
8. **Government Rules and Regulations**- Government introduces rules and regulation regarding product safety, working conditions, statutory warnings etc. People and Businesses are forced to follow these to seem legitimate. For instance, it is mandatory to write "cigarette smoking is injurious to health". Similarly, it is compulsory to mention, "Mother's milk is best for baby's health" on infant powdered milk packs. Hence the government gives guidelines to managers in determining what are the acceptable standards and practices of ethical behavior.
9. **Profession's Ethical Codes of Behavior**: Many professions give guidelines for ethical code of conduct. These become the determinants of behavior of people working in those professions. For instance- a doctor should not discuss his patient's disease with others; an auditor cannot advertise himself through personal invitations etc.
10. **Societal Pressures**- Society also becomes a source of ethical behavior. One has to honor people from different castes, creeds and religions. All have to be treated equally with respect and dignity.

Scope of Business Ethics

Ethical problems and phenomena arise across all the functional areas of business. Hence the scope of application of business ethics extends to all these functional areas. These are explained as follows-

1. **Ethics in Finance**- There are many ethical issues in finance that companies and employees confront. These may include:

– Window dressing and misleading financial analysis in accounting.

- Manipulations of accounting policies like depreciation, inventory.
- Tools used for avoidance and manipulation of taxes.
- Over billing of expenses
- Fake reimbursements
- Insider trading, securities fraud leading to manipulation of the financial markets

2. **Ethics in Human Resources**- Ethics in human resource management (HRM) cover ethical issues related to the employer-employee relationship. The issues of ethics issues may include-

- Discrimination issues i.e. discrimination on the bases of age, gender, race, religion, disabilities, etc.
- Sexual harassment of female employees in an organization
- Issues affecting the privacy of the employee including workplace surveillance, drug testing etc.
- Issues affecting the privacy of the employee as whistle-blowing.
- Issues relating to the fairness of the employment
- Occupational safety and health issues as hazardous working conditions.
- Issues related to pay systems and flexible employment contracts

3. **Ethics in Marketing- T**his includes ethical issues behind the operation and regulation of marketing. The ethical issues confronted in this area may include-

- Pricing issues as price fixation, price discrimination, price skimming.
- Anti-competitive practices like manipulation of supply, exclusive dealing arrangements.
- Deceptive and Misleading advertisements like content of advertisements, abusive use of women and children in advertisements.
- Black markets and grey markets.

4. **Ethics of Production**- These includes the ethics of business in production and production processes. These may include the following-

- Defective, addictive and inherently dangerous products.

- Wastage of resources during the process of production.
- Environment damage including pollution, carbon emissions.
- Ethical problems arising out of new technologies for instance genetically modified food.
- Product testing ethics including use of animals in testing.

Significance of Business Ethics

Ethics are important to business. The following points highlight the importance of following business ethics-

1. **No malpractices**- Business ethics restrict malpractices from various functional areas of business as production, finance, marketing and human resource management. The manipulations in accounts and salary bills, misreported content in advertisements, sub standard and hazardous production etc is exhausted when business ethics are followed.
2. **Lawfulness in business**- When business ethics are followed business tends to obey the law. There is an automatic relation of ethics and law. Business following ethics would not intentionally break the law. Hence business is saved from abnormal costs of litigations.
3. **Sustenance of business**- These days the stakeholders are very aware about the ethical and unethical practices of business. Hence those business that undertake standardized production, pay well to their staff, market the products with honesty are favored by the stakeholders. They have longer chances of survival and growth in the market.
4. **Good relations with stakeholders**- Ethical business are able to maintain healthy relations with employees, customers, suppliers, investors and the government. Even the external stakeholders as the environmentalists, NGOs and the media speak good about ethical business organizations.
5. **Goodwill**- An ethical business is able to earn goodwill in the market. It has good image and reputation. People want to work with an ethical business. Goodwill leads to many other benefits as easy availability of credit, good credit ratings, healthy relations with suppliers, cordial relations with local authorities etc.

13.3. CORPORATE GOVERNANCE

“Corporate Governance refers to practices by which organizations are controlled, directed and governed. The fundamental concern of Corporate Governance is to ensure the conditions whereby organization’s directors and managers act in the interest of the organization and its stakeholders and to ensure the means by which managers are held accountable to capital providers for the use of assets. To achieve the objectives of ensuring fair corporate governance, the Government of India has put in place a statutory framework”.

In other words, “corporate governance is the system of rules, practices, and processes by which a firm is directed and controlled. Corporate governance essentially involves balancing the interests of a company's many stakeholders, such as shareholders, senior management executives, customers, suppliers, financiers, the government, and the community”. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.

Ever since India’s biggest-ever corporate fraud and governance failure unearthed at Satyam Computer Services Limited, the concerns about good Corporate Governance have increased phenomenally.

Definitions of Corporate Governance

Some of the definitions of corporate governance given by popular authors are as follows-

According to Cadbury Committee Report (Financial Aspects of Corporate governance, published in 1992)-

“Corporate governance is “the system by which companies are directed and controlled. It is defined as holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources”.

According to The Organization for Economic Cooperation and Development (OECD)-

“as a system by which organizations are directed and controlled. It is a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders, and should facilitate effective monitoring; thereby encouraging firms to use recourses more efficiently.”

According to World Bank-

“Corporate Governance can be defined from two aspect- corporation and public policy.

From the corporation perspective, corporate governance is relationship between owners, management, board and other stakeholders (the employees, customers, suppliers, investors and communities) where the emphasis is given to the board of directors to balance their interests to achieve long term sustained value.

From a public policy perspective, corporate governance refers to providing for the survival, growth and development of the company and at the same time, its accountability in the exercise of power and control over companies.”

According to Institute of Company Secretaries of India-

“Corporate governance is the application of best management practices, compliance of law in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders”.

Objectives of Corporate Governance

The objectives of corporate governance are listed as follows-

1. A properly structured board is there to take rational and independent decisions.
2. The board is constituted with the adequate number of representative and independent directors who take interest in all the stakeholders of the company.
3. The Board has transparent practices and procedures of arriving at the decisions.
4. The board keeps shareholders informed of important decisions.
5. The board oversees the working of the management team.
6. The board has full and effective control of the affairs of the company.

Principles of corporate governance

The principles of corporate governance are discussed below-

1. **Fair and equitable treatment-** All the stakeholders of the company as the investors, shareholders, customers, employees and others should be treated equally and fairly. The board must acquaint the shareholders with their rights and also the procedure to exercise the rights.
2. **Accountability-** Organizations should honor their contractual obligations to various stakeholders. A formal code of conduct should be framed for board members; board committees, such as the audit committee and compensation committee; and senior executives. New individuals joining those appointments on these positions should also meet those established standards.
3. **Diversity.** The board of directors must maintain a commitment to ensure diversity within corporate governance and the company overall.
4. **Oversight and management.** Board members must also possess the adequate skills necessary to review management practices.
5. **Transparency.** All corporate governance policies and procedures should be disclosed to the stakeholders. This includes communication of pertinent information to customers, employees, investors, and other members of the community.

13.4. REGULATORY FRAMEWORK OF CORPORATE GOVERNANCE

The corporate governance mechanism for companies in India is managed by the following enactments/ regulations/ guidelines/ listing agreement:

1. **The Companies Act, 2013** inter alia contains provisions relating to “board constitution, board meetings, board processes, independent directors, general meetings, audit committees, related party transactions, disclosure requirements in financial statements, etc”.
2. **Securities and Exchange Board of India (SEBI) Guidelines:** SEBI is a “regulatory authority having jurisdiction over listed companies and which issues regulations, rules and guidelines to companies to ensure protection of investors”.

3. **Standard Listing Agreement of Stock Exchanges**: For companies whose shares are listed on the stock exchanges. SEBI has given Clause 49 that gives provisions of corporate governance as applicable to listed companies in India.
4. **Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI):** ICAI is "an autonomous body, which issues accounting standards providing guidelines for disclosures of financial information. Section 129 of the New Companies Act inter alia provides that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under Section 133 of the New Companies Act. It is further provided that items contained in such financial statements shall be in accordance with the accounting standards."
5. **Secretarial Standards issued by the Institute of Company Secretaries of India (ICSI)**: ICSI is an "autonomous body, which issues secretarial standards in terms of the provisions of the New Companies Act. So far, the ICSI has issued Secretarial Standard on "Meetings of the Board of Directors" (SS-1) and Secretarial Standards on "General Meetings" (SS-2). These Secretarial Standards have come into force w.e.f. July 1, 2015. Section 118(10) of the New Companies Act provide that every company (other than one person company) shall observe Secretarial Standards specified as such by the ICSI with respect to general and board meetings".

Key legal framework for corporate governance in India

The Companies Act, 2013

"The Government of India has recently notified Companies Act, 2013 ("New Companies Act"), which replaces the erstwhile Companies Act, 1956. The New Act has greater emphasis on corporate governance through the board and board processes. The New Act covers corporate governance through its following provisions:

- New Companies Act introduces significant changes to the composition of the boards of directors
- Every company is required to appoint 1 (one) resident director on its board.
- Nominee directors shall no longer be treated as independent directors.
- Listed companies and specified classes of public companies are required to appoint independent directors and women directors on their boards.

- New Companies Act for the first time codifies the duties of directors.
- Listed companies and certain other public companies shall be required to appoint at least 1 (one) woman director on its board.
- New Companies Act mandates following committees to be constituted by the board for prescribed class of companies:

– Audit committee
– Nomination and remuneration committee
– Stakeholders relationship committee
– Corporate social responsibility committee"

Listing agreement – Applicable to the listed companies

"SEBI has amended the Listing Agreement with effect from October 1, 2014 to align it with New Companies Act. Clause 49 of the Listing Agreement can be said to be a bold initiative towards strengthening corporate governance amongst the listed companies. This Clause intends to put a check over the activities of companies in order to save the interest of the shareholders. Broadly, clause 49 provides for the following:

1. **Board of Directors**- The Board of Directors shall comprise of such number of minimum independent directors, as prescribed. In case where the Chairman of the Board is a non-executive director, at least one-third of the Board shall comprise of independent directors and where the Chairman of the Board is an executive director, at least half of the Board shall comprise of independent directors. A relative of a promoter or an executive director shall not be regarded as an independent director.
2. **Audit Committee**- The Audit Committee to be set up shall comprise of minimum three directors as members, two-thirds of which shall be independent.
3. **Disclosure Requirements**- Periodical disclosures relating to the financial and commercial transactions, remuneration of directors, etc, to ensure transparency.
4. **CEO/ CFO Certification**- To certify to the Board that they have reviewed the financial statements and the same are fair and in compliance with the laws/ regulations and accept responsibility for internal control systems.

5. **Report and Compliance**- A separate section in the annual report on compliance with Corporate Governance, quarterly compliance report to stock exchange signed by the compliance officer or CEO, company to disclose compliance with non-mandatory requirements in annual reports".

(source- rbi.gov.in)

13.5. CHECK YOUR PROGRESS

Choose the correct option-

1. Business ethics are-
   a) Statutory guidelines
   b) Norms of behavior
   c) Rules of Companies Act
   d) Modifications in Articles of Association
2. Which of the following is not a determinant of business ethics-
   a) Family
   b) Colleagues
   c) Law
   d) Compensation
3. "PREMIUM NON NOCERE" means-
   a) Harming others deliberately.
   b) Not knowingly doing harm to others.
   c) Protecting others
   d) Punishing employees
4. The pivot of corporate governance are the-
   a) Directors
   b) Managers
   c) Workers

d) Employees

5. Legal framework of corporate governance is governed in India by-

    a) Companies Act 2013

    b) SEBI

    c) ICAI

    d) All of the above

13.6. SUMMARY

Ethics are the "principles of conduct governing an individual or a group". Ethics concerns attempts to distinguish 'right' from 'wrong', 'good' from 'bad' and constitution of desirable conduct in a particular set of social circumstances. Ethics can be classified as- Personal ethics, Professional ethics and Business ethics. Personal ethics are "the conception of what an individual or a group regards as desirable". Professional ethics refer to the norms and behavior that an individual follows in his professional career. Business ethics is the "application of general ethical ideas to business behavior.

Business ethics "is that set of principles or reasons which should govern the conduct of business whether at the individual level or collective level". These are the "moral principles and rule of conduct applied to a business". A business is said to be ethical if it is able to achieve a "trade off" between its economic and social objectives. "Premium Non Nocere" meaning "not knowingly doing harm" is the principle underlying business ethics. Business ethics is a code of conduct. They define a framework of business operations which is limited by morality and professional behavioral norms. Many rules and norms that a business needs to follow are implicit in nature. As and when required the code of conduct may be expressed through statutes in a business. Business ethics consist of moral values. Business ethics give protection to different stakeholders. Business ethics emerge from one's upbringing, education, relationships, friendships, social culture and also circumstances. Business ethics is a relative term that is, subjective. Business bodies, Trade Associations and Chambers of Commerce must also play an active role in setting of business ethics. The emergence of term "Business ethics" is recent. It is often used in developed nations. Business ethics are both a science and an art. Directly or indirectly business ethics focus on fulfillment of the obligations of business towards the society.

Several factors affect business ethics. First and foremost are the Family and School. All religions teach good values only. Company of friends affect individual’s development. Experiences in life teach many lessons. Fear of a situation affects one’s norms and values. There are situations where one’s profession demands one to be unethical within limits. Law also becomes the determinant of ethical behavior. Government introduces rules and regulations that govern ethics. People and Businesses are forced to follow these to seem legitimate. Many professions give guidelines for ethical code of conduct. Society also becomes a source of ethical behavior.

The scope of application of business ethics extends to all these functional areas. There are many ethical issues in finance as window dressing and misleading financial analysis in accounting, manipulations of accounting policies like depreciation, inventory etc. Ethics in human resource management (HRM) cover ethical issues related to the employer-employee relationship. Ethics in Marketing which includes ethical issues behind the operation and regulation of marketing, Pricing issues as price fixation, price discrimination, price skimming, anti-competitive practices etc. Ethics of Production include the ethics of business in production and production processes like avoiding defective production, wastage of resources during the process of production.

Business ethics restrict malpractices from various functional areas of business as production, finance, marketing and human resource management. When business ethics are followed business tends to obey the law. Those business that undertake standardized production, pay well to their staff, market the products with honesty are favored by the stakeholders. They have longer chances of survival and growth in the market. Ethical businesses are able to maintain healthy relations with employees, customers, suppliers, investors and the government. An ethical business is able to earn goodwill in the market.

Ever since India’s biggest-ever corporate fraud and governance failure unearthed at Satyam Computer Services Limited, the concerns about good Corporate Governance have increased phenomenally. “Corporate governance is the system of rules, practices, and processes by which a firm is directed and controlled. Corporate governance essentially involves balancing the interests of a company's many stakeholders, such as shareholders, senior management executives, customers, suppliers, financiers, the government, and the community”. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The corporate governance is based on some principles as fair and equitable treatment to all the stakeholders of the company as the investors, shareholders, customers, employees and others. Organizations are accountable to honor their contractual obligations to various stakeholders. The board of directors must maintain a commitment to ensure diversity within corporate governance and the company overall. Board members must also possess the adequate skills necessary to review management practices. All corporate governance policies and procedures should be disclosed to the stakeholders. The corporate governance mechanism for companies in India is managed by The Companies Act, 2013, Securities and Exchange Board of India (SEBI) Guidelines, Standard Listing Agreement of Stock Exchanges and Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI). SEBI has given Clause 49 that gives provisions of corporate governance as applicable to listed companies in India.

13.7 KEY WORDS

1. **Business Ethics**- Business Ethics “is that set of principles or reasons which should govern the conduct of business whether at the individual level or collective level”. These are the “moral principles and rule of conduct applied to a business”.
2. **Personal ethics**- Personal ethics are “the conception of what an individual or a group regards as desirable”. These are values which are applicable to everything an individual does. Professional ethics refer to the norms and behavior that an individual follows in his professional career. These include impartiality, objectivity, full disclosure, benevolence, trust, confidentiality, due diligence, avoiding conflicts etc.
3. **Business ethics-** Business ethics is the “application of general ethical ideas to business behavior. Ethical business behavior is expected by various stakeholders who are directly or indirectly attached to the business
4. **Premium Non Nocere**- “Premium Non Nocere” meaning “not knowingly doing harm” is the principle underlying business ethics.
5. **Corporate Governance**- “Corporate Governance refers to practices by which organizations are controlled, directed and governed. The fundamental concern of Corporate Governance is to ensure the conditions whereby organization’s directors and managers act in the interest of the

organization and its stakeholders and to ensure the means by which managers are held accountable to capital providers for the use of assets.”

13.8 SELF ASSESSMENT TEST

1. Define Business Ethics. Give its characteristics.
2. Explain the scope of business ethics?
3. Explain the determinants of business ethics.
4. What is the significance of following business ethics? Discuss.
5. What is corporate governance? Give its principles.
6. Explain legal framework of corporate governance in India.
7. Write notes on-
   a) Companies Act and corporate governance
   b) Features of corporate governance
   c) Nature of business ethics

13.8 ANSWERS TO CHECK YOUR PROGRESS

1. Norms of behavior
2. Compensation
3. Not knowingly doing harm to others.
4. Directors
5. All of the above

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