<u>**Bachelor of Commerce**</u>

BC - 605

BUSINESS ENVIRONMENT

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Course: Business Environment	
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An Introduction to Business Environment

STRUCTURE

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1.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Explain nature of Business.

- Explain the concept of business environment
- Describe the nature and scope of business environment
- Describe the importance of business environment
- Explain the components of business environment
- Discuss the relationship between business environment and strategic management

1.1 Introduction

Business is an organisation or enterprise engaged in producing goods and services for profit motive. It is a collective effort where a firm is engaged in commercial, industrial or professional activities. The main aim of business is to satisfy the needs of customers. The success of every business depends on adapting itself to the environment within which it functions. For example, with changes in the government policies, the business needs to adapt itself with the new policies. Similarly, any technological advancement may render the existing products obsolete, such as the introduction of smart phones has replaced the telephone to a greater extent. Therefore, it is very important to have a clear understanding of the basic concept of business environment and the nature of its various components.

Business Environment is sum or collection of all internal and external factors such as employees, customer's needs and expectations, supply and demand, management, clients, suppliers, owners, activities by government, innovation in technology, social trends, market trends, economic changes, etc. These factors affect the function of the company and how a company works directly or indirectly. Sum of these factors influences the companies or business organisations environment and situation. Business Environment consists of all those factors that have a bearing on the business, such as the strengths, weaknesses, internal power relationships and orientations of the organization; government policies and regulations; nature of the economy and economic conditions; socio-cultural factors; demographic trends; natural factors; and, global trends and cross-border developments.

A business firm is an open system. It gets resources from the environment and supplies its goods and services to the environment. There are different levels of environmental forces. Some are close and internal forces whereas others are external forces. External forces may be related to national level, regional level or international level. The environmental forces provide opportunities or threats to the business organization. Every business organization tries to grasp the available opportunities and face the threats that emerge from the business environment. Business organizations cannot change the external environment but they just react/ adjust according to the external environment. They change their internal business components (internal environment) to grasp the external opportunities and face the external environmental threats. It is, therefore, very important to analyze business environment to survive and to get success for a business in its industry. It is, therefore, a vital role of managers to analyze business environment so that they could pursue effective business strategy. A business firm gets human resources, capital, technology, information, energy, and raw materials from society. It follows government rules and regulations, social norms and cultural values, regional treaty and global alignment, economic rules and tax policies of the government. Thus, a business organization is a dynamic entity because it operates in a dynamic business environment.

The word 'Business Environment' has been defined by various authors as follows:

According to **Keith Davis**, "Business environment is the aggregate of all conditions, events and influences that surround and affect it".

According to **Reinecke** and **Schoell**, "the environment of business consists of all those external things to which it is exposed and by which it may be influenced directly or indirectly.

1.2 Business an Introduction

1.2.1 Nature of Business

Business may be understood as the organized efforts of enterprise to supply consumers with goods and services for a profit. Businesses vary in size, as measured by the number of employees or by sales volume. But, all businesses share the same purpose: to earn profits.

The purpose of business goes beyond earning profit. There are:

- It is an important institution in society.
- Be it for the supply of goods and services.
- Creation of job opportunities.
- Offer of better quality of life.
- Contributing to the economic growth of the country.

Hence, it is understood that the role of business is crucial. Society cannot do without business. It needs no emphasis that business needs society as much.

These definitions give a clear understanding of the business environment. We can say that business environment is a combination or mixture of complex, dynamic and uncontrollable external factors within which a business is to be operated.

The change in tastes and preferences of customers, introduction of new technologies, innovations, government policies, etc., all are parts of the business environment. Business needs to accept and adapt these changes promptly to survive in the market. So, it is necessary for the business to analyse the business environment

1.2.2 Businesses in Today's Environment

Modern business is dynamic and customer oriented. If there is any single word that can best describe today’s business, it is change. This change makes the companies spend substantially on Research and development (R & D) to survive in the market. Mass production and mass marketing are the norms followed by business enterprises. The number of companies with an annual turnover of Rs.100 crore each was only three in 1969-70.The figure has manifold these days.

Today’s business is characterized by diversification, which may be:

- **Concentric Diversification** - It refers to the process of adding new, but relates products or services.
- **Horizontal Diversification** - Adding new, unrelated products or services for present customers is called horizontal Diversification.
- **Conglomerate Diversification** - It refers to adding new and unrelated products or services. Going international is yet another trend followed by modern business houses.

Business houses are exposed to global competition, which argues well for consumers. Also occupying a major role is science in the global economic scenario.

1.3 Business Environment & its Concept

1.3.1 Nature of Business Environment

The business environment of an organisation usually poses threats as well as opportunities. To grasp the opportunities and reduce the threat, it is important to know the nature of business environment. Following are some points which describe nature of business environment:

- **Internal and external environment:** Every business is surrounded by internal and external environment. Internal environment can be controlled by an organisation, like men, money, material, machine and method, whereas external environment is uncontrollable like political conditions, technologies, legal regulations, etc.
- **Dynamic and ever-changing**: Business environment keeps on changing frequently in terms of technologies, government rules and regulations, socio-economic conditions, etc., which make business dynamic.
- **Complexity of the environment:** Business environment cannot be easily analysed because of too much complexity involved. Environment consists of a number of factors, events, conditions and influences, generating from different sources which impact business, thus, making the business complex.
- **Inter-relatedness:** Factors of business environment are related to each other. For example, change in political parties will result in changing the government rules, fiscal policies, market conditions, technology, etc. So, all the factors need to be scanned properly because these factors are inter-related to each other.
- **Uncertainty:** It is difficult to predict the changes going to take place in future because environment keeps on changing. These changes are uncontrollable. So, business can only try to combat from these challenges. For example, in case of fashion industries, changes take place so frequently, economy could collapse any time.
- **Impact:** Impact means the effect of environment on business. Business environment has both long-term and short-term impacts on business. For example, different firms may get influenced differently from change in monetary policy.
- **Inter-dependence:** A business firm and its environment are mutually interdependent. The economic status of a country affects the development of technology or it may change the lifestyle of people.

1.3.2 Scope of Business Environment

The aspects which fall under the scope of business environment are as follows:

- **Internal and external environment**: Internal environment includes all those factors that are within an organisation and impart strength or cause weakness in business. For example, inefficient human resource, superior raw material, etc. External environment includes those factors which are beyond the control of business and are outside the organisation. They provide opportunities and pose threat to business. For example, change in political conditions, technological change, etc.
- **Specific and general environment:** Specific environment includes external forces that directly impact or influence organisations' decisions and actions and are directly relevant to the achievement of organisations' goals. The main forces that make up the specific environment are customers, suppliers, competitors and pressure groups. General environment includes the economic, political/legal, socio-cultural, demographic, technological and global conditions that affect organisations. External forces do not affect organisations to a great extent, but organisations must plan, organise, lead and control their activities taking into account these factors.
- **Micro environment and macro environment:** Micro environment impacts the working of a particular business. It has direct impact on business activities. It includes customers, suppliers, market intermediaries, competitors, etc. These factors are controllable to some extent. Macro environment is general environment that impacts the working of all businesses. It is uncontrollable and influences indirectly and includes political conditions, economy, technology, etc., come under macro environment.
- **Controllable and uncontrollable environment:** All those factors which are governed by business come under controllable environment. Internal factors are treated as controllable factors, like men, material, machine, money, etc. Uncontrollable factors are external and are beyond the control of business like technological change and law related change.

1.3.3 Importance of Business Environment

Following points describe the importance of business environment:

- **Identification of business opportunities:** Many opportunities are provided by business environment to the organisation. Scanning business environment would help business get the first mover advantage. If changes are analysed carefully, then they can be the reason for business success.
- **Optimum utilisation of resources:** Resources like raw material, machine, money, labour, etc., are input for business. All these inputs are provided by environment to the business firms for carrying out their activities and also expect something in return.
- **Identification of threat and early warning signal:** Business can recognise the threat by analysing the change taking place in the environment. For example, if any new multinational company is entering the Indian market, the manager of an Indian firm dealing with same product as that of the multinational company should take it as a warning signal. Before the MNC launches its product, the manager should implement measures, such as improving the quality of his product and heavy advertisement.
- **Coping with the rapid changes:** To efficiently cope with these changes, managers must understand the environment and should adopt appropriate courses of action at the right time. It helps management become more sensitive to ever-changing needs of customers. As a result, they are able to respond to such changes effectively.
- **Meeting competition:** This helps firms analyse competitors' strategies and formulate their strategies accordingly.
- **Identifying firm's strength and weakness:** Business environment helps identify the individual strength and weakness in view of the technological and global developments.
- **Assisting in planning and policy formulation:** Business environment brings both threats and opportunities to a business. Having a good understanding of the business environment can immensely help an organisation's management in their future planning and decision-making endeavours. For example, competition increases with the entry of new firms in the market.

The management has to draft new plans and policies to deal with new competitors. Environmental awareness provides intellectual stimulation to planners in their decision making. They can make changes in their plans efficiently and effectively.

1.3.4 Components of Business Environment

The performance of an organisation is affected by the business environment. It has a far-reaching impact on its survival, profit and growth. There are certain forces inside and outside the organisation. These forces affect the business both in positive and negative ways. The components of business environment are explained below with the help of a diagram:

Components of Business Environment

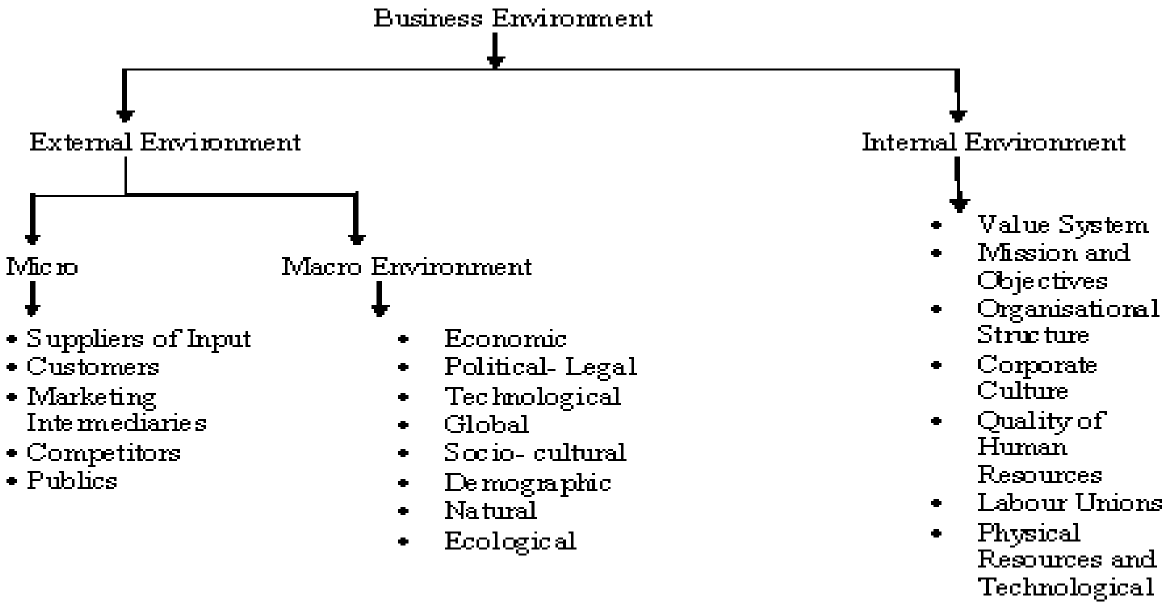

Fig: Components of Business Environment

Internal environment: The factors or conditions that exist within an organisation and affect its performance. These factors are controllable in nature and organisation can try to change or modify these factors. Organisation's resources like men, material, money, method and machine come under internal environment. Various internal factors are as follows:

- **Value system:** The values are the ethical beliefs that guide the organisation in achieving its mission and objectives. It is framed by top-level managers like board of directors. The extent to which the value system is shared by all in the organisation is an important factor contributing to its success.
- **Mission and notes objectives:** The objective is the end towards which business activities are directed. All businesses focus on maximisation of profit. Mission is defined as the overall

purpose or reason for its existence. A mission guides and influences an organisation's decisions and economic activities. An organisation can change or modify its mission and objective accordingly.

- **Organisation structure:** The organisational structure is the hierarchy in business that define roles, responsibilities and supervision. The composition of the board of directors, the professionalism of management, etc., comes under organisation structure and are important factors influencing business decisions. For efficient working of a business organisation and to facilitate prompt decision making, the organisation structure should be conducive.
- **Corporate culture:** Shared values and belief in an organisation which determine its internal environment are called corporate culture. Organisation where there is strict supervision and control results in lack of flexibility and unsatisfied employees. The sets of values that help members understand what organisation stands for how it does work, what it considers, cultural values of business forces of business, and so on. It helps in direction of activities.
- **Human resources:** Human quality of a firm is an important factor of internal environment. Skills, qualities, capabilities, attitude, competencies and commitment of its employees, etc., could contribute to the strengths and weaknesses of an organisation. Organisations may find it difficult to carry out modernisation and redesigning because of resistance by its employees.
- **Physical resources and financial capabilities:** Physical resources, such as plant and equipment, facilities and financial capabilities of a firm determine its competitive strength which is an important factor for determining its efficiency and unit cost of production. Also research and development capabilities of a company determine its ability to introduce innovations which enhance the productivity of workers. Financial capabilities are company's source of fund generation.
- **External environment:** The factors and the conditions which are outside the organisation and affect the performance of business. External factors are further divided into micro environment and macro environment which are as follows:
- **Micro environment:** Those factors which have direct impact on business. The various constituents under micro environment are as follows:

- **Suppliers of inputs:** The suppliers of inputs are important factors in the external micro environment of a firm. Suppliers provide raw material and resources to the firm. A firm should have more than one supplier for proper inflow of inputs.
- **Customers:** These are the buyers of firm's products and services. Customers are an important part of external micro environment because sales of a product or service are critical for a firm's survival and growth, so it is necessary to keep the customers satisfied.
- **Marketing intermediaries:** Intermediaries play an essential role of selling and distributing its products to the final customers. Marketing intermediaries are an important link between a business firm and its ultimate customers. Retailers and wholesalers buy in bulk and sell business products and services to the ultimate consumer.
- **Competitors:** Competitors are the rivalry in business. Competition can based on pricing of products or based on competitive advertising. For example, organisations may sponsor some events to promote the sale of different varieties and models of their products. Business formulates strategies after analysing their competitor.
- **Public:** Public or groups, such as environmentalists, media groups, women's associations, consumer protection groups, are important factors in external micro environment. According to Philip Kotler, Public, is any group that has an actual or potential interest in or impact on the company's ability to achieve its objective.

Macro Environment: These are the factors or conditions which are general to all businesses and are uncontrollable. Because of the uncontrollable nature of macro forces, a firm needs to adjust or adapt it to these external forces. These factors are as follows:

- **Economic environment:** All those forces which have an economic impact on businesses are called economic environment. It includes agriculture, industrial production, infrastructure, and planning, basic economic philosophy, stages of economic development, trade cycles, national income, per capita income, savings, money, etc., For example, low per capital income will negatively impact business because people have less money to spend.
- **Political-legal environment:** The activities of legislature, executive and judiciary play a vital role in shaping, directing, developing and controlling business activities. Rules and regulations,

framed by the government, like licensing policy, polythene ban, etc., affect the business. Business growth can be achieved by using a stable and dynamic political-legal environment.

- **Technological environment:** Systematic application of scientific or other organised knowledge to practical tasks or activities is called technology. As it is changing fast, businessmen should keep a close look on those technological changes for its adaptation in their business activities.
- **Global or international environment:** The global environment is also important for shaping business activity. In the era of globalisation, whole world is a market. Business analyses international environment to cope up with the changes.
- **Socio-cultural environment:** People's attitude towards work and wealth, lifestyle, ethical issues, role of family, marriage, religion and education and also social responsiveness of business affect the business.
- **Demographic environment:** Population size and growth, life expectancy of the people, rural-urban distribution of population, the technological skills and educational levels of labour force come under demographic environment. These features also affect the functioning of organisations.
- **Natural environment:** The natural environment plays an important role as it provides raw materials and energy for production in a firm. Natural environment consists of geographical and ecological factors such as minerals and oil reserves, water and forest resources, weather and climatic conditions and port facilities. These are very important for many business activities. For example, in places where temperatures are high, the demand for coolers and air conditioners is high. Also, demand for clothes and building materials depends on weather and climatic conditions. Natural calamities like floods, droughts, earthquakes, etc., immensely affect business activities.

1.4 Relation between Business Environment and Strategic Management

The set of decisions and actions that result in the formulation and implementation of plans designed to achieve a company objectives are called strategic management. Strategic decisions are based on what a manager forecasts rather than what he knows. Strategic decisions have complex implications for more areas of the firm. The characteristics of strategic management decisions vary with the level of strategic management activity.

- Strategic management helps in defining the objectives and policies for the business. To make strategy, a business needs to scan its environment.
- In formulating a strategy, the strategic decision makers must analyse internal as well as external conditions in the environment, which are described in the following sections:
- The analysis of internal and external environment will help managers determine what goals and mission they can or should adopt, and the strategic options that are available.
- Strategic planning should be based on business environment analysis. The world today is changing at a rapid pace. So it is very important for companies to scan the business environment more clearly, and make up strategic planning that can match the changes.
- The environment is changing, and the strategy which is suitable for companies today may bring threat tomorrow. Strategy is effective only if it is flexible.

1.5 Check Your Progress

1. ____________________ is the aggregate of all conditions, events and influences that surround and affect it.
2. All those factors which are governed by business come under controllable environment. **(True/False)**
3. A business firm and its environment are mutually ____________________.
4. ________________ and _________________ are the two types of external environment.
5. Which among the following comes under economic environment?

- Education
- Population size
- GDP
- Lifestyle

1.6 Summary

Business environment is a combination or mixture of complex, dynamic and uncontrollable external factors within which a business is to be operated. Business environment is complex, uncertain, inter-related, dynamic and interdependent. Specific environment includes external forces that directly impact or influence organisations' decisions and actions and are directly relevant to the achievement of organisations' goals. General environment includes the broad economic, political/legal, socio-cultural, demographic, technological and global conditions. Business environment helps in identifying opportunities and threats. The components of business environment are: internal and external environment. External environment consists of micro and macro factors which affect the business. The set of decisions and actions that result in the formulation and implementation of plans designed to achieve a company objectives are called strategic management. Strategic management helps in defining the objectives and policies for the business. To make a strategy, a business needs to scan its environment.

1.7 Keywords

Business Environment: Business environment is a combination or mixture of complex, dynamic and uncontrollable external factors within which a business is to be operated.

Opportunities: The favourable conditions which can give a positive outcome.

Threats: The unfavourable conditions which can give a negative outcome.

Globalisation: An integration of economies, industries, markets, cultures and policy-making around the world.

Strategic management: The set of decisions and actions that result in the formulation and implementation of plans designed to achieve an organisation's objectives.

1.8 Self -Assessment Test

1. Describe the forces which affect individual enterprises directly and immediately in their day-to-day working.

2. Explain how the understanding of business environment helps the management in coping with the rapid change and identifying opportunities and threats.

3. ABC Pvt. Ltd. was operating its business in USA. The company started exporting its product to India with the introduction of New Industrial Policy in 1991. The company appointed retailers in India who had direct links with suppliers to replenish stocks when needed. Identify and explain the dimensions of business environment discussed above.

4. Strategic decisions are based on what a manager forecasts rather than what he knows. Explain the relationship between strategic management and business environment**.**

1.9 Answers to Check Your Progress

1. Business Environment

2. True

3. Interdependent

4. Micro environment; macro environment

5. GDP

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Course: Business Environment	
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Environmental Scanning

STRUCTURE

2.0 Learning Objectives

2.1 Introduction

2.2 Meaning and Importance of Environmental Screening

2.3 Business Environmental Analysis

2.3.1 Steps in Business Environmental Analysis

2.3.2 Techniques of Environmental Analysis

2.3.3 Assessing Risk in A Business Environment

2.4 Check Your Progress

2.5 Summary

2.6 Keywords

2.7 Case Study: SWOT Analysis of Apple Inc.

2.8 Self-Assessment Test

2.9 Answers to Check Your Progress

2.10 References/Suggested Readings

2.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know the meaning of environmental screening

- Explain the importance of environmental screening
- Discuss the steps of business environmental analysis
- Describe the techniques of environment analysis i.e. ETOP, SWOT, and PESTLE etc.
- Describe the SWOT technique of business environmental analysis
- Explain the meaning of risk
- Explain how organisations assess risk

2.1 Introduction

An organisation operates within a particular environment which is comprised of internal and external environments. The internal environment of an organisation includes its employees, its policies that exist in the organisation, its strategy, its mission, etc. The internal environment is responsible to reflect the common purpose of the organisation. The external environment includes government, regulating agencies, customers, and suppliers, public at large, etc. which affect the business strategy of the organisation. Internal environment is managed internally by the key persons of the organisation. Thus, it is important for a organisation to screen the external environment in detail to make a strategy that could work for it. SWOT technique is used to make a complete analysis of internal and external environment of an organisation. In this lesson, you will be able to know the meaning and importance of environmental screening, analysis of business environment and SWOT analysis in detail. Towards the end of the lesson, risks in business environment have been discussed.

2.2 Meaning And Importance Of Environmental Screening

The term ‘environment’ means surroundings near you, which includes all components of environment like physical environment, social environment and governing environment. Physical environment consists of plants, land, water and all natural resources. Social environment consists of labourers, staff, management, suppliers, customers or all other human resources. Governing environment are rules, regulations and policies of the government. The term ‘screening’ means the process of evaluation or assessment of anything with the purpose of gathering data on any subject matter and coming to a conclusion. Thus, it may be concluded that environmental screening is a process in which an organisation makes assessment or analysis of all the components of the environment and screens their impact on its functioning, stability, growth and profits. For an effective environmental screening, an organisation must follow the following steps:

1. Defining the type of business: First, the organisation should assess what type of business it is dealing in and later on decide how environment will impact it. The same environment affects the clothing business and food business differently.

2. Defining the scope of project: If screening is done for a particular project, then it is necessary to define the scope of the project. The scope will decide how environment will affect the project of the organisation.

3. Defining the type of environment: It is important to define what type of environment an organisation is working in. It is important to consider all types of components of environment, such as physical, social or governing, and how the business will be affected due to them.

4. Preparing a report: A detailed report should be made on how the organisation will be affected by the surrounding environment.

5. Monitoring: Environment is not a static thing. It keeps on changing its features and characteristics. For example, employees keep on changing their jobs, customers keep on changing their choices, government keeps on changing its policies, etc. Thus, environment and its impacts should also be constantly monitored.

If an effective environmental screening is done properly, then it gives following benefits: € €

- It gives the clear picture of what kind of environment the organisation is working in. Also, the organisation becomes aware of the features of different components of environment. € €
- Organisation gets the idea of opportunities and threats possible in the environment. €
- Organisation is able to define the scope of its business, like how much the organisation can grow and to what extent it can raise its targets and profits.
- Organisation becomes aware of the existing and possible competitors. € €
- Continuous monitoring of environment makes an organisation aware of the upcoming dangers and updates for future challenges. This makes an organisation aware of its customers' choices, so that the organisation could further improve the quality of its products or services.

2.3 Business Environmental Analysis

The environmental analysis process is not a static process. It is rather a dynamic process which may change from one business to another. For example, the business process analysis would be different for the airline services to that of the beauty salon services. A business manager plays a vital role in the analysis of business environment which needs to thoroughly understanding the availability of opportunities and possible threats. As per the analysis, an organisation needs to work on the available opportunities as per its strength and weakness.

Following are four basic components of business environment analysis: € €

- **Scanning:** The term 'scanning' means analysing all parts or components of anything in order to develop some features of that thing. Being the first component of the environmental analysis process, this analyses the environmental factors of an organisation. The purpose of scanning is as follows:

(i) Scanning helps in identifying the possibilities of environmental changes which may affect the working of an organisation.
(ii) Understanding the present changes in the environment.

Scanning is basically a non-structured activity. This is because the data in scanning is unlimited, but is ambiguous and imprecise in nature. So, it is difficult to distinguish what data is relevant or what is not. For the environmental analysis process, it is the basic challenge to extract the relevant data and make the best use of it.

- **Monitoring:** 'Monitoring' means keeping a constant eye or check on something. Thus, in environmental analysis, monitoring keeps a check on environmental changes from time to time. For example, employees keep on changing, natural resources keep on changing, and government and their policies keep on changing. Thus, after scanning, it is necessary to keep monitoring what sort of changes the concerned environment is facing and what impact it might cause on the normal functioning of the organisation. Constant monitoring ensures that businesspersons are aware, and make responses towards the possible change in the business environment.
- **Forecasting:** Scanning and monitoring are steps on those aspects which have already happened and organisation cannot change them. These are sunk aspects, i.e., which have already taken

place in the past and will not change in the future. But when an organisation is formulating a strategy for its operations, it might require future prospects and future orientation too. Forecasting is, thus, making any predictions about future and is, consequently, a part of business environment analysis. Forecasting can be done for any business-related project or aspect. For example, a forecasting can be made about whether a particular technology will arrive in the market or not, what would be the government's new policies regarding tax, whether customers would change their preferences or would they like the innovation in the products or services, etc. These kinds of questions are being attempted to be answered in forecasting. Scanning and monitoring are comparatively easy tasks than forecasting. Forecasting is a complex task which requires brainstorming with which future predictions are being made. The scope of forecasting is more specific and clearer than monitoring and scanning. The results of monitoring and scanning are accurate as study of something present is done. But results of forecasting are contingent in future.

- **Assessing:** After scanning, monitoring and forecasting the business environment, organisation must make proper evaluation or assessment of collected data in the above-mentioned steps. The organisation also needs to analyse what impact it will create on functioning.

Assessment will provide answer to the following questions:

(i) What strategy needs to be made for the smooth functioning of the organisation?

(ii) What changes might an organisation want to bring in your current strategy?

(iii) What alternatives does an organisation have in case of negative changes in environment?

(iv) How will an organisation face the coming changes?

2.3.1 Steps in Business Environmental Analysis

Following steps need to be followed in the process of business environmental analysis:

A. Scanning all the required components

B. Grouping the scanned components

C. Observing the internal components

D. Monitoring the external components

E. Outlining variables for analysis

F. Usage of different techniques for analysis

G. Forecasting future outcomes

H. Formulating strategies

I. Execution of formulated strategies

J. Monitoring

Let us discuss the above-mentioned steps in detail:

A. **Scanning all the required components**: Environment of an organisation consists of various components. But, not all factors and aspects would be equally important or even important for the functioning of an organisation. A good strategist always distinguishes the relevant factors and scans them in detail. He/she looks for all the required components of environment and would study the relevant factors in detail. This way, he/she collects the required components and would present a scanned report.

B. **Grouping the scanned components:** In the first step, the required raw information is gathered. In this step, the collected components are to be grouped; for example, what is affecting the stability, what is affecting the sales, what is affecting the growth, etc. Grouping is made of all the collected information.

C. **Observing the internal components:** After scanning and grouping the relevant components of external environment, the strategist looks at the internal components of the organisation. For example, how the employees are reacting to the environmental changes and how smooth an organisation is functioning as the external components change in the environment.

D. Monitoring external components: As an environment is not static in nature, it keeps on changing, for example, changing in government policies, changing in customer's preferences, changing in supplier's rates, etc. Thus, just one-time scanning is not a fruitful activity for the organisation. An organisation needs to constantly monitor and make aware of the upcoming changes.

E. Outlining variables for analysis: Variables are the components responsible for bringing a change in an external environment. Some variables are national minimum wage, GDP, tax policies, competitors' policies, customers' preferences, etc. A strategist must outline all such variables and study them from time to time, so that he could bring the necessary change in the functioning.

F. Usage of different techniques for analysis: Different techniques are being used for a proper environmental analysis, such as benchmarking, scenario building, network methods, etc. The term 'benchmarking' means setting the best standard as per the industry and then comparing company's performance with the set standards. Scenario building is presentation of overall picture of the system of an organisation along with the affecting components. Network method is a complex process which is used to analyse the external environment of the organisation. This method helps in analysing the available opportunities in the market and studying possible threats. A network method also judges how internal strengths and weaknesses will be affected by the external environment. Essential data can be gathered through Delphi method, conceptualising, study and verifiable enquiry method.

G. Forecasting future outcomes: In a business environment analysis, it is necessary to make predictions for future outcomes. A good strategist will always make future predictions of how the environmental components may affect the functioning of the organisation. The assessment of past results can also be made in this step.

H. Formulating strategies: It is also one of the important steps of business environmental analysis. After the assessment of all the above environmental components, an organisation formulates the required strategies for the functioning. As you have already studied above, conduct the SWOT analysis before making an effective strategy. SWOT analysis means analysing the strengths, weaknesses, available opportunities and possible threats of the organisation. There are various ways of formulating or designing a strategy. Internal or core components are being recorded in Strategic Advantages Profiles (SAP). However, external components are being recorded in Environmental Threat and Opportunity Profile (ETOP). Both SAP and ETOP profiles can be compounded into SWOT profile. To evaluate internal and external components, External Factor Evaluation (EFE) matrix is being used by the strategists as a tool.

I. Execution of formulated strategies: After the above steps, a strategist implements and executes upon the formulated strategies. The strategist always evaluates how he had formulated the given strategy and how that can be effectively implemented. He/she also makes the required future predictions. This process is also often referred to the process of SWOT analysis

J. Monitoring: The strategist must keep monitoring the external environment. As an environment keeps on changing, thus, it is necessary to have a continuous look at the changes and bringing the required changes in the plan or strategy.

2.3.2 Techniques of Environmental Analysis

1. SWOT analysis

SWOT analysis refers to the analysis of both the internal and external environments of an organisation. In this term, S stands for Strengths and W stands for Weaknesses. Both these terms are internal components of an organisation. O stands for available Opportunities in the market and T stands for the possible Threats in the market. Both of these are the external components of the organisation.

- **Strengths:** The term 'strengths' basically means the things you are good at or your capabilities. In the organisational context, it means the core competencies or capabilities of an organisation for which it can gain strategic advantages from its competitors. Even if it does not gain any advantages over competitors, it refers to an organisation's capacities in which the organisation is having affirmative aspects. Strength is necessary for every organisation to gain competitive advantages. For example, some organisations have their employees as their strength and some organisations may have low cost of production as their strength.
- **Weaknesses:** Weaknesses are exact opposites of Strengths. While strengths are competitive advantages, weaknesses are competitive disadvantages of an organisation. Weaknesses are responsible for downfall of an organisation. The term 'weakness' also refers to the things in which the organisation is not good. For example, an organisation might not have better marketing strategies in comparison to its competitors. Then, in such a case, marketing would be its weakness.
- **Opportunities:** The term 'opportunity' means a chance to grab on in a positive sense. This is actually a favourable condition or circumstances present in the external environment, which should be grabbed by the organisation, in order to increase its strengths and gaining competitive advantages. A company's strategist must be aware of the coming opportunity in the market, so

that it could grab them on time and could raise revenues and profits; for example, sudden rise in demand of customers, new government policies in the favour of the organisation, emerging technologies, etc.

- **Threats:** The term 'threat' means exposing vulnerability of something which might create an adverse impact. In an external environment, if suddenly or even gradually some changes occur and those are not in favour of the organisation, then these are called threats to the organisation. For example, a changes in preferences of customers, and changes in government policies, which are not in favour of the organisation, are considered as threats to the organisation.

It is not necessary that an organisation has only its one single strength. An organisation might have one or more strengths at one time. More number of strengths would give an organisation more competitive advantages. An organisation might have one or more weaknesses which would degrade its competitive position in the market. The weakness of an organisation would factually hamper the growth of an organisation. The strengths and weaknesses of an organisation could be collectively determined and this combination would create a collective impact on the organisation and it is called a circumstance of synergistic effect. The concept of synergy says that if two things are merged together, then the resulting effect could be greater or lesser. This means when strengths and weaknesses of a company are understood together, then they could create a resulting strength or resulting weakness. This could be better understood as 'two plus two could be either five or three'.

The SWOT analysis is a tool to evaluate the strengths, weaknesses, opportunities and threats of an organisation. Every organisation must do this analysis very effectively, as all these areas are necessary to be understood in detail. A strategy would be formed on the basis of these elements only. Through SWOT analysis, a detailed study could be done about both internal and external factors of an organisation.

2. ETOP analysis

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

3. QUEST analysis

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

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

4. PESTLE analysis

PESTLE is an acronym and it is used as an analytical tool. It stands for the Political, Economic, Social, Technological, Legal and Environmental factors which influence the business environment of an organization.

- It helps in identifying the environmental factors that affect the strategies of the organization. However, it is not necessary that the environmental analysis provides valuable information to the organization. Hence, it becomes important for the organization to go in for a more quantitative approach to get the real data for organizational goals.
- PESTLE analysis helps in identifying the key factors of business and their differential impact on the organization. It also helps in determining the extent to which these factors affect the competitors of the organization. The three key external factors that affect the organizations include short life-span of technology, convergence of customer requirements and access to the resources available globally.

2.3.3 Assessing Risk in a Business Environment

The term ‘risk’ means a situation or circumstance where there is an exposure to danger. Business risk, therefore, means when an organisation is exposed to danger or threat, which could lower its profits or which may hamper the achievement of its targets. Any threat which may harm the normal functioning of an organisation is known as business risk. Any exposed risk could affect the organisation in the following ways:

- It could disrupt normal working.
- It could create an adverse effect on sales or revenue.
- It could defame the brand image.
- It could create an adverse impact on growth.

It is not factually correct every time to blame managers or staff for the risk. A risk to business occurs because of many reasons. Following are the reasons which may cause a business risk:

- Preference of customers, their demand and sales
- Overall per unit cost to the company
- Existing competition in the market
- Economic climate
- Government policies, rules and regulations.

Assessing risk means making an estimate of what level of risk is present in the given business situation. Thus, risk assessment is actually risk measurement. Following steps are to be taken to assess risk:

1. **Define the type of risk:** There are various types of risks that are present in the market, to which a business is exposed. The first step is to identify the types of risks that are present. There are following types of risks present in the market:

- **Financial risks:** Financial risks are risks which affect the financial or monetary position of an organisation. Financial risks include credit risk, liquidity risk, asset-based risk, foreign investment risk, equity risk, currency risk, etc. In these types of risks, the organisation faces money crisis.
- **Marketing risks:** When an organisation fails to make a better marketing strategy for its products or services, it faces such types of risks. These include a failure of marketing of products or services, risk, risk related to product development, product pricing, product promotion, etc.

- **Operational risks**: When an organisation fails to properly operate its day- to-day functioning, it is known as operational risk. In these kinds of risks, employees are not able to work properly for the organisation. For example, risk of electricity cut off, risk of disruption in the Internet, etc.
- **Strategic risks:** When there is a failure in proper strategy making or when strategy is not updated as per the changes in the environment, such situation is known as strategic risk; for example, failure of management in adapting new technology, failure in meeting customers' demands, etc.
- **Workforce risks:** When the workforce of the organisation does not perform its duties well or does not work for the organisation, it is known as workforce risks; for example, strike of labourers, continuous absence of labourers or employees, etc.

2. Estimate the likelihood of occurring: After analysing all types of risks an organisation needs to estimate what are the fair chances of each risk occurring in the future. Various techniques like percentages or probability can be used to estimate the chances of occurrence of risk. For example, there are twenty-five percent chances that the demand is going to fall down in the coming time for the said project.

3. Estimate the loss: After identifying the risks, the organisation has to estimate the chances of its occurrence and the extent of loss it may cause to the organisation. For example, there are twenty-five percent chances that the demand may fall for the said project and, consequently, the organisation may suffer loss of revenue of one million rupees in one month of time.

4. Decide whether or not to take the risk: The organisation has come to a rough figure of how much loss it is going to suffer if the risk proves to be right. Organisation takes decision whether or not that risk is worthy to take. In the above example, there are seventy-five percent chances that the demand would not fall and if the demand rises, the organisation would have profit of ten million rupees in the coming month. So, considering all these factors, project is worthy to be taken.

2.4 Check Your Progress

1. In following options, what is an opportunity for a business?

A. A business has poor marketing strategies

B. A business has a good labour force

C. A business is exposed to a low demand for its products

D. A business can have a high demands of its products in the coming future

2. Out of the following options, which one is strength of a business?

A. A business has poor marketing strategies

B. A business has a good labour force

C. A business is exposed to low demand of a product

D. A business can have high demand of its product in the coming future.

3.________ is a situation of exposure to danger.

4. Failure to adapt to a new technology is ________ risk.

2.5 Summary

- Environmental screening is a process in which an organisation makes an assessment or analysis of all the components of the environment and screens their impact on its functioning, stability, growth and profits.
- The environmental analysis process is not a static process. It is a dynamic process which may change from one business to another.
- SWOT analysis refers to the analysis of both internal and external environments of an organisation. In this term, S stands for Strengths and W stands for Weaknesses. Both these terms are internal components of an organisation. O stands for available Opportunities of the market and T stands for possible Threats in the market. Both these are external components.
- Business risk means when an organisation is exposed to danger or threat which could lower its profits or which may hamper the achievement of target. Any threat which may harm the normal functioning of an organisation is known as business risk.
- Assessing risk means making an estimate of what level of risk is present in the given business situation. Thus, risk assessment is actually risk measurement.

2.6 Keywords

Environment: The surroundings around anything/ an organisation.

Screening: The process of evaluation or assessment of anything.

Scanning: The process of analysing all the parts of anything in order to develop its feature.

Monitoring: The process of keeping a constant eye on something to check on a regular basis.

Strengths: The ability in which someone performs very well.

Weakness: The inability due to which someone performs very badly.

Opportunity: A chance available in a given situation.

Threat: Threat means exposing vulnerability of something which might create an adverse impact.

Risk: An exposure of something to a possible loss.

2.7 CASE STUDY: SWOT ANALYSIS OF APPLE INC.

SWOT analysis is basically an analysis of company or organisation's strengths, weaknesses, opportunities and threats. Here is a case study of Apple Inc. on SWOT analysis.

Apple had launched its new phone iPhone 7 in an event. It has also expanded its business boundary by launching Apple watch, and Bluetooth headphones, also known as AirPod.

Apple's strengths: iPhones have created a unique brand identity for themselves. People are willingly ready to spend lakhs in the name of iPhone. The logo of Apple is a symbol of status these days. Moreover, Apple's product design is artistic, yet simple, rich and royal and creative too. Apple has customer faith and its brand value has worldwide recognition. Its brand value is so high that most of the Apple's products are often pre-ordered worldwide. Moreover, Apple utilises its image to sell a way of life of imagination, extravagance and smoothness. This is how it advertises its items: Not as a straightforward contraption, yet as a route into designed and planned world. This is why, its revenues and, subsequently, its profit margin is too high in products like Mac Laptop, iPhone, iPad, etc.

Apple's weaknesses: One of the greatest weaknesses of Apple is its high prices of products. Although its prices are high, but it restricts its buyers from upper middle class to high class. Usually, a PC can be bought for $200. On the contrary, Apple's Mac laptop costs around $1100-$1200+. If offered at a sale price, the sales reduce the price of the product by only $50-$100. Only the students are able to get the laptops at discounted prices. If we take globally, then there are a number of lower-class people who couldn't afford to buy Apple products. Apple ignores this class of customers. We can say that this is a great weakness of Apple Inc.

Apple's opportunities: Apple has witnesses a potential advantage in teaming up with various solid and existing brands identified with its commercial centre. With its new AirPods, it has collaborated with Beats earphones to present the new remote Beats X close by its iPhone 7. Moreover, Nintendo is bringing another amusement, Mario Run, to iPhone — consolidating the Apple name with the notable diversion face of Nintendo. This is another incredible brand which could get gigantic numbers from its numerous fans all over the world? Apple's present advancement can be derided, criticised or cheered. In any case, the business openings from working together with other expansive brands over the world will profit the Apple brand monstrously, insofar as it keeps on building up these business connections.

Apple's threats: Ever since Apple Inc has entered in the market, its biggest threat is innovation. It keeps on producing the same kind of products. The regular customer might lose interest after some time. While Apple's structure is smooth and short-sighted, that is actually what makes it simple to imitate. Worldwide stores sell counterfeit renditions of iPhones and iPod contacts which, outwardly, look about indistinguishable. Furthermore, numerous individuals fall for the tricks of 'overly cheap Apple items' sold on the web. Another threat to Apple products is competition. Companies like Samsung have captured the market with the launch of the concept of androids in the market. Apple has heightened its competition by not providing earphones in its new model, iPhone 7, iphone X etc. Moreover, android companies are providing the same facilities at much cheaper rates.

2.8 Self-Assessment Test

1. What is environmental screening?
2. What is importance of environmental screening?
3. What is business environment analysis?
4. State different steps in business environment analysis.
5. What is SWOT analysis?
6. What is risk assessment?
7. How does the PESTLE analysis help in analysing the organizational strategies?

2.9 Answers to Check Your Progress

1. D

2. B

3. Risk

4. Strategic

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Public Private Partnership

STRUCTURE

3.0 Learning Objectives

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3.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know the meaning of public private partnership, and its models.
- Understand the objectives of public private partnership.
- Know the barriers, key issue and challenges for public private partnership.
- Understand the advantages and disadvantages of public private partnership.

3.1 Introduction

Public Private Partnership (PPP or 3P) have been highly controversial as funding tools, largely over concerns that public return on investment is lower than returns for the private fund provider. PPPs are closely related to concepts such as privatization and the contracting out of government services. The lack of a shared understanding of what a PPP is and the secrecy surrounding their financial details makes the process of evaluating whether PPPs have been successful complex. PPP advocates highlight the sharing of risk and the development of innovation, while critics decry their higher costs and issues of accountability. Evidence of PPP performance in terms of value for money and efficiency, for example, is mixed and often unavailable.

3.2 Public Private Partnership: Meaning

Public-private partnerships (PPPs) are a mechanism for government to procure and implement public infrastructure and/or services using the resources and expertise of the private sector. Where governments are facing ageing or lack of infrastructure and require more efficient services, a partnership with the private sector can help foster new solutions and bring finance. PPPs combine the skills and resources of both the public and private sectors through sharing of risks and responsibilities. This enables governments to benefit from the expertise of the private sector, and allows them to focus instead on policy, planning and regulation by delegating day-to-day operations. A public-private partnership (PPP) involves the private sector in aspects of the provision of infrastructure assets or of new or existing infrastructure services that have traditionally been provided by the government.

While there is no single definition of PPPs, PPP broadly refer to long-term, contractual partnerships between the public and private sector agencies, specifically targeted towards financing, designing, implementing, and operating infrastructure facilities and services that were traditionally provided by the public sector. These collaborative ventures are built around the expertise and capacity of the project partners and are based on a contractual agreement, which ensures appropriate and mutually agreed allocation of resources, risks and returns.

The Government of India defines a Public Private Partnership as: “Public Private Partnership (PPP) Project means a project based on a contract or concession agreement, between a Government or statutory entity on the one side and a private sector company on the other side, for delivering an infrastructure service on payment of user charges.” In order to achieve a successful PPP, a careful analysis of the long-term development objectives and risk allocation is essential. The legal and institutional framework in the country also needs to support this new model of service delivery and provide effective governance and monitoring mechanisms for PPPs. A well-drafted PPP agreement for the project should clearly allocate risks and responsibilities. This definition provides the broad framework under which different kind of PPP models can be chosen from. A comprehensive listing of various models is discussed in this report.

3.2.1 Public Private Partnership Models

The range of options for public-private partnerships has expanded enormously over the past 30 years. Agreements between public and private entities take many shapes and sizes for both new and existing services. At one end of the spectrum is a management or service contract, where a private company is paid a fee for a service. At the other end PPP is full privatization or divestiture (outright sale), where a government sells assets to a private company. Outsourcing has become another popular option; here a private company might handle an aspect of service, such as billing, metering, transport, or even cleaning. Hybrid models of public-private partnership have seen explosive growth in recent years, especially with the development of a more diversified pool of emerging market investors and operators with local expertise. These models often rely on simpler contractual arrangements and blend public and private money to diversify risks.

A large variety of PPP formats have been documented as:

Design Build (DB): Under this model, the government contracts with a private partner to design and build a facility in accordance with the requirements set by the government. After completing the facility, the government assumes responsibility for operating and maintaining the facility. This method of procurement is also referred to as Build-Transfer (BT).

Design Build Maintain (DBM): This model is similar to Design-Build except that the private sector also maintains the facility. The public sector retains responsibility for operations.

Design Build Operate (DBO): Under this model, the private sector designs and builds a facility. Once the facility is completed, the title for the new facility is transferred to the public sector, while the private sector operates the facility for a specified period. This procurement model is also referred to as Build-Transfer-Operate (BTO).

Design Build Operate Maintain (DBOM): This model combines the responsibilities of design-build procurements with the operations and maintenance of a facility for a specified period by a private sector partner. At the end of that period, the operation of the facility is transferred back to the public sector. This method of procurement is also referred to as Build Operate-Transfer (BOT).

Build Own Operate Transfer (BOOT): The government grants a franchise to a private partner to finance, design, build and operate a facility for a specific period of time. Ownership of the facility is transferred back to the public sector at the end of that period.

Build Own Operate (BOO): The government grants the right to finance, design, build, operate and maintain a project to a private entity, which retains ownership of the project. The private entity is not required to transfer the facility back to the government.

Design-Build-Finance-Operate/Maintain (DBFO, DBFM or DBFO/M): Under this model, the private sector designs, builds, finances, operates and/or maintains a new facility under a long-term lease. At the end of the lease term, the facility is transferred to the public sector. In some countries, DBFO/M covers both BOO and BOOT. PPPs can also be used for existing services and facilities in addition to new ones. Some of these models are described below.

- **Service contract:** The government contracts with a private entity to provide services the government previously performed.

- **Management contract:** A management contract differs from a service contract in that the private entity is responsible for all aspects of operations and maintenance of the facility under contract.

• **Lease:** The government grants a private entity a leasehold interest in an asset. The private partner operates and maintains the asset in accordance with the terms of the lease.

• **Concession:** The government grants a private entity exclusive right to provide operate and maintain an asset over a long period of time in accordance with performance requirements set forth by the government. The public sector retains ownership of the original asset, while the private operator retains ownership over any improvements made during the concession period.

• **Divesture:** The government transfers an asset, either in part or in full, to the private sector. Generally the government will include certain conditions with the sale of the asset to ensure that improvements are made and citizens continue to be served.

3.2.2 Types of PPP Arrangement

Among different possible classifications, PPPs can be categorized into two types: a PPP of a purely contractual nature and a PPP of an institutional nature. This categorization is adopted by the European Union and by many other countries. In a PPP of a purely contractual nature, the partnership between the public and the private sector is based solely on contractual links, whereas in a PPP of an institutional nature there is cooperation between the public and the private sectors within a distinct entity. Both arrangements involve delegated management of the traditional public sector activities to the private sector. In the first type of PPP, the rights and obligations are regulated by an administrative contract or series of contracts. In the second, these are guaranteed by the company's statutes and by the shareholder agreement between public and private parties. There is contractual regulation in both situations.

Contractual PPPs*:* In the scope of purely contractual PPP, there are different kinds of arrangements that depend on the characteristics of the contractual relationship and delegation of tasks to the private partner. Some of the best known models are in the development of urban infrastructure facilities: the associated provision of services corresponds to the "concession model". In this situation there is a direct link between the private partner and the final user: the private partner provides a service to the public "in place of", though under the control of, a public authority. The private party assumes all the responsibility relative to the construction, operation and maintenance of the infrastructure assets, charging users for the service. Usually the concession model is associated with long contractual periods, matching the long asset life of infrastructure.

An important variant of the contractual PPP relates to infrastructure systems where it becomes necessary to transfer funds from the government or other external entities (e.g. donors) to assure their economic-financial balance. This model, known as PFI (private finance initiative), was initially aimed at sectors such as health (hospitals) or education (schools) where there was a periodical payment (monthly or annual) to the private partner for making that infrastructure available. This model has been extended to many other sectors (e.g. in transportation, shadow tolls) and can perform a valuable role both in developing countries where cost recovery through users is socially complicated and in segments of the urban infrastructure systems production process (e.g. water or wastewater treatment plants). A plethora of different kinds of contractual PPPs and new variations emerge continuously as each PPP contract responds to very precise needs. Some of the most frequent labels are BOT (build, operate and transfer); that is, the private partner builds and operates the infrastructure, transferring it for the public partner at the end of the contract. BOOT (build, own, operate, and transfer) is the organizational form when infrastructure ownership is also private during the contract term; DBOT or DBOOT would be the acronyms if arrangements further include the responsibility for the design of the infrastructure project as well. The concession model is also, sometimes, separated into public works and public service concessions, depending on the business (contract) value of the infrastructure or service provision, respectively. In fact, many concessions are of mixed type: there is a balance between both activities.

Leasing/afterimages: A variation of the PPP concession model is afterimage (or leasing) contracts. This model is analogous to the concession model, except for investment in and financing of the infrastructure assets, which are under the responsibility of the public and not the private partner. This form of contractual PPP can be appropriate in situations where assets have already been building and it is not necessary to make investments in infrastructure or where the risk premium of transferring this responsibility to the private partner is very high. The commercial risk continues, a priori, to be allocated to the private party and the contract length is often shorter than in the case of a concession (in general between 10 and 18 years).

Delegated management contracts: Another format of contractual PPP is delegated management contracts, which are at the boundary of PPPs depending on the risk transferred in each situation. They encompass relatively short periods (3 to 8 years); the payment of the private partner is done by the public partner (rather than involving revenue collection directly from the end consumer), often according to the service delivered (e.g., drinking water treatment plant operation is paid based on the quantity of drinking water treated). This arrangement is basically service provision through outsourcing; although some of the PPP principles apply to this case (e.g. output orientation), it is not a "true partnership". Delegated management contracts are often used in preparation for more fully involved PPP contracts, e.g. long-term concession contracts, or even divestitures.

Institutionalized PPPs: Institutionalized PPPs (mixed companies) imply the establishment of an entity held jointly by the public partner and the private partner. The joint entity thus has the responsibility of ensuring the delivery of a work or service for the benefit of the public. The establishment of an institutionalized PPP can be done either through an entity where public and private sectors jointly participate or through private sector buying and owning shares in an existing public company. Usually the public partner controls the company either as shareholder or through special rights it may hold and the private partner operates the service. This kind of cooperation between public and private partners can be very positive since the public partner keeps control over the infrastructure service, it may allow for service adjustment over time according to changing needs, conflicts are resolved internally and the public partner acquires know-how from the joint work with the private party.

Notwithstanding the existence of a sector regulator, what regulate the PPP are the company statutes and the shareholder agreement. The statutes of the company establish common rules for the organization, governance and operation of the company. The shareholder agreement regulates relationships between partners (public and private). This last document is central to the performance of the entity. It establishes the minimum financial participation required by the private partner, risk sharing arrangement, the procedures to be used in a deadlock situation, and the possibility of a call-option by the public entity, placing pressure on partners to perform well during the PPP contract period. In the same way there are several advantages in the fact that the public partner can have a more active and participating role in this PPP model, being able to limit conflicts and better solve difficulties, the institution is susceptible to "capture". Due to close contact or identification with partner concerns, those representing the public might become excessively attached to the objectives of the private partner, thus harming the public interest.

3.2.3 Objectives of Public Private Partnership

While many governments have reformed their utilities without private participation, some seek finance and expertise from private companies to ease fiscal constraints and increase efficiency. By engaging the private sector and giving it defined responsibilities; governments can broaden their options for delivering better services. PPP's can emerge as a win-win for the public as well as the private sector and most importantly, the citizen. PPP's seek to address limitations of both the sectors and the main reasons for PPP projects' increased importance are:

• **Limited resources and finances:** Limitations of government resources and limited capacity to meet the infrastructure gap.

• **Need for different institutional mechanisms:** This includes incorporating the spirit of private efficiency into providing services for the public.

• **Equitable risk allocation and mitigation:** Shared risk allocation is a principal feature of a PPP project. PPP projects allow sharing of different kinds of risks between the private and public sector.

• **Complementary roles and drivers:** Putting it somewhat simplistically, the public sector is predominantly driven by the 'public good', the private sector by 'profit'. PPP projects allow both the sectors to cooperate and make these seemingly contradictory goals work together. As an example, land acquisition and environmental clearances are best obtained by governments, and the private sector can deliver much faster, if such clearances are handled by the government.

According to Asian Development Bank, the three main needs that motivate governments to enter into PPP's for infrastructure are:

1. To attract private capital investment (often to either supplement public resources or release them for other public needs);

2. To increase efficiency and use available resources more effectively; and

3. To reform sectors through a reallocation of roles, incentives, and accountability.

3.2.4 Key Issues and Challenges for PPP in India

There are many challenges for implementation of public-private partnership projects:

• **Commercial viability** - Projects as water supply and sanitation projects are yet to demonstrate their commercial viability to the public.

• **Contractual and capacities imbalance -** Insufficient experience of the partners, particularly of the public sector while contracting such projects, where we can notice an informational asymmetry operating in favor of private companies, which naturally use their endeavor and potential to negotiate better conditions for themselves.

• **Hidden debt -** From the macro-economic point of view, we can see a substantial disadvantage in the fact that as a consequence of the long-term character of PPP projects, the mandatory expenses grow and the hidden debt arises, and this debt will exist for a lot of years, and thus it can affect negatively the fighting power of the future governments and burden significantly the future generations.

• **Long gestation period -** Generally the preparation of individual PPP Projects may take up to 2- 3 years (depending on project size and complexity). This long gestation period along with its attendant uncertainties are a big dampener for private sector enthusiasm.

• **Breaking of partnerships -** Considerably negative financial impacts in the case the partnership has to be repudiated.

• **Transfer of risk -** From the private sector to the public sector possible a new set of risks, e.g. possible risk of bankruptcy of the private player.

• **Focus on economic benefits -** PPP Projects tend to focus on the economic aspects of the project, sometimes to the detriment of social and environmental aspects.

3.2.5 Barriers to Public Private Partnership (PPP)

Mr. P. Chidambaram (Finance Minister in 2006), in a major PPP Conference listed four major weaknesses in PPP development in India as:

- **Weakness in enabling policy and regulatory framework:** Substantial work need to be done in making sector policies and regulations PPP friendly. A large number of these projects are in the States and without the active participation of the States it would not be possible to achieve satisfactory results.
- **Lack of long term instruments:** The market presently does not have adequate instruments and capacity to meet the long-term equity and debt financing needed by infrastructure projects.
- **Lack of bankable projects:** Finding credible and viably structured projects continues to be a challenge. There is a lack of shelf of credible, bankable infrastructure projects, which could be offered for financing to the private sector. Some initiatives have been taken both at the central as well as the states' level to develop PPP projects these tend to be isolated cases and have demonstrated a marked lack of consistency.
- **Limited capacity to manage PPP in public sector:** There is also lack of capacity in public institutions and officials to manage the PPP process. Since these projects involve long term contracts covering the life cycle of the infrastructure asset being created, it is necessary to manage this process to maximize returns to all the stakeholders.
- In addition to these, the other obstacles include:
- **Lack of political will:** PPP contracts are often seen as government 'selling its jewels'. This myth is perpetuated partly by the political parties for maintaining vested interests, and partly by inefficient or corrupt bureaucracy which is sometimes reluctant to part away with operational control. Paradoxically the honest bureaucrat finds that 'selling' the PPP concept is more hard work than the actual implementation and also makes him / her vulnerable to charges of corruption and nepotism.
- **Varied institutional framework:** Every state has varied institutional framework especially the regulatory framework developed by different states. States like Andhra Pradesh, Gujarat, and Punjab have legislation which clearly defines what infrastructure is and how these infrastructure projects are going to be executed by the private sector. Other states have differing administrative (instead of legislative) frameworks in place for decision-making. These divergent institutional frameworks, prevents fast tracking of projects since major clearances are still required from GOI who have to deal with this multiplicity.
- **Non standardization of procurement procedures:** Prequalification, bidding, and procurement procedures are not standardized across States, sometimes not even across Ministries. This again slows down the clearances and approval procedures.
- **Need for balancing transparency with expediency:** Demand for ensuring transparent relationships and transactions, whether while selecting a partner, or defining the terms and conditions, competences and responsibilities or while concluding contracts itself makes the PPP contracts' conclusion a very arduous

and time consuming process. While RTI is an excellent means to ensure transparency, its misuse in some cases and the perceived threat of persecution, also delays PPP project design and implementation.

- **Absence of rigorous project development**: A key impediment to successful commercialization of projects in India has been the absence of rigorous project development. Many of the projects bid out by the government have been ill defined, inadequately structured, and unsuitable for PPP.
- **Public sector capacity to successfully execute PPPs**: Perhaps the single biggest reason for delays and sub optimal framing of PPP projects has been the public sector's limited skills set and experience in drafting balanced PPP contracts and concession agreements.
- **Risk and return concerns**: Need to address the Risk and Return Concerns of Foreign Investors. Financing terms generally mean that PPP's are more exposed to interest rate volatility— this causes concern in a period of rising rates and reduced liquidity.
- **Decentralization and devolution**: Water Supply and Sanitation (WSS) is a state/municipal subject in India, whereby the Constitution mandates that the responsibility of providing WSS services should vest with the respective city Government. However, given the traditional division of roles and responsibilities, and budget flow mechanisms, this responsibility has not been fully transferred to local bodies in many states. This results in a multi-layered political structure being involved in decision-making in the sector. This is further complicated by political economy issues in the designing of PPP projects in the WSS sector.

3.3 Advantages and Disadvantages of Public-Private Partnerships

Partnerships between private companies and government provide advantages to both parties. Private-sector technology and innovation, for example, can help to provide better public services through improved operational efficiency. The public sector, for its part, provides incentives for the private sector to deliver projects on time and within budget. In addition, creating economic diversification makes the country more competitive in facilitating its infrastructure base and boosting associated construction, equipment, support services, and other businesses.

There are downsides too. Physical infrastructure, such as roads or railways, involves construction risks. If the product is not delivered on time, exceeds cost estimates, or has technical defects, the private partner typically bears the burden. In addition, the private partner faces availability risk if it cannot provide the service promised. A company may not meet safety or other relevant quality standards, for example, when running a prison, hospital, or school. Demand risk occurs when there are fewer users than expected for the service or infrastructure, such as toll roads, bridges, or tunnels. If the public partner agreed to pay a minimum fee no matter the demand, that partner bears the risk.

3.4 Public-Private Partnership: Examples

Public-private partnerships are typically found in transport infrastructure such as highways, airports, railroads, bridges, and tunnels. Examples of municipal and environmental infrastructure include water and wastewater facilities. Public service accommodations include school buildings, prisons, student dormitories, and entertainment or sports facilities.

3.5 Check Your Progress

Multiple Choice Questions:

1. The main characteristic of PPP is

A. long term (sometimes up to 30 years) service provisions

B. The transfer of risks to the private sector

C. different forms of long-term contracts drawn up between legal entities and public authorities.

D. All of the above

2. What is the ingredient common to all types of PPP

A. The public sector transfers the overall responsibility to provide the public service

B. value for money will be the basic criterion for the public sector

C. No balanced sharing of the risks and gains between the public sector and private

D. none of the above

3. The National highway projects contracted out by NHAI under PPP is an example of

A. LOT

B. BOOT

C. BOT

D. DBFO

4. The common characteristic of Institutional PPPs and contractual PPPs is

A. The operation of a facility is contracted out to another private party

B. The users pay for the facility availed and such charges accrue to the private sector partner

C. The public sector usually designs, constructs and operate PPP

D. None of the above

5. What distinguishes each type of PPP model from one another is

A. The degree of risk and responsibility borne by the private sector partner

B. The degree of risk and responsibility borne by the public sector

C. The private sector partner will bring in most of the investment requirements

D. None of the above

6. The main difference between PPP and privatization is

A. There is no permanent transfer of ownership of assets to private partner

B. The responsibility and accountability to deliver the goods and services remains with the state/public sector

C. Besides the transfer of ownership to the private sector, the accountability is also shifted to the purchaser

D. None of the above

7. Find out the incorrect statement

A. The private sector partner should equally gain from the innovation brought about by it

B. The private entrepreneurs come into the PPP arrangements primarily with profit motive

C. PPP projects are aimed to provide 'improved' public services by transferring the risks to the private sector

D. None of the above

3.6 Summary

Public-private partnership (PPP), partnership between an agency of the government and the private sector in the delivery of goods or services to the public. Areas of public policy in which public-private partnerships (PPPs) have been implemented include a wide range of social services, public transportation, and environmental and waste-disposal services. Although PPPs are an ancient phenomenon but were not studied seriously by scholars until the late 1980s, when they began to be adopted in public administration and management in both developed and developing countries. PPPs have been a topic of political controversy and scholarly debate, especially regarding the advantages and disadvantages of PPPs in comparison with traditional government-run services and the nature of the partnerships they bring about.

In its most basic sense, a partnership is any business or institutional association within which joint activity takes place. A PPP exists from the moment one or more public organizations agree to act in concert with one or more private organizations. PPPs embrace public-sector partnerships with both businesses and organizations in civil society, including community organizations, voluntary organizations, and nongovernmental organizations (NGOs). PPPs have been widely adopted. Indeed, in many developed countries (e.g., the United States, the United Kingdom, France, Italy, and the Netherlands), their use has been mandated through legislation. In France, for example, the PPP concept is of quite long standing, and, since the 1980s, PPPs have been implemented in almost all areas of public policy.

3.7 Keywords

Public Private Partnership (PPP, 3P): Public-private partnerships (PPPs) are a mechanism for government to procure and implement public infrastructure and/or services using the resources and expertise of the private sector.

DBO: Design Build Operate

BOOT: Build Own Operate Transfer

BOO: Build Own Operate

DBOM: Design Build Operate Maintain

3.8 Self-Assessment Test

Q.1 Explain about public private partnership and different models of public private partnership.

Q.2 Write the advantages and disadvantages of public private partnership.

Q.3 Explain about main barriers and key issues for PPP in India.

3.9 Answer to Check Your Progress

1. (D), 2. (B), 3. (C), 4. (B), 5. (A), 6. (B), 7. (C)

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Course: Business Environment	
Course Code: **BC 605**	Author: **Dr. Rajiv Kumar**
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Concepts of Economic System

STRUCTURE

4.0 Learning Objectives

4.1 Introduction

4.2 Economic System: Meaning

4.2.1 Kinds of Economic Systems

4.2.2 Difference between Capitalist, Socialist and Mixed Economy

4.3 Basic Problems of an Economy and the Role of Government

4.4 Indian Economic System

4.5 Check Your Progress

4.6 Summary

4.7 Keywords

4.8 Self-Assessment Test

4.9 Answer to Check Your Progress

4.10 References/Suggested Readings

4.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know the meaning of economic system
- Know the types of economic system and differences in these economic systems

- Understand the advantages and disadvantages of different type economic systems
- Know the Indian economic system
- Understand the Govt. role in each type of economic system

4.1 Introduction

A business's success depends in part on the economic system of the country where it is located and where its sells its products/services. A nation's economic system is the combination of policies, laws, and choices made by its government to establish the systems that determine what goods and services are produced and how they are allocated. Economics is the study of how a society uses scarce resources to produce and distribute goods and services. The resources of a person, a firm, or a nation are limited. Hence, economics is the study of choices—what people, firms, or nations choose from among the available resources. Every economy is concerned with what types and amounts of goods and services should be produced, how they should be produced, and for whom. These decisions are made by the marketplace, the government, or both. In India, the government and the free-market system work together in the economy. An economic system, or economic order, 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. As such, an economic system is a type of social system. The mode of production is a related concept. All economic systems have three basic questions to ask: what to produce, how to produce and in what quantities and who receives the output of production (for whom to produce).You probably know more about economics than you realize. Every day, many news stories deal with economic matters: a union wins wage increases at General Motors, Reserve Bank of India lowers interest rates, Nifty has a record day, the president proposes a cut in income taxes, consumer spending rises as the economy grows, or retail prices are on the rise, to mention just a few examples.

4.2 Economic System: Meaning

Economic system is a social organism through which people make their living. It is constituted of all those individuals, households, farms, firms, factories, banks and government, which act and interact to produce and consume goods and services. Individuals and households put their resources (land, labour, capital and entrepreneurial skill) to one or more of their alternative uses and make their living; firms buy factors of production and organize them in the process of production, produce goods and services, and sell them to their users to make projects. Consumers are able to get the goods and services of their requirement; producers are able to produce and sell various kinds of products in appropriate quantities and so on. The system is operated by, what Adam Smith called “invisible hands”, the market forces of demand and supply. An economic system is a mechanism with the help of which the government’s plan and allocate accessible services, resources, and commodities across the country. Economic systems manage elements of production, combining wealth, labor, physical resources, and business people. An economic system incorporates many companies, agencies, objects, models, as well as for deciding procedures.

A modern economic system is enormously complex. Millions of people participate and contribute to its working in different capacities – as producers, traders, workers, consumers and financers and so on. Thousands of people are involved in production and distribution of single commodity. A community, before it reaches its final consumer, passes through a complex process of production and through a number of intermediary hands.

4.2.1 Kinds of Economic Systems

1. Free Enterprise / Market Economy

This economic system works on the principle of Laissez Faire system, i.e., the least interference by the government or any external force. The primary role of the government, if any, is to ensure free working of the economy by removing obstacles to free competition. This economic system is also known as capitalism or free market economic system. A free Enterprise Economy is characterized as follows:

- Means of production are privately owned by the people who acquire and posses them.
- Private gains are the main motivating and guiding force for carrying out economic activities.
- Both consumers and firms enjoy the freedom of choice; consumers have the freedom to consume what they want to and firms have the choice to produce what they want to.
- The factor owners enjoy the freedom of occupational choice, i.e., they are free to use their resources in any legal business or occupation;
- There exists a high degree of competition in both commodity and factor markets.

- There is least interference by the government in the economic activities of the people; the government is in fact supposed to limit its traditional functions viz, to defence, police, justice, some financial organizations and public utility services.

Advantages of a Free Enterprise/ Market Economy

- Consumers pay the highest price they want to, and businesses only produce profitable goods and services. There is a lot of incentive for entrepreneurship.
- This competition for resources leads to the most efficient use of the factors of production since businesses are very competitive.
- Businesses invest heavily in research and development. There is an incentive for constant innovation as companies compete to provide better products for consumers.

Disadvantages of a Free Enterprise/Market Economy

- Due to the fiercely competitive nature of a free market, businesses will not care for the disadvantaged like the elderly or disabled. This lack of focus on societal benefit leads to higher income inequality.
- Since the market is driven solely by self-interest, economic needs have a priority over social and human needs like providing healthcare for the poor. Consumers can also be exploited by monopolies.

2. Government Controlled Economy / Command Economy

The government-controlled economies are also called as Command, Centrally planned or Socialist economies. Such economies are, in contradistinction to the free enterprise economies, controlled, regulated and managed by the government agencies. The other features of a pure socialist economy are:

- Means of production are owned by the society or by the state in the name of the community private ownership of factors and property is abolished;
- Social welfare is the guiding factor for economic activities – private gains, motivations and initiatives are absent,
- Freedom of choice for the consumers is curbed to what society can afford for all, and
- The role of market forces and competition is eliminated by law.

Advantages of Command Economic Systems

- If executed correctly, the government can mobilize resources on a massive scale. This mobility can provide jobs for almost all of the citizens.
- The government can focus on the good of society rather than an individual. This focus could lead to more efficient use of resources.

Disadvantages of Command Economic Systems

- It is hard for central planners to provide for everyone's needs. This challenge forces the government to ration because it cannot calculate demand since it sets prices.
- There is a lack of innovation since there is no need to take any risk. Workers are also forced to pursue jobs the government deems fit.

3. Mixed Economy

A mixed economy is one in which there exist both government and private economic systems. It is supposed to combine good elements of both free enterprise and socialist economies. A mixed economy is widely known as one, which had both "public sector" (the government economy) and "private sector" (the private economy). The private sector has features of a free enterprise economy and the public sector has features of socialist economy. It is important to note here that most economies in the world today are Mixed Economies.

There are two different forms of the Mixed Economies.

Mixed Capitalist Economies

A mixed Capitalist economy is a variant of the free enterprise economic system. To this category fall the highly developed nations like the United States, U.K., France, Japan etc. though these economies have a very large government sector, their private sectors work on the principles of the free enterprise system. The government plays a significant role in preserving capitalist mode of production, ensuring a workable competition in factor and product markets, providing infrastructure for promotion of private sector economic activities.

Mixed Socialist Economies

Mixed Socialist Economies belong the countries which have adopted “socialist pattern of society: and economic planning as he means of growth and social justice (e.g. India) and the former communist countries (e.g. Russia and China) which have of late carried out drastic economic reforms and liberalized their economies for private entrepreneurship. The government of these countries takes upon themselves to control and regulate the private sector activities in accordance with the plan objectives.

Advantages of Mixed Economies

- There is less government intervention than a command economy. This results in private businesses that can run more efficiently and cut costs down than a government entity might.
- The government can intervene to correct market failures. For example, most governments will come in and break up large companies if they abuse monopoly power. Another example could be the taxation of harmful products like cigarettes to reduce a negative externality of consumption.
- Governments can create safety net programs like healthcare or social security.
- In a mixed economy, governments can use taxation policies to redistribute income and reduce inequality.

Disadvantages of Mixed Economies

- There are criticisms from both sides arguing that sometimes there is too much government intervention, and sometimes there isn’t enough.
- A common problem is that the state run industries are often subsidized by the government and run into large debts because they are uncompetitive.

4.2.2 Difference between Capitalist, Socialist and Mixed Economy

Basis	**Capitalist Economy**	**Socialist Economy**	**Mixed Economy**
Ownership of Property	Private ownership	Public ownership	Both public and private ownership

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 central planning authority and demand and supply.
Motive of Production	Profit motive	Social welfare	The 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	Exist only in the private sector
Distribution of income	Very Unequal	Quite Equal	Considerable inequalities exist.

4.3 Basic Problems of an Economy and the Role of Government

Whatever the nature of the economic system, all types of economies have certain common basic problems. The major economic problems faced by an economy may be classified into two broad groups: (i) micro-economic problems called basic problems, which are related to the working of the constituents of the economic system; and (ii) macro-economic problems related to the growth, stability, and management of the economy as a whole.

The way the basic problems of an economy are solved depends on the nature of the economy. While in a socialist economy, problems are solved by the government agencies, like central planning authority, in a free enterprise or mixed capitalist economy this task is performed by the Price Mechanism or Market

Mechanism. Though free enterprise system is capable of bringing economic growth, it does not ensure a stable, sustained, and balanced growth. It becomes therefore inevitable for the government to intervene fair competition, and help the economy in achieving its goals – efficiency, stability, growth and economic justice.

Now, the question arises as to what should be the appropriate role of the government in economic management of the country or what should be the form, nature and extent of government's interference with market mechanism. Nevertheless, the economic role of the government can be broadly categorized on the basis of the three economic systems which presently prevail in the world, viz., Capitalist System or Free Enterprise System, Socialist System, and the Mixed-Economy System.

- **Capital Society**: In this system, the primary role of the government are: (i) to preserve and promote free market mechanism wherever it is possible to ensure a workable competition, (ii) to remove all unnecessary restrictions on the free operation of competitive market, and (iii) to provide playground and rules of the market game through necessary interventions and controls so that free competition can work effectively. It may be inferred that the government's role in a capitalist society is supposed to be limited to (a) restoration and promotion of necessary conditions for efficient working of free market mechanism; and (b) to enter those areas of production and distribution in which private entrepreneurship is lacking or is inefficient.
- **Socialist Economy**: In contract with the capitalist system, the role of government in a Socialist economy is much more exhaustive. While in the former, the government is supposed to play a limited role in the economic sphere, in the latter, it exercises comprehensive control on almost all economic activities. In the socialist system, not only there is a complete disregard for free enterprise and market mechanism but also these systems are abolished by law. The private ownership of factors of production is replaced by the State ownership. All economic activities are centrally planned, controlled and regulated by the State. All decisions regarding production resources, allocation, employment, pricing etc., are centralized in the hands of government or the Central Planning Authority.
- **Mixed Economy**: In this system, a major part of the economy, the private sector, is allowed to function on the principles of free enterprise system or free market mechanism within a broad political and economic policy framework. The other part of the economy, the public sector, is

organized and managed along the socialist pattern. The public sector is created by reserving certain industries, trade, services, and activities for the government control and management. The government prevents by an ordinance the entry of private capital into the industries reserved for the public sector. Another way of creating or expanding the public sector is nationalization of existing industries. The promotion, control and management of the public sector industries are the sole responsibility of the State. Apart from controlling and managing the public sector industries the government controls and regulates the private sector through its industrial, monetary and fiscal policies. If necessary, direct controls are also imposed.

4.4 Indian Economic System

The economy in India today resembles a capitalist economy with certain modifications. Most economies in the world exists somewhere between a market economy and a centrally planned economy – India is one of these countries that has a mixed economy with several characteristics of a market economy. India tries to change the structure of the capitalist economy to make it more appropriate for model economy situations.

As mentioned previously, India is a combination of a Socialist and a Capitalist economy. This economic system was adopted after independence with the intention of procuring the advantages of both systems while avoiding the disadvantages. The productive activities in India are divided between the government (public sector) and the people (private sector). Some examples of industries which are placed in the public sector include: the basic industries, the capital goods industries and the heavy industries whereas light industries and consumer goods industries are placed in the private sector. While the activities of the public sector are guided by welfare, the activities of the private sector are guided by profit. This creates balance in the economy as it ensures the acquisition of profit with a high level of public welfare. The public sectors are completely directed by the government whereas the private sectors are indirectly controlled by the government.

In a mixed economy, or a modified free enterprise system, private property is owned by individuals, corporations or the government. The government sets regulations which affect private property. Additionally, the government owns schools, parks, and real estate. In India, almost the entire agricultural sector is under private ownership. However, in the non-agricultural sector, three quarters of the industries are also in the private sector. Wholesale and retail trade is part of the private sector as well as air transportation which is rapidly being privatized.

The role of the public sector is supportive, so the public sector is expected to build the infrastructure which is used by the private sector. The public sector also develops the basic and capital goods industries. Their products are used by the private sector but even in this field also fast moving towards privatization. The state intervenes in any productive activity with the intention of making it more community friendly. If it is found that the private sector is cornering the stocks of a commodity and exploiting the consumers, the state setup its own units to produce the commodity and augment its supply. The public sector mainly specialized in the production of public utilities such as local transport, supply of cooking gas, supply of water and such other commodities which enter into the common budget. The government also undertakes purchase and sale of necessaries of life so as to protect the vulnerable sections of the community against an excessive rise in prices.

To conclude, a mixed economy is crucial for a developing economy like India in its initial stages. But as the economy develops the private sector rise into prominence and the mixed economy is knowingly (or unknowingly) transformed in to a market regulated economy.

4.5 Check Your Progress

Q.1. What are the central problems of an economy?

a. What to produce?

b. How to produce?

C. For whom to produce?

d. All of the above

Q.2. Which economic system is based on public ownership of property and social welfare?

a. Socialist economy

b. Capitalist economy

c. Mixed economy

d. None of the above

Q.3. Mixed economy operates with motive of __________________

a. Profit.

b. Social Welfare

c. Both (a) and (b)

d. None of the above

Q.4. In __________ type of economy there is no intervention of government.

a. Socialist economy

b. Capitalist economy

c. Mixed economy

d. None of the above

Q.5. In __________ type of economy there is no competition level.

a. Socialist economy

b. Capitalist economy

c. Mixed economy

d. None of the above

4.6 Summary

An economic system is a set of principles on which an economy can run and make decisions about the central problems it faces in the form of scarcity of resources and unlimited wants. The way scarce resources get distributed within an economy determines the type of economic system. There are three different types of Economic Systems; a market economy, a command economy, and a mixed economy. Each type of economy has its own strengths and weaknesses but all economic systems have three basic questions to ask: what to produce, how to produce and in what quantities and who receives the output of production (for whom to produce). Economic systems are grouped into command, market, and mixed systems. A centralized authority influences command systems, while a market system is under the control of forces of demand and supply. Lastly, mixed economies are a combination of command and market systems.

4.7 Keywords

Economic System: An economic system is a mechanism with the help of which the government's plan and allocate accessible services, resources, and commodities across the country.
Free Enterprise Economy: The least interference by the government or any external force.
Government Controlled Economy: Controlled regulated and managed by the government agencies.
Mixed Economy: Combination of free enterprise economy and govt. controlled economy system.
Indian Economic System: India has adopted Mixed economy system.

4.8 Self-Assessment Test

1. What is an economic system? What are the basic problems of an economic system?

2. What are the features of a mixed economic system?

3. "The fundamental economic problem of an economy is the problem of choice". Discuss.

4. Explain the role of government in solving problems arised out of different economic systems.

4.9 Answer to Check Your Progress

1. (d), 2. (a), 3. (c), 4. (b), 5. (a)

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Course: Business Environment	
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ECONOMIC PLANNING IN INDIA

STRUCTURE

5.0 Learning Objective

5.1 Introduction

5.2 Definitions and meanings

5.2.1 Importance and objectives economic planning

5.2.2 Techniques of economic planning

5.2.3 Features of India's five year plans

5.3 Industrial Policy 1991

5.3.1 Objectives of New Industrial Policy

5.3.2 Need of New Industrial Policy OR Financial and Economic Reforms

5.3.3 Major Initiatives of New Industrial Policy

5.3.4 Appraisal of New Industrial Policy

5.3.5 Suggestions for Effectiveness of Industrial Policy

5.4 Check Your Progress

5.5 Summary

5.6 Keywords

5.7 Self-Assessment Test

5.8 Answer to Check Your Progress

5.9 References/Suggested Readings

5.0 Learning Objectives

After going through this lesson, the learners will be able to:

- Understand the concepts of economic planning.
- Understand the advantages along with the feature of economic planning and techniques which are normally used in the economic planning.
- Know the meaning and objectives of New Industrial policy
- Understand the Financial and Economic Reforms
- Know the Need of These Reforms
- Understand the Positive and Negative Impact of New Industrial Policy

5.1 Introduction

It is the era of economic planning. No country in the World can achieve rapid rate of economic growth on the basis of economic activities under taken by the private sector alone. In order to develop the economy, government has also to play its role. Economic planning refers to the process by which attempts are made to achieve a specific point and level of targets within the specified point of time. Economic planning can also be said as a step to step method in which a planning is done with the main motive of making full utilization of natural resources to the best use of economy of any country. In economic planning we have the central authority with the main motive of achieving the economic objective of the country. The change in the ideology of the people, their growing social consciousness and the realization of the social and economic evils of mal distribution of income and wealth have drawn attention to the need for directing economic growth in a manner that would bring about not only increased production but would ensure more equitable distribution of the larger output, egalitarian measure have, therefore, been called for, and regulation of economic mechanism has become necessary to ensure social justice and equality.

The Indian Economy was facing a problem of illiteracy, poverty, low per capita income, unemployment and industrial backwardness etc. at the time of independence. After attaining independence in 1947 an effort was made to begin the era of planned industrial development. It causes rules, regulations and policies adopted by the government for industries. The industrial policy has injected a substantial measure of competitive environment and market thrust to industry. Many areas earlier reserved for the public sector are now open to private sector participation. The restrictions on the expansion of large industrial houses have been removed. Licensing requirements for industries have been abolished except for a strategic and defence industries.

5.2 Definitions and meanings

Economic planning has been defined by various writes and authors, some of the definition are as follows:-

"Economic planning is the making of major economic decisions what and how much is to be produced and to whom it is to be allocated by the conscious decisions of determining authority on the basis of a comprehensive survey of economic system as a whole."

Dickinson. H.D. 1939

"Economic planning is essentially a way of and utilizing resources to maximum advantage in terms of defined social ends. The main constituents of the concept of planning are: (i) A system of ends to be pursued, and (ii) knowledge as to the available resources and their optimum allocation."

Government of India.1951

"Planning for economic development is undertaken presumably because the pace or direction of development taking place in the absence of external intervention is not considered to be satisfactory and because it is further held that appropriate external intervention will result in increasing considerably the pace of development and directing it properly planning seeks to bring about a rationalization and, if possible and necessary , some reduction of consumption to evolve and adopt a long-term plan of appropriate investment of capital resources with progressively improved technique , a Programme of training and education through which the competence of labour to make use of capital resources is increased , and a better distribution of the national product so as to attain social security and peace. Planning , therefore means, in a sense, no more tnan better organization, consistent and far-seeing organization and comprehensive all-sided organsiation. Direction, regulation, controls on private activity and increasing the sphere of public activity, are all parts of organizational effort"

Gadgil.D.R

5.2.1 Importance and objectives economic planning.

(a) Economic objective

(b) Social objective

(c) Political objective

(a) Economic objective:

Planning is regarded as a very good tool for removing the economic ills.

"*Securing rapid economic growth and expansion of employment, reduction of disparitie in income and wealth, prevention of concentration of economic power and creation of the values and attitudes of a free and equal society have among the objective of all power plans.*"

Minhas.B.S

It is therefore, advocated for the achievement of the variety of economic objectives. These are as follows:

Economic growth: It is one of the main objectives of economic planning in Underdeveloped economies to achieve all round development of the economy by removing obstacles in the way of economic development. In order to break the "vicious circle of poverty" prevailing in these countries, it because necessary to have balanced growth of the economy. In a developed economy, the objective of planning is to maintain a high level of growth.

Increase in national income and per capita income: In order to increase output and national income, economic planning aims at developing different sector of the economy like agriculture, industry, etc. Simultaneously, it seeks to reduce the growth rate of population so that per capita income is increased. Increase in per capita income leads to increase in investment which will cause the increase in the production. This will set in motion the spiral of rising national income. In either country, developed or under-developed, growth is indexed in terms of per capita income and a decent standard of living associated with it.

Reduction of Inequalities: Each welfare economy aims at reducing economic disparities. Economic inequalities give rise to class struggle. As a result, an unjust economic system comes in to being. Glaring inequalities of wealth, income and opportunities are shocking to the democratic conscience. In under-developed countries, the masses of people are unable to fulfill their basic needs, whereas few to rich people enjoy all luxuries. It is therefore necessary to plan in such a way by which poor becomes less poor and richer become a little less rich. It will help in narrowing down the gulf between the two. Economic growth with social justice is therefore an important objective of economic planning.

Reduction in regional inequalities: Regional imbalance are sought to be reduced through economic planning. Special attention is paid to the development of backward and underdeveloped regions of the country. Each welfare economy aims at reducing economic disparities. Special attention is paid to the development of backward and underdeveloped regions of the country. Specific facilities are provided for the development of industry and agriculture in these regions.

Full employment: Unemployment is the by-product of capitalism. In economically advanced countries, the aim of government is to provide full employment. Unemployment problem demand an immediate solution for the elimination of poverty. The state can redistribute labour and create work opportunities. For instance, India’s Five-Year plans aimed at providing additional opportunities for millions of additional hands. Thus, creating employment or reducing unemployment may well be a major objective of planning.

Rapid industrialization: This is another important objective which the planners should also keep in mind. This objective is important in those countries which have been left behind in the race of industrialization. In India, it assumed importance in second plan. It is realised that industrialization makes more significant contribution to the raising of national income and to the solution of the problem of unemployment. Economies relying predominantly on agriculture are bound to remain backward. Rapid industrialization is, a very desirable aim of planning.

Self-Sufficiency: Almost all countries of the world are inter-dependent. But too much dependence on other countries can be harmful for the economic development. Hence, one of the objective of the economic planning is to attain self-sufficiency in economic sector. To that end, it may be considered necessary first to make the country self-sufficiency in food and essentially row materials. That would provide a solid and sound base for the economy and prepare it for further building up. Five decades ago, on the eve of the first plan, India was dependent on foreign countries at least in three aspects:

1. The output of food grains was not sufficient.
2. On account of basic industry, e.g. , transport, equipment, machine tools, heavy engineering goods, electrical plant and machinery and many other capital goods.

3. The saving rate is very low.

India, in the First Plan, concentrated mainly on agriculture to reduce dependence on foreign countries. Therefore, this objective may take precedence over other objectives when a plan is being made.

Price Stability: One of the main objective of economic planning is the stability of prices. In this regard, while making plan, it is essentially to take steps to control the causes of inflation and deflation.

(b) SOCIAL OBJECTIVES:

In reality, the objectives of planning is the economic, social and political development of men. Many objectives of planning are therefore related to social welfare. Main social objectives of planning are :

Social Security: In capitalist countries poor and resource less people are haunted by the feeling of social insecurity. They live under the perpetual fear of unemployment, accident, diseases, etc. they are exploited by the affluent class of the society. One of the main objectives of economic planning is to provide social security to poor and exploited class of the society. To achieve this objective social insurance and social assistance programs are introduced.

Social Equality: Economic planning also aims at providing social equality to every citizen who enjoy equal opportunities for his or her development and progress.

Establishment of Socialistic Pattern of Society: Economic planning seeks to establish socialistic pattern of society in the country. This society refers to a system based on equality wherein minimum needs of people are fulfilled and there is no exploitation of may be man.

(c) Political Objectives:

Establishment of Peace: One of the main objectives of economic planning is establishment of peace. It is now a common belief that poverty in any part of the world constitutes a major threat to the prosperity in other parts of the world. Developed country are therefore offering large assistance to under-developed countries to remove poverty, unemployment, backwardness etc.

Defense: Another aims of economic planning is to strengthen the defense and freedom of the country. Economic planning, development and defense are treated as supplementary to one another. Economic planning helps in making a country strong economically and self-sufficient in matter of defense.

In short, objective of economic planning is to establish a just and developed economy by proper utilization of country's resources.

5.2.2 Techniques of economic planning:

a) General and Partial
b) Centralized and Decentralized
c) Physical and Financial
d) Democratic and Totalitarian
e) Functional and Structural
f) Prospective and Perspective
g) Inducement and Direction

a) General and Partial: According to the scope of planning, it can be divided in to two parts:

General planning: It refers to planning of all activities in an economy. All sector of the economy, namely agriculture, industry, transport, irrigation, power, social services etc. are brought under its scope. The entire resource of the country are sought to be allocated among the different sectors.

Partial Planning: It refers to the planning of a particular sector of the economy. If planning in a country is confirmed only to a agriculture sector, it is partial planning. Under it, only a part of the total investment is studied. It is a short term method which is adopted to achieve a particular objective.

b) Centralized and Decentralized: On the basis of formation of planning, it can be divided in io two parts:

Centralised Planning: Under it, plan is formulated, directed and controlled by a central planning authority. Preparing of the plan is the exclusive responsibility of this authority. This type of planning is also called planning from above. Under it, basic policies, and targets of planning are determined by the central planning authority. On the basis of these basic policies, regional and local plans are formulated.

Decentralised Planning: Planning refers to such plans as are framed by local, regional and individual organization. It is also called planning from below.

c) Physical and Financial*:* On the basis of resources and targets of the plans, the same can be divided in two parts:

Physical Planning: It refers to that planning under which targets of plans are fixed in terms of real physical resources and the plans are also prepared while taking the real resources into account. For instance, fixing the targets of production of food grains, cloth, sugar. Steel, etc. over a given period of time. These targets are fixed while taking into consideration the available physical, human and capital resources of the country, such type of planning is called physical planning. According to Second Five

Year Plan document, "Physical planning is an attempt to work out the implications of the development effort in terms of factor allocation and product yield so as to maximize income and employment."

Under physical planning it is fully assessed as to what is the position of the goods to be produced. How the same are to be disposed of and distributed. Physical planning is not concerned with piecemeal sector planning rather it covers aggregate planning. Perspective planning is also based on the existing availability of physical resources and is also based on the existing availability of physical resources and future increase thereof. There should be proper balance among different targets of plans so that output of one industry may serve as an input of other and demand of the consumers is also satisfied.

Limitation: following are the main limitation of physical planning:

1. **Inadequate Statistics:** Under-developed countries are characterized by the inadequacy of statistical data relating to physical resources, several difficulties arise in determining and formulating the targets if the statistics are insufficient.
2. **Unforeseen Circumstances:** in every economy large number of unforeseen events takes place, e.g. destruction of crops due to exclusive rains or drought. Consequently, it becomes impossible to achieve targets of agricultural production. Physical planning is, therefore very much limited by unforeseen contingencies. It is not possible to take any decision firmly.
3. **Inflationary:** there is a perpetual apprehension of rise in prices. Failure to achieve physical targets leads to inflation. It adversely affects planning.
4. **Dependence on Financial Planning:** It is not possible to implement physical planning independently. It depends largely on physical resources. If financial resources like foreign assistance, tax revenue etc., are not forthcoming as expected, targets of physical planning cannot be achieved.

Financial Planning: Financial planning is meant the allocation of resources in terms of money. Rate of growth of national income is decided under this kind of planning. Besides, decision are also taken regarding the rate of saving and investment and the total outlay on different sector of production like, agriculture, industry etc.

According to **Planning Commission, "** *The essence of financial planning is to ensure that demand and supplies are co-ordinated in a manner which exploits physical potentialities as fully as possible without major and unplanned changes in the price structure ."*

Estimates are made with regard to the total money to be spent. At the same time, the effect of investment are also studied. Keeping in view the increase in supply of and demand for money and their consequent effects on prices, necessary controls are imposed. All the activities form part of financial planning.

Limitations: Main limitations of financial planning are as under:

1. Non-Monetary Sector: In under developed economies size of non-monetary sector is very vast whereas that of monetary sector is quite small. Financial planning has no effect on non-monetary sector. Consequently, supply can decrease and price can rise. Hence, the amount of financial planning may increase considerably.

2. Adverse effects on prosperity to save: Taxes have to be increased in order to mobilize resources under financial planning. It adversely affects propensity to save.

3. Wastage: Targets of financial planning cab be achieved only if

(i) Price level does not change violently and

(ii) Money is spent honestly.

Unfortunately, Both these things do not happen. There is lot of wastage of money. As a result, financial targets are achieved physical targets are not achieved.

Conclusion: Both physical and financial planning are of great significance of success of economic planning. They are not mutually exclusive but complementary to each other. Planning is initially physical in form wherein we take in to consideration necessary row material, their production from different project use by different industries. We formulate different plans relating to them. Their physical targets are fixed. Therefore, these plans and targets are transformed in to financial plans and measured in money terms. Thus, to implement physical plans, finance are required and to make proper use of financial planning, physical resources are needed.

d) Democratic and Totalitarian: On the basis of quantum, central planning can be divided into two parts:

Democratic Planning: Democratic planning refers to that plans which is prepared by the consent of the people’s representatives. Such a planning enjoys full support and co-operation of the people. At no stage of planning any pressure is exerted by the state on the people. In India we have democratic planning.

Willing co-operation of the people and mutual consultations play a very significant role in democratic planning. While formulating the plan, people’s desires and aspirations are given due weightage. At the time of formulating central, provincial and district level plans, local resources are kept in view and people duly consulted. Under democratic planning, standard of living of people and their economic wellbeing are not allowed to go down rather efforts are made to raise the same. Targets of economic planning are determined in the light of the needs of the consumers.

Features: Main characteristics of democratic planning are as follows:

1. As a consequence of democratic planning, mixed economy comes into being. Public and private sector operate side by side.
2. Central Planning Authority has direct control over Public sector.
3. Private sector is indirectly controlled by the Central Planning Authority in the National interest through fiscal and monetary measures.
4. People enjoy economic, social and religious freedom. People are free to conduct such economic activities as consumption, production, exchange, investment, etc. in the national interest and social welfare of the community as a whole.
5. People’s co-operation is sought in the preparation of the plan. There is close relationship between welfare of the people and economic activities.
6. One of the aims of planning to co-ordinates the activities of public and private sector.
7. People co-operation is sought in achieving the targets of plan by giving them proper incentives.
8. Economic activities are conducted both to earn profit and promote social welfare.
9. Under democratic planning there is importance both of price mechanism and government-decision.
10. Objectives of public sector and private sector are co-ordinate.
11. It is quite a flexible planning. There is enough scope to modify the targets of private sector. Targets of public sector are subject to changed according to changed circumstances.
12. It has a tendency of decentralization.
13. It main objective is to raise the standard of living of people quickly. As such, consumer goods industries are given as much importance are given as heavy industries.

In short, democratic planning is a sort of admixture of capitalist and socialist planning. In it, objective of socialist planning are sought to be achieved through democratic method. Individual liberty is recognized but it is used for the social well-being.

e) Totalitarian or Communist Planning: Under Totalitarian or Communist Planning all economic activities are conducted by the government. Main means of production of are controlled by the state. Central Planning Authority prepares the plan for almost the entire economy and economic sector. All heavy and basic industries are in public sector. Freedom of consumer are is restricted by the system of rationing and controls. Much importance is not given to freedom. It is a rigid form of planning. Production and distribution system are completely under the control of the state price mechanism and profit motive play less significant role under capitalists planning. All economic activities are conducted under one plan. This type of planning prevails in communist countries likes Cuba and China.

Features: Main characteristics of totalitarian planning are as follows:

1. Public sector function in this type of planning. Government has full and direct control over them.
2. Central Planning Authority formulates and comprehensive plan for the entire economy.
3. There is no economic freedom and all economic decisions are taken by the government.
4. People's welfare can be sacrificed at the altar of rapid economic development of the country. Minimum needs of the people alone are catered to.
5. Means of production are controlled by the government that functions as on entrepreneur. Private enterprise has no place in it.
6. Economic decisions are not taken by the market forces and price mechanism but by the government.
7. There is no economic freedom. Government alone controls are economic activities.
8. All economic activities like foreign trade, foreign capital, investment, loan, etc. are controlled by the government.
9. It is a rigid planning. People can be pressurized by the government for the achievement of plan targets.
10. It is more comprehensive and efficient.

Conclusion: Many economists prefer totalitarian planning to democratic planning. According to Nobel laureate **Prof. Myrdal,** there is hardly any instance in history to prove that democracy has suffered because of totalitarian planning. Rather there are many instances contrary to it. There is no dearth of such critics who regard democratic planning imaginary. According to them democracy and planning cannot go side by side. Even under democratic planning government interference is inevitable to a large extent. According to prof. Bhattacharya, democratic planning is a mid-way between free market economy and planning by direction. It contain disadvantages of both advantages of none.

f) Functional and Structural: On the basis of changes in the social structure of country, economic planning can be divided into two parts:

Functional planning: Refers to that planning which seeks to remove economic difficulties by directing all the planning activities within the exiting economic and social structure. Under this type of planning, the exiting social structure of the country remains intact.

Structural planning: It causes good deal of changes in the social and economic frame-work of the country. Planning adopted in under developed countries is mostly structural in character. As a result of it a new social pattern emerges in the country. The major trust of second Five Year Plan in India was to evolve a new socialistic pattern of society in the country. All the subsequent plans aim at achieving this goal and so are called structural plans.

g) Prospective and Perspective: On the basis of duration of planning it can be divided in to two parts:

Prospective Planning: It refers to short term planning. Under this type of planning targets to be achieved in the near future are determined. In fact, it is part of perspective planning.

Perspective Planning: It refers to long term planning based on the existing and short term economic condition and requirements. Draft of perspective planning is prepared keeping in view the future economic condition and requirements. Long term targets and programs are parceled out in short-run programmes and their details are worked out. These details are so arranged in the short run that each successive short term plan result in preparing the ground for long term targets. In our Five Year Plans, targets regarding employment and national income have been determined on the basis of short-run and long-run planning. It was on the basis of achievement of targets relating to employment and national income during the First- Five Year Plan that fresh targets and programmes were determined in this respect for the second Five Year Plan. Likewise in the successive plans, keeping in the targets of Fourth

Five Year Plan, Programmes of Fifth Five Year Plan were chalked out. Experience of exiting condition states that we should divide our five-year plans in to annual plans, so that the progress of each year would be monitored and on its basis changes in the programs of successive years be effected.

In the words of **J. Tinbergen**,"*The main purpose of a perspective plan is to provide a background of the shorter term plans, so that the problems that have to be solved over a very long period can be taken in to account in planning over short term."*

Prof. Mahalanobis *is of the view that perspective planning is necessarily a continuous process.*

Limitations: Its main limitations are as under:

1. **Administrative Difficulties:** The main difficulties of this kind of planning is that many a time it is not possible to make necessary adjustment in the pre-conditions of the plan. Consequently, many administrative difficulties crop up.
2. **Psychological Difficulty:** Sometimes Psychological Difficulty also arise, especially when it becomes necessary to modify the plan without there being any provision for it.

h) Inducement and Direction planning: From the view point of government intervention planning is of two types:

Planning by Inducement: In planning by inducement the government tries to achieve its objectives by influencing investment decisions of the entrepreneurs by offering them necessary incentives. Under this kind of planning, private sector is induced to produce, consume, distribute, invest, etc. According to the set targets through the medium of price-mechanism. There is economic freedom in the economy but it is not full freedom. In order to achieve it objectives government imposes controls over markets and prices and thereby exercises control over entrepreneurs indirectly. This type of planning is mainly found in mixed economies. Supposing the government desires to reduce the production of goods consumed by the rich and increase the production of goods consumed by the poor. To achieve this objective government imposes taxes on the goods consumed by the rich and thereby raises their prices. This will result in to fall in their demand. On the contrary production of goods consumed by the poor is encouraged by giving subsidies to the producers. This will result into fall in their prices and hence rise in their demand. In planning by inducement, monetary and fiscal policies of the government play a very significant role.

Limitation: Main limitation s of planning by inducement are as under:

1. **Disequilibrium:** the ones of implementation of this kind of planning on the private sector. As such, problem of disequilibrium between demand and supply continuously persists. Supply of most of the goods falls short of demand. To remedy the situation, government introduces measures such as rationing, price control etc. Thus, this planning in a way takes the form of planning by direction.
2. **Inadequate incentive:** This inducement offered by the government to the producer and consumer is mostly insufficient. Consequently the latter do not come up to the expectations of the government and become impossible to achieve the targets of plans.
3. **Low rate of capital formation:** Under developed countries suffer from low rate of capital formation. Private sector cannot increase in by its own efforts. Direct intervention in the economy by the government becomes inevitable. In this way, planning by inducement ultimately changes in to planning by direction.

Planning by Direction: It refers to that type of planning where in government directly intervenes in economic affairs. Planning by direction implies a system where planning is carried out through commands, direct orders and instructions. There is a central planning committee in this type of planning. Means of production are owned by the states. All decisions are relating to economic activities, such as, production, exchange, consumption and distribution are taken by Central Planning Authority. What is to be produced and how much is to be produced are decided by this very authority. How the prices of goods and factors are to be determined, this decision is also taken by the planning authority. Again, it is this authority that issues directions regarding what to do and what not to do. Such planning is mostly found in communist countries, like china, etc. In a democratic country like India, it is planning by inducement that prevails.

Limitations: Main limitations of this planning are:

1. Lack of consumer's sovereignty
2. Inelastic
3. Expensive

Conclusion: In reality, both these type are complementary to each other. Both are put to practice under mixed economy. Government has full control over certain sector. In certain other sectors like agriculture, small scale and cottage industries producers are given many incentives. In fact, planning by inducement is more relevant to democratic countries. On the contrary, communist countries like Russia, China, etc. rely more on planning by direction.

5.2.3 Features of India's five year plans

Main feature of economic planning are:-

Central Planning Authority: - under economic planning, there is a central planning authority appointed by the state. All central economic decisions are taken by it. Normally all the decisions like what to produce, how much to produce, and by whom to produce. The authorities take into consideration the availability of the resources and then formulate the comprehensive plan to achieve the set objectives. In India the work is performed by planning commission of India.

Democratic:- The first and foremost feature of Indian planning is that it is socially based and democratic in nature. Indian planning is called as democratic because the planning is done by the democratically elected government. In addition to this, opinions of various organizations, institutions, experts are being given with due considerations while formulating a plan.

It may also be termed as socially oriented political planning because social factor is given with more with consideration than economic factor in the Indians plans.

Decentralized Planning:- the need and importance of decentralized planning was emphasized since the application of first five year plan. But the planning remains centralized till the sixth five year plan. The seventh plan witnessed the decentralized planning for the first time in India. Decentralized planning is the delegation of planning activities to the sub-state levels, i.e., district, sub-division, block and village level.

Regulatory Mechanism:- The planning commission of India plays the role of regulatory mechanism. It gives necessary direction and provides regulation over the planning system. In addition to this, a co-ordination agency, namely the national Development Council (NDC) was set up in 1952by the government of India to co-ordinate between centre and states. The implementation of planning comes under the purview of planning commission.

Existence of central and state plan:- all the five year plan havfe a co-exixtnace of both central and state plans. Central plans are controlled by the planning comic\ssion of india and central government whereas state plans are controlled by state planning board and state government.

Other Features:- Some of the other features economic planning are as follows:-

1. Indicative Economic Planning
2. Both public and private sector plans
3. Balanced Regional Development

5.3 Industrial Policy 1991

The overall objectives of industrial policy in India have been periodically articulated in the Industrial Policy resolution of 1948, 1956 and 1973, the industrial policy statement of 1980 and 1990. On July 24, 1991 the government announced a new industrial policy in parliament. Congress Government then, the Prime Minister of India P.V Narsimhan Rao announced new industrial policy in July, 1991 and this policy has changed the economy to large extent. In order to attune Industrial policy with the liberalized back-up to the service sector, as also to the approvals for FDI and NRI investment. The proposed legislation would also replace the Industries (Development and Regulation) Act, 1951. Since the focus has shifted from state-regulated planned development to the market-driven economy, it has been felt that industrial policy should go in tandem with liberalization. Till July 1991, the emphasis was on "regulation" The New Industrial Policy of 1991 shifts emphasis from "regulation to development". Now, the government endeavors to spread industrialization in backward areas not by directly setting up units in the public sector, but by appropriate incentives and infrastructure development initiatives to facilitate flow of private investment to backward areas.

5.3.1 Objectives of New Industrial Policy

- Unshackle the Indian economy from cobweb of bureaucratic control
- Liberalizing the policy regarding FDI.
- To abolish restriction on FDI.
- Redefining the role of public sector.
- Bringing of welfare scheme of Indian industries.
- Remove restriction imposed by FERA on international trade.
- To ensure quality standards.
- Emphasis on research and development capabilities.
- Abolishing of MRTP act.

- Improve the productivity of Indian industry.
- To prepare Indian industry for globally competitive.
- Integration of Indian industry with the world.

5.3.2 Need of New Industrial Policy or Financial and Economic Reforms

1. Increase in fiscal deficit: Prior to 1991, fiscal deficit of the government had been mounting year after year on account of continuous increase in its non-development expenditure. Fiscal deficit means difference between the total expenditure and total receipts minus loans. It is equivalent to total borrowings by the government. In 1981-82, it was 5.4 per cent of gross domestic product (GDP). In 1990-91, it rose to 8.4 per cent of GDP. With a view to meeting fiscal deficit, the government is obliged to raise loans and pay interest thereon. Thus, due to persistent rise in fiscal deficit there was a corresponding rise in public debt and interest payment liability. In 1980-81, interest payment on public debt amounted to 10 per cent of total government expenditure. In 1991, amount of interest liability rose further to 36.4 percent of total government expenditure. There was serious apprehension that the government was fast heading for debt trap.

2. Increase in adverse balance of payments: Balance of payment is the difference between total exports and total imports of a country. When total imports exceed total exports, the balance of payments becomes adverse. Government granted diverse kinds of incentives and concessions to the exporters under export promotion program, yet the export did not rise to the desired extent. It was mainly due to the fact that in international market our exports could not complete in price and quality. All this was the direct result of the policy of protection so liberally pursued by the government and for so long. As against slow growth of exports there was rapid increase in imports. As a result, balance of payments deficit increased very much. Deficit of balance of payments had been rising continuously since 1980-81. For instance, in 1980-81, balance of payments on current account was adverse to the tune of Rs. 2,214 crore and it rose in 1990-91 toRs.17367crore. To meet this deficit large amount of foreign loans had to be obtained.

3. Gulf Crisis: On account of Iraq war in1990-91, prices of petrol shot up. India used to receive huge amount of remittances from Gulf countries in foreign exchange all that stopped totally. Gulf crisis thus further accentuated already adverse balance of payments position. This has increased balance of payments deficit very much.

4. Fall in foreign exchange reserves: in 1990-91India's foreign exchange reserves fell to such a low level that the same were not enough to pay for an import bill for even 10 days. Foreign exchange reserves that were Rs. 8151 crore in 1986-87 declined sharply to Rs. 6252 crore in 1989-90. The situation grew so acute that Chandrashekhar government had to mortgage country's gold to discharge its foreign debt servicing obligation.

5. Rise in prices: In India prices continued to rise very high. Average annual rate of inflation increased from 6.7 per cent to 16.7 per cent. Main reason for inflation or annual rate of increase in prices was rapid increase in the supply of money. This, in turn, was due to excessive resort to deficit financing by the government. Deficit financing implies borrowing from Reserve Bank of India by the government to meet its deficit. Bank offered this loan by printing new currency notes. Cost of production takes an upward jump due to high rate of inflation. It adversely affects domestic and foreign demand for our products.

6. Poor performance of Public Sector Undertakings (PSU): In 1951 there were just 5 enterprises in public sector in India but in 2001 their number rose 232. Several thousand crores of public funds were invested therein. In the initial 15 years their functioning was quite satisfactory but thereafter most of these suffered losses. Because of their poor performance, Public sector undertakings degenerated into liability. On account of the above compelling factors, it became inevitable for the government to adopt New Economic Policy. It was all the more necessary to increase industrial output and attract foreign capital.

5.3.3 Major Initiatives of New Industrial Policy

Major initiatives or we can say features of new industrial policy are as following:

(I) Abolishing industrial licensing: For liberalize the economy, need was felt to abolishing of industrial licence except 18 industries that require Compulsory Licensing. There 18 industries were:

1. Coal and Lignite
2. Petroleum

3. Sugar
4. Animals fats and oil
5. Cigars and Cigarettes of tobacco and manufactured tobacco substitutes
6. Motor cars
7. Paper& Newsprint
8. Defence equipment
9. Hazardous chemicals
10. Drugs & Pharmaceuticals
11. Entertainment Electronics (VCR, DVD, Tape recorders)
12. White goods (Domestic Refrigerator, Dishwashing Machines Etc)
13. Tanned or Dressed Fur skins
14. Asbestos and its based products
15. Distillation and brewing of Alcoholic drinks
16. Raw hides & skin, Leather
17. Industrial explosives
18. Plywood and others wood based products and

With the passage of time this has been reduced to 14, then to 9 and later to 8 and 5 and at present only 4 industries require compulsory licensing are as follows:

1. Cigars and Cigarettes of tobacco and manufactured tobacco substitutes
2. Hazardous chemicals, Drugs and Pharmaceuticals
3. Electronics aerospace and Defence equipment
4. Industrial explosives – including detonating fuses, safety fuses, gunpowder, nitrocellulose and matches.

(2) Role of public sector: Inspite of huge investment public sector was not performing good, so need was felt to redefine the role of public sector. The number of industries reserved for public sector reduced from 17 to 8 and then further to 6.and then 6 to 3, and at present only two sectors are reserved for public sector: 1.Atomic Energy, 2.Railway operations, other than construction, operation and some maintenance functions.

(3) Foreign investment: Earlier it was necessary for every industry to take the prior approval of government which led to unnecessary delay and sometime due to frustration foreign investors do not invest to promote export of Indian goods in the world market unconditional approval was given under new industrial policy 1981 for FDI up to 51 % in high priority industries.

(4) MRTP Act: New industrial policy 1991 removed the threshold limit of assets in respect of MRTP companies this eliminates the company for prior approval of central government for expansion, establishment of new industries undertaking ,merger etc.

(5) Foreign technology: (i) Automatic permission for foreign technology agreement in high priorities industries up to 1 crore 5% royalty for domestic sales 8% for export (ii) No permission for hiring of foreign technicians

(6) Convertibility of Rupee: The new industrial Policy of the year 1991 has given the privileges to the industrial regarding import of raw material and technology. The new policy has introduced the rupee convertibility on current account as well as on capital account. The government made the current account fully convertible, while under the capital account the repayment of loan and deprecation of assets has been made convertible. Further, under the previous provisions the financial institution extending loans to industrial houses had an option to convert their 20% loans into equity it was a major threat to the industrialist in posting threat to their positions. Under the new industrial policy such as compulsory clause of conversion of loans in to equity has also been abolished.

(7) Reservation for small scale industries: In the year 2006, small scale units were defined as a unit having investment of 5 cr. in Plant and machinery. In Oct 2008, 21 items were reserved for manufacturing in small scale industries.

(8) Encouragement to industries in backward areas: Government has taken various measures to encourage the industries in backward areas. Various incentives will be offered by govt to industries in the backward region for reducing regional disparities.

(9) Freedom from administrative control: Expansion programmes launched by government are exempted from administrative controls and already existing units will be free to produce any commodity on the basis of the licensed already issued.

5.3.4 Appraisal of New Industrial Policy

Positive aspect of New Industry Policy

1. Building competitiveness in Indian industries: The new industrial policy undoubtedly claims the credit of creating and promoting competitive economic conditions in the Economy. It includes:

- New Industrial policy almost removed all kinds of protections given to the domestic industry.
- It has opened the industries for private investment that were previously reserved for investment by the public sector only.
- The new industrial policy has also liberalized the location norm and has also made the import of technology free from government restrictions.
- The procedural delays have been removed leading reduced cost of the project.

2. Attracting FDI: Under the new policy the government has broken up the natural monopoly of the public sector units by attracting the private and foreign capital in to the industries that were earlier reserved for public sector. Now, in high priority industries no prior approval of the government is required for FDI Upto 51%.

3. Import of technology in India: The process of import of technology in India was simplified with grant of automatic permission in high priority industries to remove unnecessary delays that were hampering the decision making process regarding import of technology.

4. Development of global quality standard in India: The objective of new industrial policy was to focus on development of global quality standard in India for improving the quality of production in all respects. In order to promote exports and bring global competitiveness in Indian Industry. The policy emphasized the shifting of quality standard from Indian Standard Industries and International Standard Organisation.

5. Removal of MRTP act: Removal of restrictive conditions of MRTP Act like pre entry scrutiny of investment decision by MRTP commission, prior approval of centre for expansion, establishment of new undertaking. Merger, amalgamations, takeover and provisions to appoint foreign Director will strength such units.

6. Removal of restrictive condition of FERA: The Industrial policy has abolished almost all the restrictive provisions of FERA. The abolition of FERA was a major relief provided to the industries engaged in export activities.

7. Development of consumerism in India: The new Industrial Policy has shifted the role of state from regulatory in nature to managerial one. Under the new Industrial policy the state has to create competitive economic conditions to make the industry more accountable to the society.

Negative aspect of New Industry Policy:

1**. More weight age to foreign investor:** The New Industrial Policy has laid more emphasis on FDI in India. In fact, FDI considered a panacea of all the socio-economic problem of the country. It has been decided to provide approval for direct foreign investment up to 51% foreign equity in high priority industries. H.K. Para jape agreed that 34 high priority industries, having provisions for automatic permission for foreign investment, would make it possible for large multinational companies to dominate certain growing areas of our country argued that if the same amount of incentives and concessions are being provided to indigenous industry houses then better results can be expected without taking the risk of foreign capital.

2 Exploitation of domestic resources: The natural resources are limited. Each country of the world, either developing or developed, intends to make optimum use of available resources for the overall growth and development of the country. The critics of New Industrial policy are of the opinion that the provisions of huge foreign capital in the country will lead to wastage and even misuse of resources available with the country. The multinational companies have huge marketing and financial resources. They have the latest technologies and huge production capacities. The MNCs will utilize their natural resources to produce the products belonging to non-priority categories for serving the world market. It leads to the early depletion of available resources of the country.

3. Threat to environment: the environmental laws in all the developed countries of the world are very strict and their violation leads to harsh consequences for the industries. On the other side, the environment laws in developing and least developed countries and their implementations also ineffective. Further the developing countries are victims of corruption, favouritism and other malpractices.

4. Reduction in growth of production of industrial goods: The most negative indicator goes against the industrial policy is the sudden fall in production of industrial growth. In the initial years of liberalisation the growth of industrial goods has shown the negative figures.

5.3.5 Suggestions for Effectiveness of Industrial Policy

1. Effectiveness of private sector: There is a need that government should provide sufficient resources to the private sector in the form of technical support, infrastructural support, and liberal credit policy so that they can develop their industries in a good manner and can compete with the foreign enterprises.

2. Enhance the profitability of public sector: This is very important that public sector should be more efficient and profitable. The following steps should be taken:

- More and more efficient human resources are appointed.
- Promotion to employees should be on the basis of merit not on seniority basis.
- Inspections should be done properly.
- Production capacity of older public sector enterprises should be increased.
- Accounting records are properly checked with time to time.
- Non planned expenditure should be reduced at most.

3. Development of infrastructure: Government should take effective measures to strengthen the infrastructure of the economy, in the field of transportation, communication, power supply etc. In the lack of strong infrastructure, the economy of India cannot develop in the proper way.

4. Not too much dependence upon the foreign investment: The government should ensure that there is not having too much independence upon the foreign capital inflow in the country. Too much flow of foreign inflows results the deficit finance in the country resultant into negative balance of payments.

5. Proper attention to sector enterprises: Small scale sector of India needs so much improvements .Various fiscal and non –fiscal incentives should be given to small scale units to support them. If proper attention to be given to this sector, unemployment situation of the country can be reduced to greater extent because of highly labour intensive utilisation.

6. Set up units in backwards areas: To remove the regional imbalances there should be a proper set up of units in the backward areas. For this special assistance should be provided by the government to reduce the regional imbalance in the country.

7**. Support to domestic industrial units for their expansion:** Government should provide financial assistance to domestic sector unit's so that they can expand their business not only to the domestic territory but also can expand business in foreign countries also. After industrial policy 1991, National Manufacturing Policy and MSME policy was introduce to boost the manufacturing sector of India. Main points regarding these policies are as following:

5.4 Check Your Progress

1. Consider the following statements and identify the right ones.
i. The Industrial Policy of 1948 was the first industrial policy statement by the Government
ii. It gave leading role to the private sector

(A). I only

(B). ii only

(C). both

(D). none

2. In which among the following years, a new "Liberalized Industrial Policy" in India was announced for the first time?

(A) 1986

(B) 1991

(C) 1992

(D) 1993

3. Which of the following cannot be described as an achievement of the public sector in India?

(A) Strengthening infrastructure (B) introducing modern technology

(C) Over capitalization (D) none of these

4. Which of the following industries have been reserved for the public sector under July 1991 Industrial Policy?

1. Atomic energy

2. Coal and lignite

3. Mineral oils

4. Mining of diamonds

(A) 1 and 2 (B) 1 and 3

(C) 1, 2 and 3 (D) all of them

5. Industrial licensing has been abolished for all industries by the July 1991 Industrial Policy statement except for

(A) 15 industries (B) 18 industries

(C) 22 Industries (D) 25 Industries

5.5 Summary

In sort we can say that economic planning is one of the most important tool that government is using for the balanced growth of the country. While making the economic development both central and state level coordination is required. All the plans are made with the main objective of achieving the best result with the available resources.

At the time of independence, India was really backward in industrial area. After independence govt. of India make industrial policy in 1948 and gives more attention on industrialization. In present India has rapid growth in all industrial sectors and have a sound economy. India has more competitive products in international market. To make more competitive industrialization, Indian govt. changes policies time to time and make economy stronger and more sustainable. The Industrial policy of 1948, which was the first industrial policy statement of the Government of India, was changed in 1956 in a public sector dominated industrial development policy that remained in force till 1991 with some minor modifications and amendments in 1977 and 1980. In 1991, far reaching changes were made in the 1956 industrial policy. The new Industrial Policy of July 1991 heralded the framework for industrial development at present. These industrial policies are completing their objectives which are discussing above and some other important financial and economic reforms are also taken for better economic performance.

5.6 Keywords

New Industrial policy: Industrial policy introduced in 1991 is called new Industrial policy.

Economic Reforms: Economic reforms refer to various policy measures and changes introduced since 1991.

Globalization: A process associated with increasing openness, growing economic interdependence and deepening economic integration in the world economy.

Privatization: Privatization means allowing the private sector to set up more and more of such industries as were previously reserved for public sector.

Liberalization: Liberalization of the economy means to free it from direct or physical controls imposed by the government.

5.7 Self-Assessment Test

Q1. Decribe new industrial policy and its positive and negative impacts on Indian economy.

Q2. Write about liberlisation, privatisation and globalisation**.**

Q3. What is MSMED act 2006, its objective and criteria for MSME enterprises.

Q4. What is financial and economic reforms, explain recent reforms in Indian economy?

5.8 Answer to Check Your Progress

1. (A) 2. (B) 3. (C) 4. (D) 5. (B)

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Fiscal and Monetary Policy in India

STRUCTURE

6.0 Learning Objectives

6.1 Introduction

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6.0 Learning Objectives

After going through this lesson, the learners should be able to:

- Know the Fiscal policy of India and its objectives

- Understand the techniques and important terms of fiscal policy
- Know the Monetary policy of India and its objectives
- Understand the Instruments of monetary policy and its important terms

6.1 Introduction

Economic stability and economic developments are always intertwined. One of the essential prerequisite for growth of the country as well as for sustaining it in this era of highly globalised world is existence of price stability. Of course, there are chances of occurrence of fluctuations in the economy. To overcome these fluctuations there is need of monetary and fiscal policies. Monetary and fiscal policies in any country are two macroeconomic stabilization tools. However, these two policies have often been pursued in different countries in different directions. Monetary policy is often pursued to achieve the objective of low inflation to stabilize the economy from output and price shocks. On the other hand, fiscal policy is often biased towards high growth and employment even at the cost of higher inflation. For achieving an optional mix of macroeconomic objectives of growth and price stability, it is necessary that the two policies complement each other. However, the form of complementarily will vary according to the stage of development of the country's financial markets and institutions. With increasing independence of central bank in the conduct of monetary policy from fiscal dominance during the last few decades, there has been a renewed interest in the issue of monetary and fiscal policy coordination. With increasing independence of central bank in the conduct of monetary policy from fiscal dominance during the last few decades, there has been a renewed interest in the issue of monetary and fiscal policy coordination.

6.2 Fiscal Policy of India

Fiscal policy means the use of taxation and public expenditure by the government for stabilization or growth of the economy. According to Culbarston, "By fiscal policy we refer to government actions affecting its receipts and expenditures which ordinarily as measured by the government's receipts, its surplus or deficit." The government may change undesirable variations in private consumption and investment by compensatory variations of public expenditures and taxes. An effective fiscal policy is composed of policy decisions relating to entire financial structure of the government, including tax revenue, public expenditure, loans, transfers, debt management, and budgetary deficit and so on. The policy also tries to attain a proper balance between these foresaid units so as to achieve the best possible results in term of economic goals.

Objectives

Before moving on the discussion on objectives of India's Fiscal Policies, firstly know that the general objectives of Fiscal Policy.

General objectives of Fiscal Policy are given below:

- To maintain and achieve full employment.
- To stabilize the price level.
- To stabilize the growth rate of the economy.
- To maintain equilibrium in the **Balance of Payments.**
- To promote the economic development of underdeveloped countries.

Fiscal policy of India always has two objectives, namely improving the growth performance of the economy and ensuring social justice to the people.

The fiscal policy is designed to achieve certain objectives as follows:

1. Development by effective mobilization of resources: The principal objective of fiscal policy is to ensure rapid economic growth and development. This objective of economic growth and development can be achieved by mobilization of financial resources. The central and state governments in India have used fiscal policy to mobilize resources.

The financial resources can be mobilized by:

1. Major three important methods:

a. **<u>Taxation:</u>** Through effective fiscal policies, the government aims to mobilize resources by way of direct taxes as well as indirect taxes because most important source of resource mobilization in India is taxation.

b. **Public Savings:** The resources can be mobilized through public savings by reducing government expenditure and increasing surpluses of public sector enterprises.

c. Private Savings: Through effective fiscal measures such as tax benefits, the government can raise resources from private sector and households. Resources can be mobilized through government borrowings by ways of treasury bills, issuance of government bonds, etc., loans from domestic and foreign parties and by deficit financing.

2. Reduction in inequalities of income and wealth: Fiscal policy aims at achieving equity or social justice by reducing income inequalities among different sections of the society. The direct taxes such as income tax are charged more on the rich people as compared to lower income groups. Indirect taxes are also more in the case of semi-luxury and luxury items which are mostly consumed by the upper middle class and the upper class. The government invests a significant proportion of its tax revenue in the implementation of Poverty Alleviation Programmes to improve the conditions of poor people in society.

3. Price stability and control of inflation: One of the main objectives of fiscal policy is to control inflation and stabilize price. Therefore, the government always aims to control the inflation by reducing fiscal deficits, introducing tax savings schemes, productive use of financial resources, etc.

4. Employment generation: The government is making every possible effort to increase employment in the country through effective fiscal measures. Investment in infrastructure has resulted in direct and indirect employment. Lower taxes and duties on **small-scale industrial (SSI)** units encourage more investment and consequently generate more employment. Various rural employment programmes have been undertaken by the Government of India to solve problems in rural areas. Similarly, self employment scheme is taken to provide employment to technically qualified persons in the urban areas.

5. Balanced regional development: there are various projects like building up dams on rivers, electricity, schools, roads, industrial projects etc run by the government to mitigate the regional imbalances in the country. This is done with the help of public expenditure.

6. Reducing the deficit in the Balance of Payment: some time government gives export incentives to the exporters to boost up the export from the country. In the same way import curbing measures are also adopted to check import. Hence the combine impact of these measures is improvement in the balance of payment of the country.

7. Increases national income: It's the strength of the fiscal policy that is brings out the desired results in the economy. When the government wants to increase the income of the country then it increases the direct and indirect taxes rates in the country. There are some other measures like: reduction in tax rate so that more peoples get motivated to deposit actual tax.

8. Development of infrastructure: when the government of the concerned country spends money on the projects like railways, schools, dams, electricity, roads etc to increase the welfare of the citizens, it improves the infrastructure of the country. A improved infrastructure is the key to further speed up the economic growth of the country.

9. Foreign exchange earnings: when the central government of the country gives incentives like, exemption in custom duty, concession in excise duty while producing things in the domestic markets, it motivates the foreign investors to increase the investment in the domestic country.

6.2.1 Techniques of Fiscal Policy

1. **Taxation policy:** One of the important sources of revenue for government of India is the tax revenue. Both the direct and indirect taxes are being levied by the government of India. The total tax revenue collected by the government of India stands at 72.13% of the total revenue of the government. The main objectives of taxation policy in India include mobilization of resources for financing economic development and formation of capital by promoting saving and investments.
2. **Public expenditure policy:** Public expenditure is an expenditure of the government and is mostly related to the development activities, viz. development of infrastructure, health facilities, industry, and educational institutions and so on. Some important features of this policy are:
   - Development of infrastructure
   - Development of public enterprises
   - Support to private sector
   - Social welfare and employment programmes
3. **Public debt policy:** The government is taking recourse to public debt for financing its development expenditure. The total public debt of the central government includes internal and external debt.
   - The internal debt indicates the amount of loan raised by the government from within the country.

- The external debts indicate the amount of loan raised by the government from international financing agencies.

4. **Deficit financing policy:** The deficit financing in India indicates loan taking by the government from the RBI in form of issuing fresh dose of currency. Deficit financing helps the country by providing necessary funds meeting the requirements of economic growth but at same time, it also creates the problem of inflationary rise in prices. Thus it must be kept within the management limit.

6.2.2 Important Terms in Fiscal Policy

6.2.2.1 Revenue:

Every form of income which do not increase the financial liabilities of a government or an organization i.e., tax-income, non-tax income, grants.

Non-revenue:

Every form of income which increases the financial liability of a government or any organization namely borrowings of an organization.

6.2.2.2 Revenue Receipts:

a) Tax revenue receipts:

It includes all the money earned by the government through direct and non-direct taxes

b) Non – tax revenue receipts:

It comprises all the money received by the government through non-tax sources.

Non-tax sources:

- Interests earned by the nation through all the loans it lent
- **Profits & dividends** from the public sector undertakings
- **Grants** – **External grants** from different parts of the world to the country
- **Internal grants** from the central government to the state governments
- **Fees, fines** levied by the government

- **Earnings** from the fiscal **services** like currency printing & general services like irrigation, power distribution etc

Expenditure:

a) Revenue expenditure:

Revenue expenditure is a kind of consumptive expenditure that does not lead to creation of productive assets. It increases the financial liabilities or decreases the financial assets. It consists of:

- **Subsidies** given by the government in different sectors
- **Interests** paid by the government for all the loans it has taken
- **Salaries, provident fund, pensions** paid to the employees by the government
- Expenditures towards social **services** like education, health care etc & non-capital defense expenditure
- **Grants** extended by the government towards other nations and states.

b) Capital expenditure:

Capital expenditure is a kind of expenditure that increases the financial assets or decreases the financial liabilities. It consists of:

- Capital expenditure by the government on **general services** like infrastructure, railways etc.
- Capital D**efence expenditure** like purchase of weapons, defence infrastructure etc.
- **Loans** extended by the central government to the state governments, other countries etc.
- **Loans repaid** by the government which have been previously received.
- *Deficit*

6.2.2.3 Important Types of Deficits

a) Fiscal deficit

b) Primary deficit

c) Revenue deficit

d) Effective revenue deficit

e) Monetized deficit

a) Fiscal deficit:

Fiscal deficit reflects the extent of market borrowings by the government. The more the government borrows the lower the credit worthiness of the government, the higher the interest burden. It also means the government is spending beyond its means i.e., more than its income.

Fiscal deficit = Total expenditure – (revenue receipts + non-debt creating capital receipts)

Non-debt creating capital receipts = disinvestments from PSUs, sale of assets by the Govt. recovery of past loans

b) Primary deficit:

Primary deficit shows what government's fiscal deficit would have been if there was no burden of interest payments .A high primary deficit would mean that fiscal deficit is not on account of interest payments but due to some structural factors. A low primary deficit would mean that a large part of fiscal deficit is on account of interest payments.

Primary deficit = Fiscal deficit – interest payments

c) Revenue deficit:

If the balance of total revenue receipts and total revenue expenditures is negative, it is said to be the revenue deficit. Revenue deficit shows that the government is not able to meet its day to day expenditures.

Revenue deficit = Revenue expenditure – Revenue rec*e*ipts

d) Effective Revenue deficit:

This concept is given by the former president of India **Pranab Mukarjee** in the Union budget 2012-13 in the context of amendment of Fiscal Responsibility & Budget management Act.

Effective revenue deficit = Revenue deficit – those grants given to states that are used by the states for productive purposes

e) Monetized deficit:

Monetized deficit is the deficit which is plugged by the government through **borrowing** from the **RBI**. It means financing the deficit by printing more currency notes by the RBI.

6.2.2.4 Merits of fiscal policy

1. Capital formation
2. Mobilization of resources
3. Incentives to savings
4. Reduction of inequality
5. Alleviation of poverty and unemployment

6.2.2.5 Demerits of fiscal policy

1. Instability
2. Defective tax structure
3. Negative return of the public sector
4. Inflation
5. Growing inequality

6.2.2.6 Suggestions for necessary reforms in fiscal policy

1. Progressive taxes
2. Checking tax evasion
3. Increasing reliance on direct taxes
4. Simplified tax structure
5. Reduction of Non-development expenditure
6. Checking blank money.

The union budget 2018-19 shows an update in the government fiscal target which was revised to 3.3% in the GDP as opposed to 3% previously. While the estimated fiscal deficit budget for fiscal year 2017-18 was 3.2 % of the GDP, now after the declaration the new budget the revised estimated target is 3.5%

of the GDP. Apart from the government will also be targeting on reducing the debt to GDP ratio to 40% from the present ratio of 49.4%.

6.3 Monetary Policy of India

Monetary policy is primarily concerned with the management of supply of money in a growing economy and managing the rate of growth of money supply per period. The Reserve Bank of India (RBI) is vested with the responsibility of conducting monetary policy. This responsibility is explicitly mandated under the Reserve Bank of India Act, 1934. The Monetary and Credit Policy is the policy statement, traditionally announced twice a year, through which the Reserve Bank of India seeks to ensure price stability for the economy. These factors include - money supply, interest rates and the inflation. In banking and economic terms money supply is referred to as M3 - which indicates the level (stock) of legal currency in the economy. Besides, the RBI also announces norms for the banking and financial sector and the institutions which are governed by it.

6.3.1 Main Goals of Monetary Policy of India

Maintain price stability:

The primary objective of monetary policy is to maintain price stability while keeping in mind the objective of growth. Price stability is a necessary precondition for sustainable growth. To maintain price stability, inflation needs to be controlled. The government of India sets an inflation target for every five years. RBI has an important role in the consultation process regarding inflation targeting. The current inflation targeting framework in India is flexible in nature.

Monetary policy framework: While the Government of India sets the Flexible Inflation Targeting Framework in India, it is the Reserve Bank of India (RBI) which operates the Monetary Policy Framework of the country.

- The amended RBI Act explicitly provides the legislative mandate to the Reserve Bank to operate the monetary policy framework of the country.
- The framework aims at setting the policy (repo) rate based on an assessment of the current and evolving macroeconomic situation, and modulation of liquidity conditions to anchor money market rates at or around the repo rate.

- Repo rate changes transmit through the money market to the entire financial system, which, in turn, influences aggregate demand – a key determinant of inflation and growth.
- Once the repo rate is announced, the operating framework designed by the Reserve Bank envisages liquidity management on a day-to-day basis through appropriate actions, which aim at anchoring the operating target – the weighted average call rate (WACR) – around the repo rate.

Monetary Policy Committee (MPC)

Now in India, the policy interest rate required to achieve the inflation target is decided by the Monetary Policy Committee (MPC). MPC is a six-member committee constituted by the Central Government (Section 45ZB of the amended RBI Act, 1934).The MPC is required to meet **at least four times in a year**. The quorum for the meeting of the MPC is four members. Each member of the MPC has one vote, and in the event of an equality of votes, the Governor has a second or casting vote.

The resolution adopted by the MPC is published after the conclusion of every meeting of the MPC. Once in every six months, the Reserve Bank is required to publish a document called the **Monetary Policy Report** to explain: (1) the sources of inflation and(2) the forecast of inflation for 6-18 months ahead.

The present Monetary Policy Committee (MPC)

The Central Government in September 2016 constituted the present MPC as under:

1. Governor of the Reserve Bank of India – Chairperson, *ex officio*;
2. Deputy Governor of the Reserve Bank of India, in charge of Monetary Policy – Member, *ex officio*;
3. One officer of the Reserve Bank of India to be nominated by the Central Board – Member, *ex officio*;
4. Shri Chetan Ghate, Professor, Indian Statistical Institute (ISI) – Member;
5. Professor Pami Dua, Director, Delhi School of Economics – Member; and

6. Dr. Ravindra H. Dholakia, Professor, Indian Institute of Management, Ahmedabad – Member.(Members referred to at 4 to 6 above, will hold office for a period of four years or until further orders, whichever is earlier.

The Reserve Bank of India defines the monetary aggregates as:

- **Reserve Money (M0)**: Currency in circulation + Bankers' deposits with the RBI + 'Other' deposits with the RBI = Net RBI credit to the Government + RBI credit to the commercial sector + RBI's claims on banks + RBI's net foreign assets + Government's currency liabilities to the public – RBI's net non-monetary liabilities. M0 outstanding was ₹14.75 trillion in August 2017.
- **M1**: Currency with the public + Deposit money of the public (Demand deposits with the banking system + 'Other' deposits with the RBI). M1 was 184 per cent of M0 in August 2017.
- **M2**: M1 + Savings deposits with Post office savings banks. M2 was 879 per cent of M0 in August 2017.
- **M3**: (Broad concept of money supply)M1+ Time deposits with the banking system = Net bank credit to the Government + Bank credit to the commercial sector + Net foreign exchange assets of the banking sector + Government's currency liabilities to the public – Net non-monetary liabilities of the banking sector (Other than Time Deposits). M3 was 880 per cent of M0 in August 2017.
- **M4**: M3 + All deposits with post office savings banks (excluding National Savings Certificates).

6.4 Instruments/Techniques of Monetary Policy

Broadly, instruments or techniques of monetary policy can be divided into two categories:

(A) Quantitative or General Methods.

(B) Qualitative or Selective Methods.

A. Quantitative or General Methods:

1. Bank Rate or Discount Rate:

Bank rate refers to that rate at which a central bank is ready to lend money to commercial banks or to discount bills of specified types. Thus by changing the bank rate, the credit and further money supply can be affected. In other words, rise in bank rate increases rate of interest and fall in bank rate lowers rate of interest.

During the course of inflation, monetary authority raises the bank rate to curb inflation. Higher bank rate will check the expansion of credit of commercial banks. The banks will be left with fewer resources which would restrict the credit creating capacity of the bank. On the contrary, during depression, bank rate is lowered; business community will prefer to have more and more loans to pull the economy out of depression. Therefore, bank rate or discount rate can be used in both types of situation i.e. inflation and depression.

2. Open market operations:

By open market operations, we mean the sale or purchase of securities. As it is known that the credit creating capacity of the commercial banks depend on the cash reserves of the banks. In this way, the monetary authority (Central Bank) controls the credit by affecting the base of the credit-creation by the commercial banks. If the credit is to be decreased in the country, the central bank begins to sell securities in the open market.

This will result to reduce money supply with the public as they will withdraw their money with the commercial banks to purchase the securities. The cash reserves will tend to diminish. This happens in the period of inflation. During depression when prices are falling, the central bank purchases securities resulting in expansion of credit and aggregate demand.

3. Variable Reserve Ratio:

The commercial banks have to keep given percentage as cash-reserve with the central bank. In lieu of that cash ratio, it allows commercial banks to contract or expand its credit facility. If the central bank wants to contract credit (during inflation period) it raises the cash reserve ratio. As a result, commercial banks are left with fewer amounts of deposits. Their favour to credit is curtailed. If there is depression in the economy, the reserve ratio is reduced to raise the credit creating capacity of commercial banks. Therefore, variable reserve ratio can be used to affect commercial banks to raise or reduce their credit creation capacity.

CRR is cash reserve ratio which is 4% of NDTL. It means banks have to keep aside cash and can't lend it to anyone. So basically a reserve is created for bank.

4. Change of Liquidity:

According to this method, every bank is required to keep a certain proportion of its deposits as cash with it. When the central bank wants to contract credit, it raises its liquidity ratio and vice versa. SLR(Statutory liquidity ratio) which is 21.5% of NDTL is similar as CRR just that now bank have to keep aside these many cash, gold, RBI approved securities. They are not allowed to lend this and they don’t get any interest on these as these are just kept untouched by the banks.

B. Qualitative or Selective Methods:

1. Change in Marginal Requirements

Under this method, the central bank effects a change in the marginal requirement to control and release funds. When the central bank feels that prices are rising on account of stock-piling of some commodities by the traders, then the central bank controls credit by raising the marginal requirements. (Marginal requirement is the difference between the market value of the assets and its maximum loan value). Let us suppose, a borrower pledged goods worth Rs. 1000 as security with a bank and gets a loan amounting to Rs. 800.Thus marginal requirement is Rs. 200 or 20 percent. If this margin is raised, the borrower will have to pledge goods of greater value to secure loan of a given amount. This would reduce money supply and inflation would be curtailed. Similarly, in case of depression, central bank reduces margin requirement. This will in turn raise the credit creating capacity of the commercial banks. Therefore, margin requirement is a significant tool in the hands of central authority during inflation and depression.

2. Regulation of consumer credit

During inflation, this method is followed to control excess spending of the consumers. Generally the hire purchase facilities or installment methods are used to reduce to the minimum to curb the expenditure on consumption. On the contrary, during depression period, more credit facilities are allowed so that consumer may spend more and more to pull the economy out of depression.

3. Direct Action

This method is adopted when some commercial banks do not co-operate with the central bank in controlling the credit. Thus, central bank takes direct action against the defaulter. The central bank may take direct action in a number of ways as under.

(i) It may refuse rediscount facilities to those banks that are not following its directions.

(ii) It may follow similar policy with the bank seeking accommodation in excess of its capital and reserves.

(iii) It may change rates over and above the bank rate.

(iv) Any other strict restrictions on the defaulter institution.

4. Rationing of the credit:

Under this method, the central bank fixes a limit for the credit facilities to commercial banks. Being the lender of the last resort, central bank rations the available credit among the applicants.

Generally, rationing of credit is done by the following four ways.

(i) Central bank can refuse loan to any bank.

(ii) Central bank can reduce the amount of loans given to the banks.

(iii) Central bank can fix quota of the credit.

(iv) Central bank can determine the limit of the credit granted to a particular industry or trade.

5. Moral Persuasion or Advice:

In the recent years, the central bank has used moral suasion also as a tool of credit control. Moral suasion is a general term describing a variety of informal methods used by the central bank to persuade commercial banks to behave in a particular manner. Moral suasion takes the form of Directive and Publicity.

6.5 Check Your Progress

Multiple choice questions

1. ———— means the use of taxation and public expenditure by the government for stabilization or growth of the economy.

a. Monetary policy

b. Fiscal policy

c. Both a and b

d. None of the above

2. Which of the following are the techniques of fiscal policy?

a. Taxation policy

b. Public expenditure policy

c. Deficit financing policy

d. All of the above

3. —————— is primarily concerned with the management of supply of money in a growing economy and managing the rate of growth of money supply per period.

a. Monetary policy

b. Fiscal policy

c. Taxation policy

d. Deficit financing policy

4. Which of following are the quantitative methods of monetary policy?

a. Bank rate

b. Variable reserve ratio

c. Open market operations

d. All of the above

5. Which of the following reflects Fiscal deficit – interest payments?

a. Fiscal deficit

b. Primary deficit

c. Revenue deficit

d. None of the above

6.6 Summary

Monetary and fiscal policies in any country are two macroeconomic stabilization tools. However, these two policies have often been pursued in different countries in different directions. Monetary policy is often pursued to achieve the objective of low inflation to stabilize the economy from output and price shocks. On the other hand, fiscal policy is often biased towards high growth and employment even at the cost of higher inflation. For achieving an optional mix of macroeconomic objectives of growth and price stability, it is necessary that the two policies complement each other. However, the form of complementarily will vary according to the stage of development of the country's financial markets and institutions. With increasing independence of central bank in the conduct of monetary policy from fiscal dominance during the last few decades, there has been a renewed interest in the issue of monetary and fiscal policy coordination. With increasing independence of central bank in the conduct of monetary policy from fiscal dominance during the last few decades, there has been a renewed interest in the issue of monetary and fiscal policy coordination. Fiscal policy means the use of taxation and public expenditure by the government for stabilization or growth of the economy. The government may change undesirable variations in private consumption and investment by compensatory variations of public expenditures and taxes. An effective fiscal policy is composed of policy decisions relating to entire financial structure of the government, including tax revenue, public expenditure, loans, transfers, debt management, and budgetary deficit and so on. The policy also tries to attain a proper balance between these foresaid units so as to achieve the best possible results in term of economic goals. Monetary policy refers to the use of **monetary instruments** under the control of the **central bank** to regulate magnitudes such as interest rates, money supply and availability of credit with a view to achieving the **ultimate objective of economic policy.** Both of the policy plays a major role in Indian economy and Government of India makes several changes in these policies for its effective implementations.

6.7 Keywords

Monetary policy, Fiscal policy, Reserve Bank of India, Bank rate, Fiscal deficit, Primary deficit, Revenue deficit

6.8 Self-Assessment Test

1. What is Fiscal policy? What are its objectives?

2. Explain the techniques of Fiscal policy?

3. Define Monetary policy. What are its objectives?

4. Explain the instruments or techniques of monetary policy?

5. What are credit control measures of the RBI? Explain each in brief.

6.9 Answer to Check Your Progress

Answer of multiple choice questions:

1. Fiscal policy

2. All of the above

3. Monetary policy

4. All of the above

5. Primary deficit

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Course: Business Environment	
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Foreign Investment in India

STRUCTURE

7.0 Learning Objectives

7.1 Introduction to FDI

7.1.1 Significance of Foreign Investment

7.1.2 Type of Foreign Investments

7.1.3 Disadvantages in FDIs

7.1.4 Government Initiatives to Promote FDI

7.2 Factors Affecting International Investment

7.3 Growth of FDIs

7.4 Recent Trends in FDIs

7.5 Check Your Progress

7.6 Summary

7.7 Keywords

7.8 Self-Assessment Test

7.9 Answer to Check Your Progress

7.10 References/Suggested Readings

7.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know the meaning and significance of Foreign Investment
- Understand the advantages and disadvantages of Foreign Investment
- Know the factors affecting International Investment
- Understand the Growth and Recent Trends in FDIs

7.1 Introduction to Foreign Investment in India

Apart from being a critical driver of economic growth, foreign direct investment (FDI) is a major source of non-debt financial resource for the economic development of India. Foreign companies invest in India to take advantage of relatively lower wages, special investment privileges such as tax exemptions, etc. For a country where foreign investments are being made, it also means achieving technical know-how and generating employment. The Indian government's favorable policy regime and robust business environment have ensured that foreign capital keeps flowing into the country. The government has taken many initiatives in recent years such as relaxing FDI norms across sectors such as defense, PSU oil refineries, telecom, power exchanges, and stock exchanges, among others.

The economic liberalizations that swept across the world, particularly since the late 1980s, have very significantly changed the environment for international investments. At the same time, the surging international capital flows, in its turn, are substantially impacting the business environment. As Peter F. Drucker in his Managing for the Future observers, "increasingly world investment rather than world trade will be driving the international economy. Exchange rates, taxes, and legal rules will become more important than wage rates and tariffs."

7.1.1 Significance of Foreign Investment

Following the analysis of Donald MacDougall and Paul Streeten, Gerald Meier observes that, from the standpoint of national economic benefit, the essence of the case for encouraging an inflow of capital is that the increase in real income resulting from the act of investment is greater than the resultant increase in the income of the investor. If the value added to output by the foreign capital is greater than the amount appropriated by the investor, social returns exceed private returns. As long as foreign investment raises productivity, and this increase is not wholly appropriated by the investor, the greater product must be shared with others, and there must be some direct benefits to other income groups as mentioned below:

1. Domestic Labour: Domestic labour may get higher real wages because of the increase in productivity. There might also be an expansion of the employment opportunities.

2. Consumers: If foreign investment is cost-reducing in a particular industry, consumers of the product may gain through lower product prices. If the investment is product-improving or product-innovating, consumers benefit from better quality products or new products.

3. Government: The increase in production and foreign trade resulting from foreign capital might increase the fiscal revenue of the government.

4. External economies: Foreign capital may bring in a number of indirect gains through the realisation of external economies. For instance, if foreign investment is used for the development of infrastructure, this could stimulate domestic investment in industrial and other sectors.

There are various factors that signify the importance of FDI in India some of which are listed below:

1) Helps in balancing international payments:

FDI is the major source of foreign exchange inflow in the country. It offers a supreme benefit to country's external borrowings as the government needs to repay the international debt with the interest over a particular period of time. The inflow of foreign currency in the economy allows the government to generate adequate resources which help to stabilize the BOP (Balance of Payment).

2) FDI boosts development in various fields:

For the development of an economy, it is important to have new technology, proper management and new skills. FDI allows bridging of the technology gap between foreign and domestic firms to boost the scale of production which is beneficial for the betterment of Indian economy. Thus, FDI is also considered an asset to the economy.

3) FDI & Employment:

FDI allows foreign enterprises to establish their business in India. The establishment of these enterprises in the country generates employment opportunities for the people of India. Thus, the government facilitates foreign companies to set up their business entities in the country to empower Indian youth with new and improved skills.

4) FDI encourages export from host country:

Foreign companies carry a broad international marketing network and marketing information which helps in promoting domestic products across the globe. Hence, FDI promotes the export-oriented activities that improve export performance of the country.

Apart from these advantages, FDI helps in creating a competitive environment in the country which leads to higher efficiency and superior products and services.

7.1.2 Types of Foreign Investment

Broadly, there are two types of foreign investment, namely, foreign direct investment (FDI) and portfolio investment. FDI refers to investment in a foreign country where the investor retains control over the investment. It typically takes the form of starting a subsidiary, acquiring a stake in an existing firm or starting a joint venture in the foreign country. Direct investment and management of the firms concerned normally go together. If the investor has only a sort of property interest in investing the capital in buying equities, bonds, or other securities abroad, it is referred to as portfolio investment. That is, in the case of portfolio investments, the investor uses his capital in order to get a return on it, but has no much control over the use of the capital.

FDIs are governed by long-term considerations because these investments cannot be easily liquidated. Hence, factors like long-term political stability, government policy, industrial and economic prospects etc. influence the FDI decision, However, portfolio investments, which can be liquidated fairly easily, are influenced by short-term gains. Portfolio investments are generally much more sensitive than FDIs. Direct investors have direct responsibility with the promotion and management of the enterprise. Portfolio investors do not have such direct involvement with the promotion and management. Since the economic liberalisation of 1991, there has been a surge in the FDI and portfolio investments in India. There are mainly two routes of portfolio investments in India, viz., by Foreign Institutional Investors (FIIs) like mutual funds and through Global Depository Receipts (GDRs), American Depository Receipts (ADRs) and Foreign Currency Convertible Bonds (FCCBs). GDRs/ADRs and FCCBs are instruments issued by Indian companies in the foreign markets for mobilising foreign capital by facilitating portfolio investment by foreigners in Indian securities. Since 1992, Indian companies, satisfying certain conditions, are allowed to access foreign capital markets by Euro issues.

7.1.3 Disadvantages of FDI

Foreign capital, private and official (governmental and institutional) have certain limitations. Certain additional risks are associated with the private foreign capital. One of the important limitations to utilise the foreign capital is the absorptive capacity of the recipient country, i.e., the capacity of the country to utilise the foreign capital effectively. Lack of infrastructural facilities, technical know-how, personnel, inputs, market, feasible projects, inefficiency or inadequacy of administrative machinery etc. are important factors that affect the absorptive capacity. Sometimes 'strings' are attached to the official assistance—the recipient country may be pressurised to fall in line with the ideology or direction of the donor.

The following criticisms are levelled against foreign capital:

1. Private foreign capital tends to flow to the high profit areas rather than to the priority sectors.

2. The technologies brought in by the foreign investor may not be adapted to the consumption needs, size of the domestic market, resource availabilities, stage of development of the economy, etc.

3. Through their power and flexibility, the multinational corporations can evade or undermine economic autonomy and control, and their activities may be inimical to the national interests of particular countries.

4. Foreign investment, sometimes, have unfavourable effect on the Balance of Payments of a country because the drain of foreign exchange by way of royalty, dividend, etc., is more than the investment made by the foreign concern.

5. Foreign capital sometimes interferes in the national politics.

6. Foreign investors sometimes engage in unfair and unethical trade practices.

7. Sometimes, foreign investment can result in the dangerous situation of minimising/ eliminating competition and the creation of monopolies or oligopolistic structures.

8. FDI can also potentially displace domestic producers by pre-empting their investment opportunities.

9. Often, several costs are associated with encouraging foreign investment. Meier observes that these costs may arise from special concessions offered by the host country, adverse effects on domestic saving, deterioration in the terms of trade, and problems of balance of payments adjustment.

10. **Other Disadvantages**

- **Disappearance of cottage and small scale industries:** Some of the products produced in cottage and village industries and also under small scale industries had to disappear from the market due to the onslaught of the products coming from FDIs. Example: Multinational soft drinks.

- **Contribution to the pollution:** Foreign direct investments contribute to pollution problem in the country. The developed countries have shifted some of their pollution-borne industries to the developing countries. The major victim is automobile industries. Most of these are shifted to developing countries and thus they have escaped pollution.

- **Exchange crisis:** Foreign Direct Investments are one of the reason for exchange crisis at times. During the year 2000, the Southeast Asian countries experienced currency crisis because of the presence of FDls. With inflation contributed by them, exports have dwindled resulting in heavy fall in the value of domestic currency. As a result of this, the FDIs started withdrawing their capital leading to an exchange crisis. Thus, too much dependence on FDls will create exchange crisis.

- **Cultural erosion:** In all the countries where the FDls have made an inroad, there has been a cultural shock experienced by the local people, adopting a different culture alien to the country. The domestic culture either disappears or suffers a setback. This is felt in the family structure, social setup and erosion in the value system of the people. Importance given to human relations, hither to suffers a setback with the hi-fi style of living.

- **Political corruption:** In order to capture the foreign market, the FDIs have gone to the extent of even corrupting the high officials or the political bosses in various countries. Lockheed scandal of Japan is an example. In certain countries, the FDIs influence the political setup for achieving their personal gains. Most of the Latin American countries have experienced such a problem. Example: Drug trafficking, laundering of money, etc

- **Inflation in the economy:** The presence of FDIs has also contributed to the inflation in the country. They spend lot of money on advertisement and on consumer promotion. This is done at the cost of the consumers and the price is increased. They also form cartels to control the market and exploit the consumer. The biggest world cartel, OPEC is an example of FDI exploiting the consumers.

- **Trade deficit:** The introduction of TRIPs (Trade Related Intellectual Property Rights) and TRIMs (Trade Related Investment Measures) has restricted the production of certain products in other countries. For example, India cannot manufacture certain medicines without paying royalties to the country which has originally invented the medicine. The same thing applies to seeds which are used in agriculture. Thus, the developing countries are made to either import the products or produce them through FDIs at a higher cost. WTO (World Trade Organization) is in favour of FDIs.

- **World Bank and lMF aid:** Some of the developing countries have criticized the World Bank and IMF (International Monetary Fund) in extending assistance. There is a discrimination shown by these international agencies. Only those countries which accommodate FDIs will receive more assistance from these international institutions.

- **Convertibility of currency:** FDIs are insisting on total convertibility of currencies in under-developed countries as a prerequisite for investment. This may not be possible in many countries as there may not be sufficient foreign currency reserve to accommodate convertibility. In the absence of such a facility, it is dangerous to allow the FDIs as they may withdraw their investments the moment they find their investments unprofitable.

7.1.4 Government Initiatives to Promote FDI

The Indian government has initiated steps to promote FDI as they set an investor-friendly policy where most of the sectors are open for FDI under the automatic route (meaning no need to take prior approval for investment by the Government or the Reserve Bank of India). The FDI policy is reviewed on a continuous basis with the purpose that India remains an investor-friendly and attractive FDI destination. FDI covers various sectors such as Defence, Pharmaceuticals, Asset Reconstruction Companies, Broadcasting, Trading, Civil Aviation, Construction and Retail, etc.

In the Union Budget 2018, the cabinet approved 100% FDI under the automatic route for single-brand retail trading. Under this change, the non-resident entity is permitted to commence retail trading of ‘single brand’ product in India for a particular brand. Additionally, the Indian government has also permitted 100% FDI for construction sector under the automatic route. Foreign airlines are permitted to invest up to 49% under the approval route in Air India.

The main purpose of these relaxations in foreign investment by the government is to bring international best practices and employee the latest technologies which propel manufacturing sector and employment generation in India. To boost manufacturing sector with a focus on ‘Make in India’ initiative, the government has allowed manufacturers to sell their products through the medium of wholesale and retail, including e-commerce under the automatic route.

7.2 Factors Affecting International Investment

The theories of foreign investment described above have indicated several possible reasons for foreign investment. This section is a further extension of the important factors affecting international investment.

1. Rate of interest: One of the most important stimuli to international capital movements is the difference in the rate of interest prevailing at different places. Capital has a tendency to move from a country with a low rate of interest to a country where it is higher, other things being equal, interest rates or foreign exchange rates.

2. Speculation: Short-term capital movements may be influenced also by speculation pertaining to anticipated changes in the interest rates or foreign exchanges rates.

3. Profitability: Private foreign capital movement is influenced by the profit motive. Hence, other things being equal, private capital will be attracted to countries where the return on investment is comparatively higher.

4. Costs of production: Private capital movements are encouraged by lower costs of production in foreign countries. As Kreinin points out, we may distinguish between two types of cost-reducing investment. The first arises from the need to obtain raw materials from abroad. Such materials may be either unavailable at home or obtainable only at extremely high costs, but they are essential for the production and sale of final products at home or abroad. Without them, profit opportunities would remain unexploited. Indeed, vast investments in the extractive industries are motivated by the fact that the capital must go where the resources are. The second type of cost-reducing investment pertains to costs of commodities other than materials, primarily labour.

5. Economic conditions: Economic conditions, particularly the market potential and infrastructural facilities, influence private foreign investment. The size of the population and the income level of a country have an important bearing on the market opportunities.

6. Government policies: Government policies, particularly towards foreign investment, foreign collaboration, remittances, profits, taxation, foreign exchange control, tariffs, and monetary, fiscal and other incentives, are important factors that may influence foreign investment in a country. Foreign investment can have many undesirable consequences if not properly monitored and regulated.

7. Political factors: Political factors like political stability, nature of important political parties and relations with other countries also influence capital movements.

7.3 Growth of FDI

Following the sweeping changes in the economic policy, foreign investment has been surging in many countries. Today, the worldwide FDI flows and stocks are about 20 times their size in the early 1980s. Trends in Magnitude of Flows although foreign direct investment flows have their ups and downs; the long-term trend has been one of fast growth. For example, between 1970 and 2000, FDI inflows worldwide increased more than a hundred times. The growth has been the sharpest between 1990 and 2000 thanks to the universal liberalisation, privatisation and the surge in cross-border M&As by these developments. It was estimated at $1461 billion in 2013. After peaking in 2000, the FDI flows had a downturn. The upward trend in inflows began again in 2004. FDI inflows peaked in 2007 ($2100 billion but was lower in subsequent years). While the FDI flows had their ups and downs, the stock of FDI has increased tremendously over time. Worldwide FDI inward stock increased from $1779 billion in 1990 to $5810 in 2000 and further to $11999 billion in 2006. FDI inward stock as a percentage of GDP increased more than four times between 1990 and 2013, from 8.4 per cent to 34.3.

Cyclical Behaviour FDI flows are characterised by cyclical behaviour. The decline in FDI flows after peaking in 2000 followed rapid increases during the late 1990s. As the World Investment Reports point out, there was a similar pattern during the late 1980s and early 1990s, and in 1982- 1983. Thus, this is the third downward cycle in FDI, each punctuating a long upward trend in FDI every ten years or so. Factors Affecting the Trend in FDI Flows The swings in FDI flows reflect changes in several factors. The main ones are business cycles, stock market sentiment and M&As. These short-term factors (including factors such as the terrorist attack of September 11, 2000) work in tandem with longer-term factors, sometimes offsetting and at other times reinforcing them. There is, on the other hand, a stable and positive relationship between global FDI flows and the level and growth of world GDP. Technological change, shrinking economic distance and new management methods favour international production. Their impact is, however, countered by cyclical fluctuations in income and growth. The decline in FDI in 2001 reflected a slowdown in the world economy. More than a dozen countries – including the world's three largest economies fell into recession. On the supply side, FDI is affected by the availability of investible funds from corporate profits or loans, which is in turn affected by domestic economic conditions. On the demand side, growing overseas markets lead TNCs to invest, while depressed markets inhibit them. The more interdependent host and home economies become, and the more widely a recession or upswing spreads, the greater are the corresponding movements in global FDI. Data for 1980-2001 show that a bulge in global FDI accompanies high economic growth, and a trough accompanies low growth. However, the relationship between GDP growth and FDI is not uniform across groups of economies. They go together in developed but not in developing countries. One explanation for the different patterns of FDI flows is that business cycles spread much faster across developed countries than others. A supplementary explanation may be that some countries (as in CEE) had been cut off from substantial FDI flows for so long that they have a lot of "catching up" to do – short-term cycles do not affect their attractiveness. The rise in global FDI flows in 2006 was partly driven by increasing corporate profits worldwide and resulting higher stock prices that raised the value of cross-border mergers and acquisitions (M&As). M&As continued to account for a high share of FDI flows, but greenfield investment also increased, especially in developing and transition economies. As a result of higher corporate profits, reinvested earnings have become an important component of inward FDI. They accounted for an estimated 30 per cent of total inflows worldwide in 2006 and for almost 50 per cent in developing countries alone. One of the important determinants of the FDI trend is the trend in cross-border M&A. For example, the dramatic increases in cross-border M&As led to record flows in 1999 and 2000. Cross-border M&As made its contribution to the decline in the FDI too.

7.4 Recent Trends in FDIs

Enthused by a record foreign investment inflow, India is optimistic of continuing to be one of the world's favourite FDI destinations in 2020 on the back of the Modi government's liberalised norms and a significant jump in the ease of doing business ranking. Secretary in the Department for Promotion of Industry and Internal Trade (DPIIT) Guruprasad Mohapatra said that despite a slowdown in the global economy, inflows of foreign investment into the country have not been impacted. India received a USD 27.2-billion foreign investment in the first half of 2019 and the pace is said to have sustained thereafter. The healthy growth in the overseas investments is proving that there is a lot of optimism and enthusiasm about India as a foreign investment destination. All the ministries, departments and states are working to address issues and providing stable policies to facilitate entry of foreign companies. Ease of doing business is very critical for FDI. Foreign companies look into the World Bank's ranking and they have been very impressed with India's much-improved ranking so far. The improvement in the business environment gives a pleasant experience to foreign investors as it helps in making processes easier. Some of the states are also wooing investments. So there is a need to further work on the areas in which the investments are coming and see how quickly and seamlessly, we can give those approvals. The global companies which are looking to shift their bases from China to India, the government is focusing on those firms which are looking at India as a second investment destination. In the World Bank’s doing business report, India's rank has improved to 63rd this year among 190 economies from 77th last year. The department is also holding a series of meetings to further relax foreign direct investment norms in the coming months in areas like AVGC (animation, visual effects, gaming and comics), and insurance. Although, the FDI is allowed through automatic route in most of the sectors, certain areas such as defence, telecom, media, pharmaceuticals and insurance, government approval is required for foreign investors. Under the government route, the foreign investor has to take prior approval of the respective ministry/department. Through the automatic approval route, the investor just has to inform the RBI after the investment is made.

7.5 Check Your Progress

Multiple Choice Questions:

1. _______________ is a major source of non-debt financial resource for the economic development.

a. Balance of Payment

b. Foreign direct investment

c. GDP

d. None of the above

2. Which of these factors affect the international investment?

a. Economic Conditions

b. Cost of Production

c. Both a and b

d. Only a

3. Which among them is not a disadvantage of FDIs?

a. Exchange crisis

b. Political corruption

c. Cultural erosion

d. Boost to cottage industries

4. Introduction of__________ & __________has restricted the production of certain products in other countries.

a. M&As

b. TRIPs & TRIMs

c. Exchange crisis & Economic Condition

d. FDIs &FIIs

5. Which among these institutions is in favour of FDIs?

a. IMF

b. World Bank

c. World Trade Organisation

d. IDBI

7.6 Summary

Encouraged by the favourable business environment fostered by the global liberalisation, the international private capital flows have been increasing rapidly. Cross-border M&As have been the major driver of the recent surge in the FDI. Foreign capital now contributes a significant share of the domestic investment, employment generation, industrial production and exports in a number of economies, including China. Broadly, there are the following two types of foreign investment;

• Foreign direct investment (FDI) where the investor has control over participation in the management of the firm.

• Portfolio investment where the investor has only a sort of property interest in investing the capital in buying equities, bonds, or other securities abroad. In the case of portfolio investments, the investor uses his capital in order to get a return on it, but has no much control over the use of the capital. The major portfolio investment in the Indian capital market is by the foreign institutional investors (FIIs).

Broadly there are three economic motives of FDI, viz., resources seeking (e.g., exploiting the natural resources of the host country); market seeking (i.e., to exploit the market opportunities of the host countries) and efficiency seeking (like low cost of production deriving from cheap labour). The presence of any (or even all) of these determinants alone need not attract FDI. Several other factors like the political environment, government policies, bureaucratic culture, social climate, infrastructural facilities etc. are also important determinants of FDI. Although the international capital flows to the developing countries have increased substantially in the last one decade or so, they are still predominantly between the developed countries. A small number of countries account for the lion's share of the international capital inflows to the developing world. Although India has substantially liberalised its foreign investment policy, the FDI inflows had been much below the targets. India had not been getting even one-tenth the size of FDI flow to China. Even the cumulative FDI flow to India between 1991 and 2007 was less than the annual flow to China. Bureaucratic problems, certain unfavourable government attitudes, poor infrastructure, labour factors, high input costs etc. are regarded as the major reasons.

7.7 Keywords

1. Foreign Direct Investment: A foreign direct investment (FDI) is an investment made by a firm or individual in one country into business interests located in another country.

2. M&As: Mergers and acquisitions (M&A) is a general term used to describe the consolidation of companies or assets through various types of financial transactions, including mergers, acquisitions, consolidations, tender offers, purchase of assets and management acquisitions.

3. Government Initiatives: The Government takes initiatives to increase FDIs in India as it has amended FDI policy to increase FDI inflow.

4. Recent Trends: Recent trends mean the recent inflows and outflows of investments which affect the Indian economy.

7.8 Self-Assessment Test

1. What are Foreign Direct Investments and its significance?
2. What are the negative impacts of foreign direct investment for India?
3. Which all factors affect the international investment?
4. What are the recent trends and growth in FDIs?
5. Discuss the government initiatives to enhance FDIs.

7.9 Answers to Check Your Progress

1. Foreign Direct Investment

2. Both a & b

3. Boost to cottage industries

4. TRIPs & TRIMs

5. World Trade Organisation

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Multinational Corporation in India

STRUCTURE

8.0 Learning Objectives

8.1 Introduction

8.2 Multinational Corporation

8.2.1 Characteristics of MNC

8.2.2 Dominance of MNCs

8.2.3 Perspective

8.2.4 Code of Conduct

8.2.5 Opportunities and Challenges for MNCs in India

8.2.6 Problems from the Growth of MNCs

8.3 MNCs in India

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8.10 References/Suggested Readings

8.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know about Multinational corporations and their Objectives.
- Understand the Opportunities and Challenges for MNCs in India.
- Know the problems in Growth of MNCs.
- Understand Current status and Criticisms against MNCs in India.

8.1 Introduction

The dynamics of the business environment fostered by the drastic political changes in the erstwhile communist and socialist countries and the economic liberalisation across the world has enormously expanded the opportunities for the multinational corporations, also known by names such as international corporation, transnational corporation, global corporation (or firm, company or enterprise) etc. The rapidity with which the MNCs are growing is indicated by the fact that while according to the World Investment Report 1997 there were about 45000 MNCs with some 2.8 lakh affiliates, according to the World Investment Report 2010 there were more than one lakh of them with about 9 lack affiliates. Only one-third of these affiliates were in the developed countries. China is host about to 36 per cent of the total number of affiliates. The MNCs account for a significant share of the world's industrial investment, production, employment and trade. Although the multinational corporation took birth in the early 1860s, it was after the Second World War that multinationals have grown rapidly. In the early days, the United States was the home of most of the MNCs. Now, there are a large number of Chinese, Japanese and European multinationals. There has been a fast increase of developing country firms in the Fortune 500. In 2014, China had 95, South Korea 17 and from India 8 companies in the list. MNCs of the US are more focused, i.e., they confine their business to one industry or product category. In fact, several American MNCs which attempted diversification, mostly by the acquisitions route, reverted to focus, after bitter experiences with the diversification. Compared with the US MNCs, most European companies have a much broader product line. Japanese companies, generally, have product lines that are much too broad. Of the top ten corporation in the US, only one (General Electric) is a classic conglomerate, while in Japan eight are conglomerates and only two are not (Toyota Motor and Nippon Telegraph and Telephone). Similarly, the Korean corporations are far too diversified. Recent trends indicate that the diversified corporations have many odds against them and the focus strategy is more successful.

As the concept of multinationality has several dimensions, there is no single universally agreed definition of the term multinational corporation. According to an ILO Report, "the essential nature of the multinational enterprises lies in the fact that its managerial headquarters are located in one country (referred to for convenience as the ("home country") while the enterprise carries out operations in a number of other countries as well ("host countries"). Obviously, what is meant is "a corporation that controls production facilities in more than one country, such facilities having been acquired through the process of foreign direct investment. Firms that participate in international business, however large they may be, solely by exporting or by licensing technology are not multinational enterprises." Among the various other benchmarks sometimes used to define 'multinationality' is that the company in question must:

- Produce (rather than just distribute) abroad as well as in the headquarters country
- Operate in a certain minimum number of nations (six for example)
- Derive some minimum percentage of its income from foreign operations (e.g., 25 per cent)
- Have a certain minimum ratio of foreign to total number of employees, or of foreign total value of assets
- Possess a management team with geocentric orientations
- Directly control foreign investments (as opposed simply to holding shares in foreign companies).

The definitions of the terms transnational corporation (used to mean the same thing as MNC and similar terms) foreign affiliate, subsidiary and branch given in the UN's World Investment Report are as follows. Transnational Corporations are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A parent enterprise is deemed as an enterprise that controls assets of other entities in countries other than its home country, usually by owning a certain equity capital state. An equity capital stake of 10 per cent or more of the ordinary shares or voting power for an incorporated enterprise, or its equivalent for an unincorporated enterprise, is normally considered as a threshold for the control of assets. (In some countries, such as Germany and United Kingdom, the threshold is a stake of 20 per cent or more.) A Foreign Affiliate is an incorporated or unincorporated enterprise in which an investor, who is resident in another economy, owns a stake that permits a lasting interest in the management of that enterprise (an equity stake of 10 per cent for an incorporated enterprise or its equivalent for an unincorporated enterprise). In the World Investment Report, subsidiary enterprise, a subsidiary enterprise, associate enterprise and branches are all referred to as foreign affiliates. A Subsidiary is an incorporated enterprise in the host country in which another entity directly owns more than a half of the shareholders' voting power and has the right to appoint or remove a majority of the members of the administrative, management or supervisory body. An Associate is an incorporated enterprise in the host country in which an investor owns a total of at least 8 per cent, but not more than a half, of the shareholders' voting power.

8.2 Multinational Corporation

This was the type of the corporation popular when many European companies internationalised during the pre-war (1920s and 1930s) when the trade barriers were very high. According to Bartlett and Ghoshal, the multinational organisation is defined by the following characteristics: a decentralised federation of assets and responsibilities, a management process defined by simple financial control systems overlaid on informal personal coordination and a dominant strategic mentality that viewed the company's worldwide operations as a portfolio of national businesses. In a multinational organisation, the decisions, obviously, are decentralised.

8.2.1 Characteristics of Multinationals

MNCs will always look out for opportunities. They carry out risk analysis and send their personnel to learn and understand the business climate. They develop expertise understanding the culture, politics, economy and legal aspects of the country that they are planning to enter. The essential element that distinguishes the true multinational is its commitment to manufacturing, marketing, developing R&D, and financing opportunities throughout the world, rather than just thinking of the domestic situation.

Some of characteristics of MNCs are:

(i) Mode of Transfer:

The MNC has considerable freedom in selecting the financial channel through which funds or profits or both are moved, e.g., patents and trademarks can be sold outright or transferred in return through contractual binding on royalty payments. Similarly, the MNC can move profits and cash from one unit to another by adjusting transfer prices on intercompany sales and purchases of goods and services. MNCs can use these various channels, singly or in combination, to transfer funds internationally, depending on the specific circumstances encountered.

(ii) Value for Money:

By shifting profits from high-tax to low-tax nations, MNCs can reduce their global tax payments. In addition, they can transfer funds among their various units, which allow them to circumvent currency controls and other regulations and to tap previously inaccessible investment and financing opportunities.

(iii) Flexibility:

Some to the internationally generated claims require a fixed payment schedule; other can be accelerated or delayed. MNCs can extend trade credit to their other subsidiaries through open account terms, say from 90 to 180 days. This gives a major leverage to financial status. In addition, the timing for payment of fees and royalties may be modified when all parties to the agreement are related.

8.2.2 Dominance of MNCs

The global liberalisation has paved the way for fast expansion and growth of the MNCs. The following paragraphs excerpted from the World Investment Reports 2000 and 2003 provide some indications of the economic dominance of the multinationals. Many countries and economic activities are dominated by MNCs, rendering them a formidable force in today’s world economy. According to UNCTAD’s World Investment Report 2009, there were more than 82,000 multinationals in the world with over 8 lakh foreign affiliates.

The size of large TNCs is sometimes compared to that of countries’ economies, as an indicator of the influence that the former have in the world economy. According to one comparison of the sales volume of firms with the GDP of countries, the sales of the top 200 firms accounted for 27.5 per cent of world GDP in 1999. Of the 50 largest “economies”, 14 were TNCs and 36 were countries. Their economic impact can be measured in different ways. In 2010, foreign affiliates accounted for about 68 million employees, compared to 21 million in 1990; their sales of almost $33 trillion were more than double the world exports in 2010, compared to 1990 when both were roughly equal; and the stock of outward foreign direct investment (FDD, increased from $1.7 trillion to $6.6 trillion over the same period. Foreign affiliates now account for one-tenth of world GDP and one-third of world exports. Moreover, if the value of worldwide TNC activities associated with non-equity relationships (e.g., international subcontracting, licensing, and contract manufacturers) is considered, TNCs would account for even larger shares in these global aggregates.

8.2.3 Perspective

Future holds out an enormous scope for the growth of MNCs. The changes in the economic environment in a large number of countries indicate this. For instance, the number of bilateral treaties that promote and/or protect FDI has increased markedly in recent times. A United Nation’s Report described several developments that points to a rapidly changing context for economic growth, along with a growing role for transnational corporations in that process. These include:

1. Increasing emphasis on market forces and a growing role for the private sector in nearly all developing countries.

2. Rapidly changing technologies that are transforming the nature of organisation and location of international production.

3. The globalisation of firms and industries.

4. The rise of services to constitute the largest single sector in the world economy; and

5. Regional economic integration, which involve both the world’s largest economies as well as selected developing countries.

8.2.4 Code of Conduct

It is widely felt that there must be a code of conduct to guide and regulate the MNCs. According to the Brandt Commission, the principal elements of an international regime for investment should include:

1. A framework to allow developing countries as well as transnational corporations to benefit from direct investments on terms contractually agreed upon. Home countries should not restrict investment or the transfer of technology abroad, and should desist from other restrictive practices such as export controls or market, not restrict current transfers such as profits, royalties and dividends, or the repatriation of capital, so long as they are on terms which were agreed when the investment was originally approved or subsequently negotiated.

2. Legislation promoted and coordinated in home and host countries, to regulate the activities of transnational corporations in such matters as ethical behaviour, disclosure of information, restrictive business practices, cartels, anti-competitive practices and labour standards. International codes and guidelines are a useful step in that direction.

3. Cooperation by Governments in their tax policies to monitor transfer pricing and to eliminate the resort to tax havens.

4. Fiscal and other incentives and policies towards foreign investment to be harmonised among host developing countries, particularly at regional and sub-regional levels, to avoid the undermining of the tax base and competitive positions of host countries.

5. An international procedure for discussions and consultations on measures affecting direct investment and the activities of transnational corporations.

The Code of Conduct for MNCs, drawn up by the Commission on Transnational Corporations, set up by the UN’s Economic and Social Council, required MNCs, inter alia, to:

• Respect the national sovereignty of host countries and observe their domestic laws, regulations and administrative practices.

• Adhere to host nations’ economic goals, development objectives and socio-cultural values.

• Respect human rights.

• Not interfere in internal political affairs or in inter-governmental relations.

• Not engage in corrupt practices.

• Apply good practice in relation to payment of taxes, abstention from involvement in anti-competitive practices, consumer and environmental protection and the treatment of employees.

• Disclose relevant information to host country governments.

According to the 1976 declaration of the OECD Code of Practice on MNC operations, MNCs should contribute positively to economic and social progress within host nations. Its main provisions were that MNCs should:

- Contribute to host countries' science and technology objectives by permitting the rapid diffusion of technologies.
- Not behave in manners likely to restrict competition by abusing dominant positions or market power.
- Provide full information for tax purposes.
- Consult with employee representatives regarding major changes in operations, avoid unfair discrimination in employment and provide reasonable working conditions.
- Consider the host nation's balance of payments objectives when taking decisions.
- Regularly make public significant information on financial and operational matters, host countries themselves should, the Code insists, possess the absolute right to nationalise foreign-owned assets within their frontiers, but must pay proper compensation. It is very interesting to note that the demands by developing countries that the Code become legally binding were rejected by the UN General Assembly, at the behest of economically advanced countries.

8.2.5 Opportunities and Challenges for MNCs in India

For succeeding in India, you need to cater the locals with their local flavour, keep your prices competitive, value their diverse cultures, not hurt sentiments, provide outstanding services, and lot more things. India witnessed a number of foreign companies entering India since liberalisation in 1991. Out of these companies, many have shut down in short terms, since they could not survive India. Be it General Motors announcing its exit in mid-2017, or banks like Barclays and Royal Bank of Scotland shutting down their banking services, there were a number of reasons for their failure. Often times, the challenges they faced weren't accounted for in initial planning. Let us dwell deeper into some common challenges Multi-National Companies face while setting up business in India.

1. Infrastructure

Selecting a suitable place in India can be quite a challenge for Multinational Companies. Western companies tend to lease office spaces rather than owning it. Due to lack of professional infrastructure and high demands, companies need to book offices in under construction buildings way before they are completed. Not only this, they also need to lease large office spaces in the very beginning to keep a check on growth of the company, and availability of more space. This creates quite a hassle in the beginning for the spaces are too large for the amount of people it holds. Once the company grows, and there is scope of expansion, a company should be considered lucky if it gets another office near the existing ones. For instance, HP has more than 20 offices in Bangalore which are scattered all over the city. Now, it is looking towards constructing its own office campus, getting into real estate business, which was never in its initial plan.

2. Recruitment

Recruitment is another challenge for the companies as there is an enormous crowd applying for jobs in India, whereas the number of quality and talented professionals is very less. The fact that India has become a hub for IT/Software and Service sector, there is a race among top multinationals to hire the best available talent in the country. Also, the supply of labour is enormous in the country. To filter out the cream is a challenge in itself. For instance, there was once a time when there was a scarcity of software engineers in India, and hence, companies paid them high since the supply was low. Now, the tables have turned completely. Companies like Infosys receive more than 1.4 million applications in a year, out of which not more than 60–70k are interviewed. The final selection is as low as 25,000 per company. Since the supply has skyrocketed, the cost of labour has gone down. It is only a cream of students from top institutes who are employed by such companies.

3. Diverse culture

While Unity in Diversity is one of the top strengths of India, it is also one big weakness for the companies to set up their business. Since most companies are western, and the top management is foreign in the beginning, there is a huge problem in coping up with the culture of the diversity of employees they hire. This can stir quite unrest in the employees. In mono culture teams and countries, a person can freely express his views, whereas, in a diverse cultural nation like India, you are more likely to offend people with your thoughts and opinions.

4. Price centric customers

In India, another problem that companies face is the mentality of the people in buying goods and availing services. India is more of a price centric nation, which does not witness as much brand loyalty, as it does consider the price. Hence, not only do the companies need to provide quality products, they also need to charge a competitive price for that. People would compare features without going into the premium depth, and hence choose a cheaper version. The fall of the telecom sector is a perfect example for the price centric mentality of the people. For well settled companies which entered India are used to these challenges. Whereas, companies who have just started on a multinational path, have a long way to go to understand how the cultural, political and legal system works in India. The suggested solutions for all companies to deal with the government and also with cultural and recruitment problems is to hire Business Consultants or Senior Management who have in-depth knowledge of the same. India is a country that can provide you with vast business opportunities, only if you know how to utilize it the right way.

8.2.6 Problems from the Growth of MNCs

Much of the concern about MNCs stems from their size, which can be formidable. MNCs may impose on their host governments to the advantages of their own shareholders and the disadvantages of citizens and shareholders in the country of shareholders in the past. It can be difficult to manage economics in which MNCs have extensive investments. Since MNCs often have ready access to external sources of finance, they can blunt local monetary policy. When the Government wishes to constrain any economic activity, MNCs may nevertheless expand through foreign borrowing.

Similarly, efforts at economic expansion may be frustrated if MNCs move funds abroad in search of advantages elsewhere. Although it is true that any firm can frustrate plans for economic expansion due to integrated financial markets, MNCs are likely to take advantage of any opportunity to gain profits. As we have seen, MNCs can also shift profits to reduce their total ‘tax burden by showing larger profits in countries with lower tax rates citizens and shareholders in the country of shareholders in the past.

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8.3 Multinational Corporations in India

MNCs have been operating in India even prior to Independence like Singer, Parry, Philips, Unit- Lever, Proctor and Gamble. They either operated in the form of subsidiaries or entered into collaboration with Indian companies involving sale of technology as well as use of foreign brand names for the final products. The entry of MNCs in India was controlled by existing industrial policy statements, MRTP Act, and FERA. In the pre-reform period the operations of MNCs in India were restricted.

New Industrial Policy 1991 and Multinational corporations:

The New Industrial Policy 1991 removed the restrictions of entry to MNCs through various concessions. The amendment of FERA in 1993 provided further concession to MNCs in India.

At present MNCs in India can—

(i) Increase foreign equity up to 51 percent by remittances in foreign exchange in specified high priority areas. Subsequently MNCs are free to own a majority share in equity in most products.

(ii) Borrow money or accept deposit without the permission of Reserve Bank of India.

(iii) Transfer shares from one non-resident to another non-resident.

(iv) Disinvest equity at market rates on stock exchanges.

(v) Go for 100 percent foreign equity through the automatic route in Specified sectors.

(vi) Deal in immovable properties in India.

(vii) Carry on in India any activity of trading, commercial or industrial except a very small negative list.

Thus, MNCs have been placed at par with Indian Companies and would not be subjected to any special restrictions under FERA.

8.4 Criticisms against MNCs in India

The operations of MNCs in India have been opposed on the following grounds:

(i) They are interested more on mergers and acquisitions and not on fresh projects.

(ii) They have raised very large part of their financial resources from within the country.

(iii) They supply second hand plant and machinery declared obsolete in their country.

(iv) They are mainly profit oriented and have short term focus on quick profits. National interests and problems are generally ignored.

(v) They use expatriate management and personnel rather than competitive Indian Management.

(vi) Though they collect most of the capital from within the country, they have repatriated huge profits to their mother country.

(vii) They make no effort to adopt an appropriate technology suitable to the needs. Moreover, transfer of technology proves very costly.

(viii) Once an MNC gains foothold in a venture, it tries to increase its holding in order to become a majority shareholder.

(ix) Further, once financial liberalizations are in place and free movement is allowed, MNCs can stabilize the economy.

(x) They prefer to participate in the production of mass consumption and non-essential items.

8.5 Check Your Progress

Multiple choice questions:

1. In order to succeed in Indian market which activity is not major for MNCs.

e. Culture analysis

f. Competitive Price

g. Outstanding services

h. Ambiguous strategies

2. Which of these is the main objective of the MNCs which become a weak point for India?

e. Focus on Mergers and Acquisitions

f. Major eye on short term quick profit

g. Both a and b

h. None of the above

3. ______________a decentralised federation of assets and responsibilities.

e. Liberalisation

f. Multinational Corporation

g. Multilevel companies

h. None of the above

4. Higher growth of MNCs in India can cause:

e. Blunt of monetary policy

f. Advantages to own shareholders

g. Movement of funds outside India

h. All of the above

5. Which of these is not a major challenge or opportunity for MNCs?

e. Infrastructure

f. Finance

g. Diverse culture

h. Recruitment

8.6 Summary

The lesson goes through all aspects of MNCs and their challenges and opportunities in India. *India* has been attracting various *multinational companies* with its attractive and friendly policies. India is an emerging country and the best reason for its development is *MNC's* of *India*. They are multi-process and multi-product enterprises. India is an investment-friendly nation and has attracted the attention of leading multinational organizations because of the population resources, the potential of our workforce, constantly improving when it comes to ease of doing business and a dynamic consumer-oriented market that is quick to absorb new ideas and services.

India benefits from the best multinational companies through their investments, coming in with new technology, contributions to infrastructure, capital and foreign exchange and boosting economic health. Employment generation is also a major aspect. But, at the same time MNC's are facing the challenges to survive and compete in the environment. A MNC always face the challenge of appropriate infrastructure, resources, consumers and many more hurdles to successfully implement their strategies.

Multinational companies are also coming out as a threat for Indian economy as they have their aims which are contradictory to host countries aim. MNCs concentrate on their own short term profits, transferring of funds to their country, recruitment of key personnel from home country and various other aspects. Multinational companies have a long way to go in India and with time it will face new challenges and will get new opportunities.

8.7 Keywords

Multinational Corporation: A *multinational corporation* (*MNC*) is usually a large corporation incorporated in one country which produces or sells goods or services in various countries.

Challenges: MNCs entering a new country face lots of challenges such as availability of resources, infrastructure, labour and various other.

Opportunities: Opportunities are the best prospects available for the MNCs in their host country.

MNCs Growth: MNCs growth in India is causing harm to Indian economy or is boosting the economy is debatable issue.

Code of conduct: They are certain rules or acts to guide the conduct of MNCs.

8.8 Self-Assessment Test

1. What is a Multinational Corporation? What is its nature?
2. What are the major opportunities and challenges faced by MNCs in India?
3. Which are the major threats to Indian economy due to increased rate of MNCs?

4. What is the current status of MNCs in India?
5. "MNCs as Indian economy accelerators or decelerators" Discuss.

8.9 Answer to Check Your Progress

Answer of Multiple Choice Questions

1. Ambiguous strategies
2. Both a and b
3. Multinational Corporation
4. All of the above
5. Finance

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GLOBALISATION

STRUCTURE

9.0 Learning Objectives
9.1 Introduction
9.2 What is Globalisation
9.2.1 Features of Globalisation
9.2.2 Essentials Conditions for Globalisation
9.2.3 Stages of Globalisation
9.2.4 Advantages and Disadvantages of Globalisation
9.3 Strategies for Entering into Foreign Market
9.4 Measures adopted by Indian Government for Globalisation
9.5 Check Your Progress
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9.9 Answers to Check in your Progress
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9.0 LEARNING OBJECTIVES

After reading this chapter one should be able to understand:

- About Globalisation and its features.
- Essential Conditions for Globalisation.
- Different stages of Globalisation
- Various strategies for entering into foreign market
- Advantages and Disadvantages of Globalisation.

- Various measures taken by Indian Government for globalisation

9.1 INTRODUCTION

The term "globalization" has acquired considerable emotive force. Some view it as a beneficial process, others regard it with hostility believing that it increases inequality within and between nations, threatens employment, living standards and thwarts social progress. .Globalization offers extensive opportunities for genuinely global development, but it is not progressing evenly. Some countries are becoming integrated into the global economy more quickly than others. Countries that have been able to integrate are seeing faster growth and reduced poverty. Outward-oriented policies brought dynamism and greater prosperity too much of East Asia, transforming it from one of the most deprived areas of the world 40 years ago. And as living standards rose, it became possible to make progress on democracy and economic issues such as the environment and work standards. By contrast, in the 1970s and 1980s when many countries in Latin America and Africa pursued inward-oriented policies, their economies stagnated or declined, poverty increased, and high inflation became the norm. In many cases, especially Africa, adverse external developments made the problems worse. As these regions changed their policies, their incomes have begun to rise. A remarkable transformation is underway. Encouraging this trend, not reversing it, is the best course for promoting growth, development and poverty reduction.

The crises in the emerging markets in the 1990s have made it quite evident that the opportunities of globalization do not come without risks—risks arising from volatile capital movements and the dangers of social, economic, and environmental degradation created by poverty. It is not a reason to reverse direction, but for all concerned—in developing countries, in the advanced countries, and of course investors—to embrace policy changes to build strong economies and a more reliable world financial system that will produce more rapid growth and ensure that poverty is reduced.

9.2 WHAT IS GLOBALISATION

Globalization refers to a process of interaction and integration among the people, companies, and government of different nations. It is the process of spreading Western culture and value system, specifically capitalist market culture. It is the process by which the world is becoming increasingly interconnected. It is linking the economy of a nation with the economies of other countries through free trade, free mobility of capital and labour, etc. The International Monetary Fund (IMF) defines Globalization as “the growing economic interdependence of nations worldwide through increasing volume and variety of cross border transactions in goods and services, international capital flow, and widespread diffusion of technology”. It is a mind-set which views the entire world as a single market. It does not differentiate between domestic market and foreign markets. In other words, there is nothing like a home market and the international market. There is only one market that is the global market.

9.2.1 FEATURES OF GLOBALISATION

Globalization is not a new concept, and it has been prevalent for the past many years, but the nature and system of globalization have changed over the years. In the past, it meant the exchange of goods and service between countries without any barriers but in the present scenario apart from goods and services globalization implies the transfer of culture value, jobs, technical knowhow and so many other things. Globalization has become a much broader concept now; let’s look at some of the essential features of globalization:

1. **Efficient Use of Resources:** Globalization leads to more efficient use of world resources because every country has a different set of natural and human resources which results in that country producing particular product at lowest possible price than any other country. The globalization by opening up world markets forces the nation to provide those products which yield the maximum profits.
2. **Quick Transfer of Innovation:** Globalization leads to faster transfer of any invention or discovery made in one country from another country. Those days were gone where one country had to wait for many months to get better and new technological advancement from other countries. Nowadays, the countries get the new technological invention to discover in another country almost instantly, which in turn leads to better efficiency.
3. **Immediate Help:** According to this feature of globalization, during times of natural calamity like floods, earthquakes, famines, all other countries send immediate help to the country which is stuck by natural disaster. It helps in reducing the deaths due to the shortage of basic amenities.
4. **Integration of financial Market:** Integration of financial markets is another important feature of globalization. Due to it, all financial markets of the world interconnected. Hence, one event leads to

a reaction is not only the home market, but it has implications over other global markets also. This connection is not limited to the only stock market; instead, it covers the commodity market, currency markets and bond markets even.

5. **Movement Across the World:** According to this feature, due to globalization, people can travel and explore other countries, experience and discover a new culture, food, tradition, and so on. It helps to remove the mental barrier because as people travel, they tend to learn new facts about the other countries and remove many misconceptions they have about other countries. A few decades back if you ask people to develop countries to visit countries in Asia and the African region, they say no. Still, nowadays people go happily to these countries for vacation as well as adventure.
6. **The whole world is a stage:** According to this feature, due to globalization, the world as a whole is open for talented people to show their skills. Whether an individual is an actor or businessmen or sportsmen or in any other field he or she can prove his or her skills and make name and money all over the world which was not possible few decades back. Hence, it provides a platform to people irrespective of their age, religion, ethnicity, and background to make most of their talent.
7. **Creation of New Markets:** Globalization implies a drastic reduction of physical barriers between countries. It has allowed the market to diversify and expand, increasing the production of goods and services. As a result of diversification, new markets have emerged. Some critics of globalization indicate that this has created an ideal platform for countries with enormous wealth to take advantage of the advantages of working with poorer countries since the labour force in these countries is more economical.

9.2.2 ESSENTIAL CONDITIONS FOR GLOBALISATION

There are some essential conditions for successful globalisation of the business that is satisfying on the part of the domestic economy as well as the firm. Followings are the necessary conditions for successful globalisation of firms:

1. **Business Freedom:** According to this condition, there should not be any undue government restrictions such as import restriction, restriction on sourcing finance from abroad, and restriction on foreign investment etc. which come in the way of globalisation. The business has freedom from all types of limitations from the government.

2. **Facilities:** The availability of infrastructure and another type of facility is essential for the development of a firm globally. The extent to which an enterprise can develop globally from home country base depends upon the facilities available like infrastructure facilities.
3. **Government Support:** According to this condition, unnecessary government interference is a hindrance to successful globalisation of firms. Government support helpful in encourage globalisation in the form of policy and procedural reforms, development of infrastructure facilities, research and development support, financial market reforms, and so on.
4. **Resources:** According to this condition, resources is one of the crucial factors for the successful globalisation of firms. It helps decide the ability of a firm to globalise. The resources include finance, technology, R & D capabilities, managerial expertise, company and brand image, human resource etc.
5. **Competitiveness:** According to this condition, the competitive advantage of the firm is a crucial determinant of success in global business. A firm may derive competitive advantage from any one or more of the factors such as low costs and price, product quality, product differentiation, technological superiority, after-sales service, marketing etc.
6. **Orientation:** According to this condition, a global orientation on the part of the business firms and suitable globalisation strategies such as exporting, licensing/franchising, contract manufacturing, management contract, assembly operations, joint venture etc. are essential for globalisation.

9.2.3 STAGES OF GLOBALISATION

Usually, a firm passes through different stages of development before it becomes a truly global or Transnational Corporation. Typically, a domestic firm starts its international business by exporting. Later, it may establish joint ventures or subsidiaries abroad. At last, it may then develop into a multinational or global firm from an international firm.

Ohmae identifies five different stages in the development of a firm into a worldwide corporation. The five steps are:

- **First Stage:** The early stage is the arm's length service activity of the domestic company which moves into new markets overseas by linking up with the foreign local dealers and distributors.

- **Second Stage:** In the second stage, the domestic company enter into new markets overseas by takes over the dealing and distributing activities on its own instead of the foreign local dealers and distributors.
- **Third Stage:** It is the extension of the second stage. In this stage, the domestic company or home country begins to carry out it's manufacturing, marketing, and sales in the key foreign markets.
- **Fourth Stage:** In the fourth stage, the domestic or home-based company moves to a full insider position in the key foreign markets. The company supported by a complete business system including Research and Development (R&D) and engineering. This stage forces the mangers to extend the reach of national headquarters to all overseas activities.
- **Fifth Stage:** In the fifth stage, the company genuinely moves towards the global mode of operation. At this stage, the company becomes a global company. The company starts its services all over the world.

9.2.4 ADVANTAGES AND DISADVANTAGES OF GLOBALISATION

India's economic integration with the rest of the world was minimal because of the restrictive economic policies followed until 1991. The situation is changing now. Globalization is more than just a buzzword. It's changed the way that many companies work and how they approach many aspects of their operations.

Following are the main advantages and disadvantages of globalization:

Advantages of Globalization:

Followings are the main advantages of the globalization:

1. **Employment Opportunities:** According to this, Globalisation helps in generating employment opportunities. It creates employment opportunities for those people who still don't have a job. Most companies today move to a well-civilized country to give a chance to unemployed workers to gain a job that suits their abilities and expertise.
2. **Low or Cheaper Price:** According to this, globalization increases the inflow of foreign technology from superior and advanced developed nations. These modern technology helps produce goods and services at a lower or cheaper price.
3. **Encourage Free Trade:** According to this, globalization encourages the free trade of goods and services across borders without imposing any tariff or taxes. When there are fewer complications

for consumers, then there are more opportunities for them to purchase products or services. It helps create an environment where competition encourages free trade at lower prices.

4. **Better Communication:** According to this, globalization encourages open lines of communication with the rest of the world, which is helpful in cross border transactions. If the world had fewer borders, then it would be easier to communicate with one another without requiring the Internet to do so. Communication makes us stronger as humans because it gives us access to more information. The technology today allows people to achieve precise and continuous contact with their family or VIP in different countries.
5. **Improvement in Standard of living:** As a result of globalization, the Standard of living of people improves. Due to globalization, people get quality goods at cheaper or lower prices. It helps in improves their Standard of living.
6. **Expansion of Market:** According to this, globalization helpful in the development of market size. It allows the business units to expand their business in the whole world by opening up branches. Globalization opens up new opportunities for companies to sell their goods and services to much larger markets.
7. **Development of Capital Market:** According to this, globalization is helpful in the growth of the capital market. As a result of globalization, many foreign investors starting investment activities in the capital market in the form of foreign direct investment and international portfolio investment.
8. **Increase in Foreign Collaboration:** According to this, globalization promotes international collaboration with the firms in the form of technical cooperation, financial cooperation or both. In financial partnership, the foreign company provide financial assistance to the firm, while in technical collaboration provide modern technology to the firm.
9. **Transfer of Technology:** Globalization acts as a mechanism for transmission of the technology from the developed countries to the under-developing countries like India. The present technology available in India is obsolete. So the Indian companies approach to the developed foreign countries for technological up gradation. Because of Globalization, Indian companies get advanced technologies from developed countries that lead to higher productivity and industrial growth.
10. **Education:** Globalization made it easy for those who want to move across the border to acquire better knowledge. People from underdevelopment countries have started to move to developed

countries to get a better education. This migration for education opens new doors for the integration of cultures.

Disadvantages of Globalization:

Followings are the main disadvantages of globalization:

1. **The loss to Domestic Industries:** As a consequence of globalization, foreign competition increases. Now, domestic industrial units have to compete with international industrial groups. These industrial units are producing quality goods and services at a low cost. Because of this, local industrial units fail to compete with them and close down.
2. **Unemployment:** According to this, international industrial units use capital intensive technology in the production of goods and services. It increases the unemployment rate and reduces employment opportunities.
3. **Political Interference:** As a consequence of globalization, global companies interference in the economic and political freedom of host countries. These companies interference in the politics of the host country nationals. They make all efforts to bring that political party to power in the host country, which is favourable for their business.
4. **Unbalanced Regional Development:** According to this, globalization leads to uneven regional development. The industrial units set up industries in those develop cities and towns where infrastructure facility readily available and not in backward areas. As a result, local disparity increases.
5. **Tax Evasion:** As a consequence of globalization, the domestic or host nation government imposes various types of tax on the income of the companies such as corporate tax. Foreign industrial units reduce their profits by adopting transfer pricing methods to avoid taxes. The international groups buy intermediate goods from their subsidiaries abroad at a high price to reduce local benefits. In other words, global companies over invoice the imports and under invoice the exports to show fewer profits.
6. **Adverse Effect on Culture and Value System:** According to this, many industrial units sell such products which distort our culture and value system. The vulgar advertisements shown by some multinational companies harm the thinking of a young generation. Some MNCs promotes the

unethical and corrupt practices for their self-interest. These MNCs do not hesitate to offer bribes to high officials of the host nation to serve their self-interest.

7. **The exploitation of Labour:** As per the consequences of globalization, it is exploiting the unskilled workers by giving lower wages, less job security, and long working hours. The workers have to work even in these conditions because bad jobs and fewer salaries are better than no posts.
8. **Production of Prohibited Goods:** According to this, to gets more profits, global companies indulge in the production of those goods which are harmful to the consumers. These goods are a ban in their parent nations. Global companies earn profits even at the cost of the health of consumers.
9. **Dominant Global Brand:** In the era of globalization, the competition has reached its peak, and in such a competitive environment, it becomes difficult for the small industries to survive. The dominant global brands don't let the small enterprises to grow. Superior technologies hold the most of market share and for new and small industries to keep a good grip on the market becomes a challenge.
10. **Environmental Degradation:** The environment has suffered dramatically due to globalization. On the one hand, the increase in traffic between countries polluted tourist destinations. On the other hand, the poisonous gases released into the air by large industries have increased environmental pollution. The globalized business has exploited the natural resources of the earth beyond the tolerable limit. Some places on earth, which was once abundant in minerals and forests can no longer claim their richness.

9.3 STRATEGIES FOR ENTERING INTO FOREIGN MARKET

One of the most critical strategic decisions in international business is the mode of entering into the foreign market. On the one extreme, a firm or company may do the complete manufacturing of the product domestically and export it to the international market. On the other height, a company may do a full production of the product in the foreign market itself. There are several alternatives strategies between the two extremes. Following are the main strategies adopt by a firm or company to become a global firm or company:

- **Export:** Export is the most traditional mode of entering the foreign market. In exports, goods and services produce in one country are purchase by residents of another country. It doesn't matter what the good or service is. It doesn't matter how it is sent. It can be shipped, sent by email, or carried in personal luggage on a plane.

- **Licensing:** Under international licensing, a firm or licensor in one country permits a firm or licensee in another country to use its intellectual property rights such as patents, trademarks, copyrights, technology, technical know-how, marketing skills etc. The licensee pays royalty or fees to the licensor for the licensing.
- **Franchising:** Franchising is a form of licensing in which a parent company or the franchiser grants another independent company or the franchisee right to do business in a prescribed manner. This right can take the form of selling the franchisor's products, using its name, production and marketing techniques. In return, the franchisee pays specific fees and agrees to comply with certain obligations, typically set out in a franchise agreement.
- **Contract Manufacturing:** Contract manufacturing is a process that establishes a working agreement between two companies. In contract manufacturing, one company arranges for a company located in a different country to handle the manufacturing process of its products.
- **Management Contracting:** Management contracting is a low-risk method of getting into a foreign market. It is a contractual arrangement under which operational control of a company lies in the hands of another company that performs the necessary managerial functions for a fee.
- **Turnkey Contracts:** The turnkey contract is a business arrangement in which a project is delivered to the owner in a complete state by the developing company without owner input. Under the turnkey contract, the contractor is responsible for both the design and construction of a project at the agreed price and finishes it on a fixed date.
- **Joint Ventures:** It is a common strategy of entering into the foreign market. A joint venture is a business arrangements form by two or more companies in which one company is an international company that agrees to pool their resources for the accomplishment of the common objective. This objective can be a new business project or any other business activity. It is a temporary contract between participating companies that dissolves at a specific future date or on completion of the project.
- **Wholly Owned Manufacturing Facilities:** A company with long term interest in a foreign market establishes utterly owned manufacturing facilities. Several factors like trade barriers, cost

differences, government policies, and so on encourage the setting up of production facilities in foreign markets. Manufacturing abroad provides the firm with total control over quality and production.

- **Third country Location:** Sometimes, third-country location is used as an entering strategy into a foreign market. When there are no commercial transactions between two countries due to reason like political conditions firm which wants to enter into the market of another nation, will have to operate from a third country base. It is helpful to take advantage of the friendly trade relations between the third country and foreign market concern.
- **Mergers and Acquisition (M&A):** The term mergers and acquisitions (M&A) refers to the process of one company combining with another. A merger is the combination of two firms, which subsequently form a new legal entity under the banner of one corporate name. On the other hand, in an acquisition, one company purchases the other outright. The acquired firm does not change its legal name or structure.
- **Strategic Alliance:** This strategy as an entering approach in foreign market helpful in enhancing the long term competitive advantage of the firm by an alliance with its competitors. In a strategic partnership, two or more businesses join hands to pursue mutual interest through combining their resources, capabilities and core competencies for a set period.
- **Assembly Operations:** It is a variation of the subsidiary. In assembly operations, a foreign production plant is set up in international markets to assemble the parts or components of product manufacture in the domestic company or elsewhere. The establishment of assembly operation represents a cross between exporting and overseas manufacturing.
- **Countertrade:** It refers to the reciprocal exchange of goods and services with other products and services rather than with money. This type of international trade is more common in developing countries who have limited foreign exchange or credit facilities. Countertrade takes several forms. In any way, it provides a mechanism for countries with limited foreign exchange or credit facilities to exchange goods and services with other nations. The followings are the most common form of the countertrade:

- **Barter:** It is the oldest form of countertrade. In the barter, the direct exchange of goods or services takes place between two parties with other products or services without the use of money as a means of purchase or payment.
- **Counter purchase:** It refers to the sale of goods and services to a company in a foreign country by a company that promises to make a future purchase of a specific product from the same company in that country. In counter purchase arrangement, the exporter receives the full payment in cash but agrees to spend an equivalent amount of money in importer country within a specified period.
- **Buyback:** Under the buyback agreement, the supplier of plant, equipment, or technology agrees to purchase goods manufacture with that equipment or technology. For example, company A builds a salt processing plant in country B. In return, country B pays partly in cash and rest in salt from the plant to the company A.
- **Compensation Deal:** It refers to that form of countertrade in which the seller of goods and services receives a part of the payment in cash and the rest in products for their selling.
- **Switch Trading:** It refers to that form of countertrade in which one company sells its obligation to another company known as switch trader to purchase in a given company. For example, Two Companies' A' and 'B' are counter trading salt for sugar. The switch trader gets the sugar from Company B at a discount and sells it for money uses as payment to company B.

9.4 MEASURES ADOPTED BY INDIAN GOVERNMENT FOR GLOBALISATION

Indian economy is one of the fastest-growing economies in the world. But it was a completely different scenario in 1991, the year in which new policies and reforms introduced. The year which serves as a backbone to many of the current policies and decisions. It was during 1991 that India met with the economic crisis which occurred due to its external debt liability. Due to obligation, the government was not able to make the payments for the borrowings it had made from the foreign countries. As a result, the government had to adopt new measures to reform the conditions of the Indian economy. There were many programs and initiatives introduced primarily consisted of liberalization, privatization, and globalization. Following are the leading measures which are adopted by the Indian government to promote globalization in India:

1. **Increase in Foreign Investment:** Under economic reforms, the limit of foreign capital investment has been raised. In many Industries, foreign direct investment (FDI) has been allowed to the extent of 100 per cent without any restriction. Foreign Exchange Regulation Act (FERA) 1973 replaced with the more liberal act that is the Foreign Exchange Management Act, 1999. Many incentives are given to Non-Resident Indian (NRI) to motivate them to invest in India. Table 13.1 shows the foreign investment limits in different sectors.

Table 13.1 Foreign Investment Limits

Sr. No.	Sectors	Foreign Investment Limits
1.	Infrastructure	100 % FDI investment through automatic route is permitted in construction sectors of cities and towns.
2.	Automotive	100 % FDI investment is permitted through automatic route this sector.
s3.	Pharmaceuticals	74 % FDI investment is permitted in this sector
4.	Insurance	49 % FDI limit is permitted in this sector
5.	Railways	100 % FDI is allowed under automatic route in most areas of railway other than operations like High speed train, railway electrification, passenger terminal, mass rapid transport systems etc.
6.	Chemicals	100 % FDI is allowed under automatic route in this sector except Hydrocynic acid, Phosgene, Isocynates and their derivatives.
7.	Textile	100 % FDI is allowed under automatic route in this sector.
8.	Airlines	100 % FDI is allowed in a scheduled or regional air transport service or domestic scheduled airline.

2. **Partial Convertibility of Indian Rupee:** It was introduced in March 1992. It refers to the freedom to convert domestic currency into foreign currency and vice-versa. It called partial convertibility because it covers only current account transactions. Under the partial cover ability of the rupee, the dispensation of 40% of the foreign exchange surrendered to RBI at the official rate, and balance of 60% of the foreign exchange dispose-off by the exporter at market rate. The primary objective of partial convertibility of rupee was to make the foreign exchange available at a low price for essential export-import transactions.
3. **The liberal and Long term Foreign Trade Policy:** In conformity with economic reforms, foreign trade policy was enforced for a long duration, viz., five years. India’s present international trade policy 2015-20 is a liberal and long term policy. Under this policy, various restrictions and controls on foreign trade have been removed. Open competition has been encouraged. Administrative controls have also been minimized.
4. **Reduction in Tariffs:** Under new economic reforms, custom duties and tariffs imposed on imports and exports reduced gradually to promote foreign trade of India.
5. **Export Promotion Measures:** Export promotion measures are public policy measures taken by the government of a country to enhance the export and import of goods and services of that country. In India, many export promotion schemes like the establishment of Export Processing Zones (EPZ), Free Trade Zone (FTZ), and Special Economic Zones (SEZ) provides to the exporters to increase the share of Indian exports in world trade.
6. **Freedom to Repatriate:** Until the new economic policy, foreign investment was allowed on non-repatriation basis in India. It means foreign investors cannot take their income on foreign investment back to their country without prior permission of RBI. The Reserve Bank of India (RBI) allows this repatriation on a very restrictive basis. But as per new economic policy reforms, the investor is free to repatriate their investment income.
7. **Increase in Foreign Technology Agreements:** Under the new economic reforms, the government allows the import of foreign technology through foreign technology agreements with foreign countries. Indian companies are now allowed to hire external technicians without prior permission of RBI. The companies have not required the approval of RBI to make payment for foreign technology and technicians.

8. **Setting up Joint Ventures:** Under the new economic reforms, the conditions for setting up joint ventures in abroad are modifying and liberalize. The foreign investors can own even more than 51% share capital in a joint venture set up in India. A more liberal act Competition act, 2002 replaces the MRTP Act, 1969 to remove the obstacles of global merger and acquisition.
9. **Setting up of Foreign Investment Promotion Board:** The Foreign Investment Promotion Board (FIPB) was an inter-ministerial body under the Department of Economic Affairs in the Ministry of Finance set up in 1991 for the facilitation of foreign trade in India. This board arranges conferences in India as well as in foreign nations to attracts foreign investor. The Foreign Investment Promotion Board (FIPB) is now replaced by the Foreign Investment Facilitation Portal (FIFP) to speed up the FDI inflow and to increase the transparency in the FDI approvals in May 2017.
10. **Liberalization:** Under the new economic reforms, Indian government liberalize foreign trade policy, foreign investment policy, industrial and licensing strategy, and taxation policy to promote foreign investment. The government also simplified procedural, forms, documents norms related to international trade and investment. The Single Window Clearance Scheme has been started for promoting foreign investment and to reduce bureaucratic, lengthy, and cumbersome procedures.
11. **Privatization:** Under new economic reforms, the private sector is allowed to set up units in those industries which were previously reserve for the public sector. The number of industries reserve for the public sector has been reduced from 17 to 2.
12. **Market Determine Exchange Rate:** Under new reforms, An essential measure in external sector was to devalue the rupee in July 1991 and after about two years in 1993 exchange rate was changed from basket based pegged exchange rate system to the market-determined exchange rate. With this, the exchange rate of the rupee today determined by demand and supply conditions in the foreign exchange markets.

9.5 CHECK YOUR PROGRESS

State whether the following statements are true or false:

1. Globalization has restored much of the global dominance of the former imperialist powers, such as Western Europe, Japan, and above all the US.

2. Globalization refers to the greater interconnectedness among the world's people.

3. Globalization is a new phenomenon

4. Globalization has changed the structure of work. Worker security worldwide has increased. Labour unions have gained more of their power
5. Globalization, can collaborate and compete in real time with other people on more different kinds of work using computers, email, fibre-optic networks, teleconferencing, and dynamic software.
6. One of the negative impacts of globalisation is that it reduces employment opportunities.
7. With increase in globalisation, there is constant switch over of jobs which can affect the organisations adversely.

9.6 SUMMARY

Globalization is not a new concept, and it has been prevalent for the past many years, but the nature and system of globalization have changed over the years. Globalization refers to a process of interaction and integration among the people, companies, and government of different nations. It is linking the economy of a country with the economies of other nations through free trade, free mobility of capital and labour. Efficient use of resources, quick transfer of innovation, immediate help, integration of financial market, movement across the world, the whole world as a stage, and creation of new markets are the main features of the globalization. Business freedom, facilities, government support, resources, competitiveness, and orientation are the essential conditions of successful globalization.

Usually, a firm passes through different stages of development before it becomes a truly global or Transnational Corporation. Ohmae identifies five distinct stages of development of a firm into a worldwide corporation. Globalization has both positive and negative effects on the Indian economy. Employment opportunities, lower price, encourage free trade, better communication, improve the standard of living, expansion of the market, development of the capital market, increase in international collaboration, transfer of technology and education are the main advantages of the globalization. The disadvantages of globalization include loss to domestic industries, unemployment, political interference, unbalanced regional development, tax evasion, the lousy effect on culture and value system, exploitation of labour, production of prohibited goods, the dominance of global brand and degradation of the environment.

Export, licensing, franchising, contract manufacturing, management contracting, turnkey contract, joint venture, wholly-owned manufacturing facilities, third-country location, merger and acquisition, strategic alliance and countertrade are the various modes of entering into a foreign market. The government of India is also adopting different measures to promote globalization in India. These measures include the partial convertibility of Indian rupee, reduction in tariff, export promotion measures, adoption of the market-determined exchange rate, setting up of joint ventures and Foreign Investment Promotion Board.

9.7 KEYWORDS

- **Globalisation:** Globalization is refers to a process of interaction and integration among the people, companies, and government of different nations.
- **Export:** An export is the shipping of domestic goods and services to a foreign country.
- **Licensing:** Licensing is a business arrangement in which one company gives another company permission to manufacture its product for a specified payment.
- **Franchising:** Franchising is a form of business by which the owner (franchisor) of a product, service or method obtains distribution through affiliated dealers (franchisees).
- **Management Contract:** It is an contractual arrangement under which operational control of a company is vested in the hands of another company that performs the necessary managerial functions for a fee.
- **Joint Venture:** A joint venture is a business arrangements form by two or more companies agrees to pool their resources for the accomplishment of common objective.
- **Countertrade:** Countertrade is a reciprocal form of international trade in which goods or services are exchanged for other goods or services rather than for hard currency.
- **Compensation Deal:** It refers to that form of countertrade in which the seller of goods and services receives a part of payment in cash and the rest in products.
- **Switch Trading:** It is practice in which one company sells to another its obligation to make a purchase in a given country.

9.8 SELF-ASSESSMENT TEST

1. What do you mean by Globalisation? What are the main features of Globalisation?

2. What is Globalisation. Explain the essential conditions of Globalisation.

3. Explain the Ohmae five stages of globalisation.

4. What is Globalisation? Explain the main advantages and disadvantages of Globalisation.

5. What do you mean by Countertrade? Explain the various forms of countertrade.

6. Explain the various modes of entering into foreign market by a domestic company.

7. What is Globalisation? Explain the various measures adopted by the Indian Government to promote the globalisation in India.

9.9 ANSWER TO CHECK YOUR PROGRESS

Answer of statements of true or false:

1. True
2. True
3. False
4. False
5. True
6. False
7. True

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Course Code: BC 605	Author: Mr. Ankit
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LEGAL BUSINESS ENVIRONMENT: (COMPETITION ACT, FOREIGN EXCHANGE MANAGEMENT ACT)

STRUCTURE

10.0 Learning Objectives
10.1 Introduction
10.2 Legal System Relevant for Business
10.3 Competition Act
10.3.1 Objectives of Competition Act
10.3.2 Four Pillars of Competition Act
10.3.3 Competition Appellate Tribunal (COMPAT)
10.4 Foreign Exchange Management (FEMA) Act
10.4.1 Objectives of Foreign Exchange Management Act
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10.0 LEARNING OBJECTIVES

After reading this lesson, one should be able to understand

- Legal environment of business
- Legal system relevant for business

- Competition Act
- Foreign Exchange Management Act (FEMA)

10.1 INTRODUCTION

The legal environment include various legislation passed by government administrative on order of government authorities, court judgment as well as the service rendered by various commission and agencies at every level of government: center, state or local. It is imperative for management of every business to obey the law of land. Therefore, an adequate knowledge of rules and regulations framed by the government is a pre-requisite for better business performance. Noncompliance of law can land the business enterprise into legal problem. The legal environment of a business refers to the relevant laws and regulations under which the business operates. In a country, the law can serve the following purpose such as maintain the peace and status quo preserve individual rights, protect minorities against majorities, and promote social justice. Some legal systems serve these purposes better than others. To know the legal environment of a country, it is important to understand the country's legal framework.

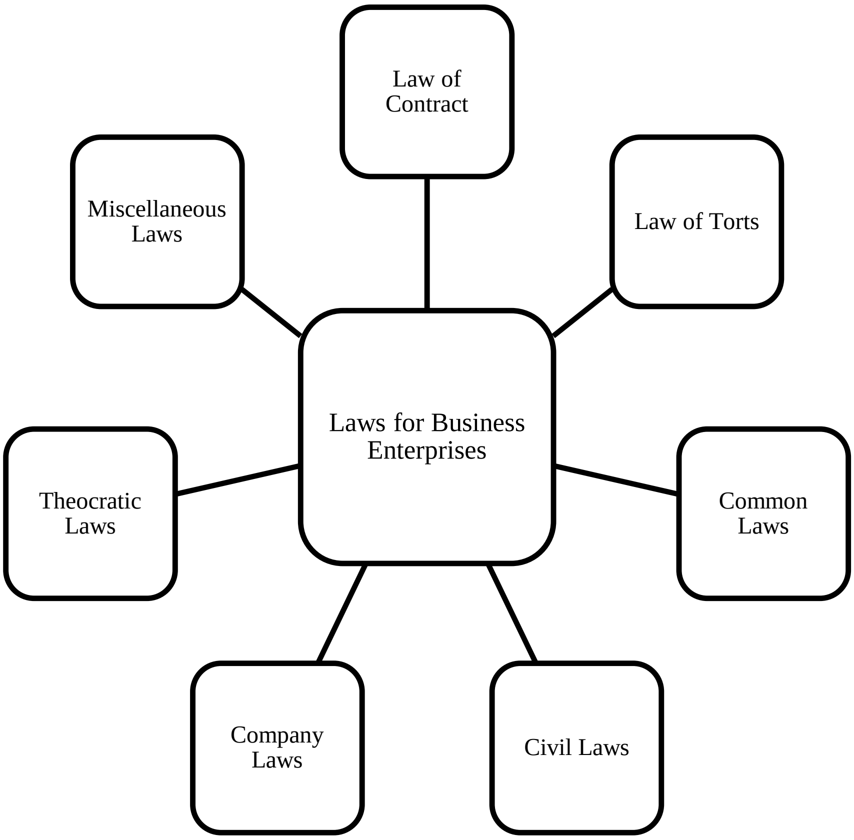
10.2 LEGAL SYSTEMS RELEVANT FOR BUSINESS

The importance of legal system can hardly be exaggerated in the development and growth of business in any country. There are different types of laws with which a business manager should be intimately acquainted, and ignorance of law is not an excuse. The legal system will comprise the following types of laws (Figure 10.1) which are relevant for business enterprise.

Laws of Contract: A contract is an agreement generally between two parties. However, there may be breach of contract at later dates. So, the victimized party may ask for legal action. The law of contract deals with such types of cases. The business houses makes contracts with suppliers, consumers, investors and so forth and breach of contract demands for legal action.

Common laws: Common law is the legal tradition that is emerged from the interpretation and application of laws in different countries. A rich source of common law is Great Britain. Every country has its common laws that are governed from judgements delivered by the apex court like Supreme Court of India. In common laws, an interpretation given in a case becomes a precedent to be used in all future cases of same type.

Figure 10.1 Laws relevant for business enterprises



Civil Laws: The civil laws are codified laws. These laws are not flexible as common laws. These laws are enacted by law making authorities of the government. They are established laws until and unless amended. For instance, the punishment prescribed in an offence coming under jurisdiction of civil law cannot be changed by a court of law without any valid reason.

Law of Torts: It is a body of law that is allowed an injured person to claim compensation from the person responsible for the injury. This law is relevant for business in the sense that sometimes, some products made by a company may prove to be injurious to the users and hence, compensation can be claimed by them. The injury will be physical, mental or psychological.

Company Laws: These laws are deals with almost all matters related to the management and administration of company affairs, formation, dissolution, partnership, corporate, and so on. All legal issues and problems relating to these companies come within the purview of the company laws. All the manager must be fully aware with the main provisions and basic terms of company laws.

Theocratic Laws: Theocratic laws are laws based on the religious codes. These laws were codified in 10^{th} century but are still applied in many Islamic countries including Malaysia, Indonesia, and Saudi Arabia. The application of Islamic laws can be found most prominently in the areas of banking. Riba (interest) is prohibited in Islam and making excess profits is also not ethically accepted principle. These laws are guiding the people to help one another in the spirit of sharing and caring.

Miscellaneous Laws: Apart from all aforesaid fields of laws, a business enterprise will do well if it through knowledge of the following types of laws:

• Consumer protection laws	• Trade union Acts
• Laws of Taxation	• Corporate laws
• Mercantile laws	• Protection of property laws
• Trade-related laws	• Copyright protection Acts
• Laws of Patents	• Competition laws
• Corporate management legislation	• Essential Commodities Act
• Labour laws	• Foreign Exchange Regulation Act
• Employees provident Act	• Industrial Disputes Act

Along with through knowledge of all these laws, it is important for a business person to know the applicability of these laws in the context of a particular country. Without an understanding of all these, the knowledge about the legal environment of a country remains incomplete.

10.3 COMPETITION ACT

Since the adoption of the economic reforms of LPG (Liberalisation, Privatisation, and Globalization) programs in 1991, businesses have been pressuring for the scrapping of the MRTP Act, 1969. The argument was that the MRTP Act had lost its relevance in the new era of liberalization and global competitive markets. It was pointed out that only large companies can survive in these new competitive markets. So, the government is appointed an expert committee headed by S. V. S. Raghavan to examine the whole situation. This committee submitted its reports to the government in May 2000. The committee is recommended the adoption of new competition law. Based on the recommendations of the Raghavan Committee, the Monopolies and Restrictive Trade Practices Act, 1969 (MRTP Act) was abolished and was replaced by the Competition Act, 2002, with effect from 1 September 2009. The Competition Act, 2002 came into existence in January 2003 and the Competition Commission of India **(CCI)** was established on 14 October 2003. CCI consists of a Chairperson and 6 Members appointed by the Central Government. CCI is functioning as a market regulator to prevent anti-competitive practices in the country. A Competition Appellate Tribunal was also established, which is a quasi-judicial body established to hear and dispose of appeals against any direction issued, or decision made by the CCI.

10.3.1 Objectives of Competition Act

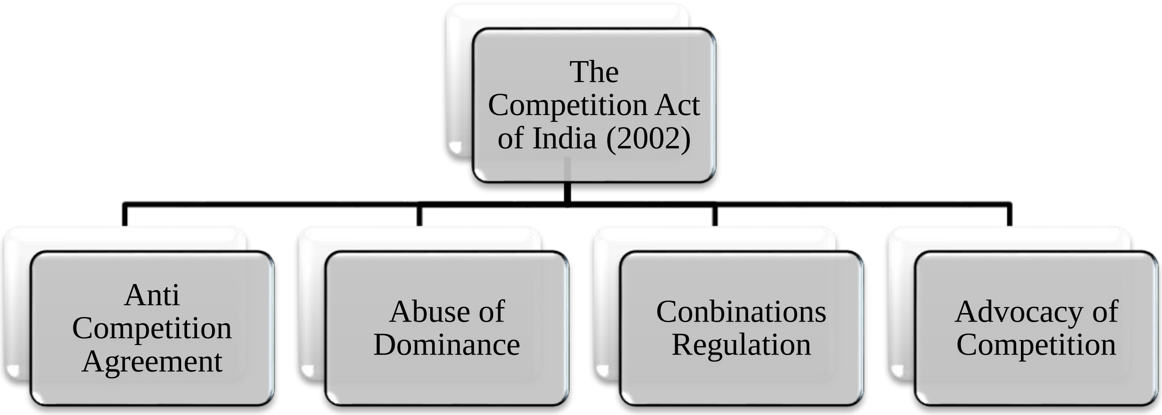
Followings are the main objectives of competition act, 2002:

- To establish a commission to prevent practices having adverse effect on competition.
- To promote and sustain all types of competition in the market.
- To protect and promote the interest of consumers and end users.
- To ensure freedom of trade in the Indian markets.
- To prevent and correct the abuses of dominant position in the market actively.
- To regulate the operations and activities of combinations (Acquisition, Merger, and Amalgamation).
- To Create and impart training about the competition act.
- To regulate anti-competitive agreements.
- To prevent entry barriers to any trade and business.

10.3.2 Four Pillars of Competition Act, 2002

The Act was subsequently amended by the Competition (Amendment) Act, 2007 and Competition (Amendment) Act, 2009. The provisions of the Competition Act relating to anti-competitive agreements and abuse of dominant position were notified on 20May, 2009.There are basically four pillars of the Competition Act, 2002 (See Figure 10.2)

Figure 10.2 Four Pillars of Companies Act, 2002



Anti-Competition Agreement:

Anti-Competition agreement is an agreement that restrict competition. Section 3 of the companies act is dealing with the anti-competitive agreements and arrangements. According to this section of Competition Act, 2002, no person or business or group will enter into an agreement that causes the adverse effects on competition within India in respect of production, supply, distribution, storage, acquisition or control of goods or rendering of services. An agreement is anti-competitive if it cause or likely to causes an adverse effect on competition. The term adverse effect is not defined in the competition act. However, the act specifies the number of factors which the Competition Commission of India (CCI) must consider while determining whether an agreement has adverse effect on competition or not. Following are the factors which determine the adverse effect on competition or not:

- Creating of barriers to new entrance
- Driving existing competitors out of market
- Foreclosure of competition by hindering entry into the market
- Improvements in production or distribution of goods and services
- Accrual of benefits to the consumers
- Promotion of technical, scientific, and economic developments

There are mainly two types of anti-competitive agreements.

- Horizontal Agreements
- Vertical Agreements

Horizontal Agreements: Horizontal agreement is referred to that agreement which is takes place between businesses or companies engaged in trade of identical or similar goods and services. It is an agreement between two or more firms operating at the same level of production chain in same market. These agreements have a direct negative impact on effective competition and prices of goods in the market. Thus, they are void per se.

Vertical Agreements: The vertical agreement is referred to that agreement which is take place between two or more firms operating at the different level of production or distribution chain. These agreements are not generally treated as anti-competitive per se but are to be judge under the 'Rule of Reason' test.

The figure 10.3 explains the restrictive business practices of horizontal restraint and vertical restraint that are addressed by competition law.

Figure 10.3 Selected Restrictive business Practices Addressed by Competition Law

Horizontal Restraints	
Price Fixing	Competing suppliers enter into cooperative agreements regarding price and sales conditions.
Restraint of Output	Competing suppliers enter into agreements regarding output and product quality.
Market Allocation	Competing suppliers allocate customers among themselves, who therefore cannot benefit from competition by other supplier.
Exclusionary Practices	Competing suppliers employ practices that inhibit or preclude the ability of other actual or potential suppliers to compete in the market for a product.
Collusive Tender	Competing suppliers exchange commercially sensitive information on bids and agree to take turns as to who will make the most competitive offer.

Conscious Parallelism	Competing suppliers generally set the same prices, but without an explicit agreement.
Vertical Restraints	
Excusive Dealing	A producer supplies distributors and guarantee not to supply other distributors in a given region.
Reciprocal Exclusivity	A producer supplies on the condition that the distributor does not carry anybody else's products.
Refusal to Deal	A supplier refuses to sell to parties wishing to buy.
Resale Price Maintenance	A producer supplies distributors only on the conditions that the distributor sells at a minimum price set by the supplier.
Territorial Restraint	A supplier sells to distributors only on the condition that the distributor does not market the product outside a specified territory.
Discriminatory Pricing	A supplier charges different parties different prices under similar situations.
Predatory Pricing	Suppliers sell a very low price or supply intermediate goods to competitors at excessive prices in order to drive competitors out of business.
Premium Offers	A dominant supplier offers discounts or other inducements only to certain parties on the condition they do not sell someone else's products.
Tied Selling	Producers forces purchasers to buy goods they do not want as condition to sell them those they do want, or force resellers or wholesalers to hold more goods than they wish or need
Full line Forcing	A supplier requires distributors, for access to any product, to carry the suppliers' entire product.
Transfer Pricing	May involve over-invoicing or under-invoicing of intermediate inputs between foreign affiliates. Under-invoicing can be used to facilitate predatory pricing.

Abuse of Dominance:

A dominant position is a position of strength in the relevant market enjoyed by an enterprise which enable it to operate independent of competitive pressures in the relevant market and also effect consumer, competitor, and market positively by its actions. The market dominance is a function of many factors such as net worth, net profit, turnover rate, assets, market power, the degree of monopoly power, controlling ability, degree of leadership quality and so forth. The position of dominance is based on economic and political strength of a company acquired over the years. This position is reflected in a large market share, asset structure, profit margins and leadership in the market. This position of dominance may be abused to prevent new entries and competition in the market.

Combination Regulations:

The provision relating to the combination is given in sections 5, 6, and 20 of the Competition Act, 2002. The Competition Act of 2002 has the power to regulate the combinations in the form of acquisition, merger, or amalgamation both in India and outside India. The combined companies must notify the details of such combinations to the Competition Commission of India (CCI). The Competition Commission has the power to regulate mergers or combinations and to reverse merger or combinations if it believes that a merger or combination destroys the competition in India.

Advocacy of Competition:

The Competition Commission of India (CCI) is a statutory body established under the Competition Act, 2002 has the power to eliminate practices having adverse effect on competition, promote and sustain competition, protect the interest of consumer, and ensure freedom of trade carried on by other participant in Indian market. The CCI will take proactive actions to facilitate competition and investigate into all cases that are coming to its notices. The competition commission is mandated under section 49 of the act to take suitable measures for the promotion of competition advocacy, creating awareness, and imparting training about competition issues.

10.3.3 Competition Appellate Tribunal

The Competition Appellate Tribunal (COMPAT) is a statuary body established by the central government on 15th May 2009 to hear and dispose of appeals against any order passed by the Competition Commission of India (CCI) of Competition Act, 2002. The Appellate Tribunal is composed of a chairperson and the other two members who served for five years. They all are eligible for reappointment unless they reach the age of 68 in the case of chairperson and 65 in the case of other members. Only a former Supreme Court (SC) judge or Chief Justice of High Court (HC) can be appointed as a chairperson of COMPAT. The other member of the COMPAT should be a person whose experience in competition policy matters is not less than twenty-five years. The Competition Act is allowed for a final appeal against the order of CCI in the Supreme Court of India if the aggrieved parties are not satisfied with the adjudication of the Appellate Tribunal. With effect from 27 May 2017, the appellate function of COMPAT would now transfer to the National Company Law Appellate Tribunal (NCLAT).

10.4 FOREIGN EXCHANGE MANAGEMENT ACT (FEMA) ACT

FEMA stands for the Foreign Exchange Management Act. Foreign Exchange Management Act (FEMA) is passed by Lok Sabha on 2 December 1999 as a replacement for the Foreign Exchange Regulation Act (FERA), 1973. This act applies to all parts of India and is also applicable to all branches, offices, and agencies operated outside India owned or controlled by a person resident in India. The main objective of this act is to formulate the law relating to foreign exchange for promotion, development, and maintenance of foreign exchange market in India. Reserve Bank of India (RBI) is playing an important role in the management and administration of FEMA Act, 1999. Some of the rules, regulations, sections, and norms of this act are made by the RBI after consultation with the central government.

10.4.1 Objective of Foreign Exchange Management Act

Following are the main objective of Foreign Exchange Management Act:

- To reinforce and amend the law relating to foreign exchange.
- To simplify and ease the external trade and payments.
- To promote the systematized development and maintenance of a healthy foreign exchange market in India.
- To remove disparity of payments in foreign exchange.
- To control and direct the employment business and investment of the non-residents.
- To utilise the foreign exchange resources effectively for the country.

10.4.2 Provisions of Foreign Exchange Management Act

The central government enacts the law relating to foreign exchange and the RBI ensures its enforcement. Directorate of Enforcement, New Delhi is the administrative and managing authority of the FEMA. There is a total of 49 Sections divided into 7 chapters in FEMA Act. The Reserve Bank of India (RBI) notified time to time a number of regulations under FEMA 1999. The following are the important provisions of the FEMA 1999:

1) Under section 3 of the FEMA 1999, no one shall deal in or transfer foreign exchange or foreign security to any unauthorized persons.

2) Under section 4 of FEMA 1999, no Indian national shall acquire, hold, own, possess or transfer any foreign exchange, foreign security, or any immovable property located outside India except otherwise provided for it in the act.

3) Section 5 of the FEMA stipulates that any person may sell or drawn foreign exchange to or from an authorised person if such sale or drawl is one of current account transaction " provided that the central government may in public interest and in consultation with RBI, imposed such reasonable restrictions for current account transactions, as may be prescribed".

4) Section 5 of the FEMA stipulates that any person may sell or drawn foreign exchange to or from an authorised person for a capital account transaction. The RBI may in consultation with the government of India specify the clause of permissible capital account transactions, the limit up to which foreign exchange shall be admissible for such transactions. However, the RBI may prohibit, restrict or regulate the following:

(a) Transfer or issue any foreign security by an Indian national, by a person living outside India, or by any branch, office or agency in India of a person resident outside India

(b) Borrow or lend in terms of foreign exchange in whatever form or by whatever name it is called

(c) Borrow or lend in rupees between an Indian national and a person resident outside India

(d) Deposits between Indian national and a person outside India

(e) Export, import or holding a currency or currency notes

(f) Transfer of immovable property outside India other than a lease for a period not exceeding 5 years by an Indian national; likewise, acquire or transfer of immovable property in India other than a lease for a period not exceeding 5 years by a person resident outside India

(g) Give a guarantee or surety in respect of any debt, obligation or other liability incurred by a person resident in India and owed to a person resident outside India

5) Sub-Section 4 of Section 6 of FEMA 1999 stipulates that a person resident in India may hold, own, transfer or invest in foreign currency, foreign security or any immovable property located outside India, if such currency, security, or property was acquired, held or owned by such person when he was resident outside India or inherited from a person who is resident outside India.

6) Sub-Section 5 of Section 6 of the Act applies to person who reside outside India, i.e., they may hold, own, transfer or invest in foreign currency, foreign security or any immovable property located in India, if such currency, security, or property was acquired, held or owned by such person when he was resident in India.

7) Under Sub-Section 6 of Section 6, the RBI is empowered by regulation of the said Act, prohibit, restrict, or regulate establishment in India of a branch, office or other place of business by a person resident outside India, for the purpose of carrying on any activity relating to such branch, office or other place of business.

8) Under FEMA, 1999, every exporter of goods shall declare to RBI a document containing true and correct material particulars including the amount representing the full export value of the goods exported without any delay for the purpose of ensuring the realization of the full export proceeds by such exporters. Moreover, every exporter of services shall declare to RBI a statement containing the true and correct material particulars in relation to payment for such services.

9) Where any amount of foreign exchange is due or has accrued to any person resident in India, such person shall take all reasonable steps to realize and repatriate the amount to India within the time limit and manner specified by RBI.

10) Section 9 refers to certain exemptions from realization and repatriation of foreign exchange in certain cases.

10.4.3 Contravention and Penalties

Following are the main contravention and penalties under FEMA 1999:

1. If anybody contravenes any provision of FEMA, 1999 or contravenes any rule, regulation, notification, direction or order issued in exercise of the powers under this act or contravene any condition subject to which authorization is issued by RBI; such person shall be liable to penalty up to twice the sum involved in such contravention.

2. "Property" in respect of which contravention is said to have taken place refers to for the purpose of this Act, "deposits in a bank, where the said property is converted into such deposits. Indian currency, where the said property is converted into that currency, any other property which has resulted out of the conversion of that property."

3. An Appellate Tribunal for Foreign exchange shall be established by the central government to hear appeals against the orders of the adjudication authorities under this act. Appeal against the judgement of Appellate Tribunal lies with the High court

4. If anybody does not make full payment of the penalty awarded to him within 90 days of the notice issued to him in this context, he shall be liable for civil imprisonment.

5. Section 40 of the Act empowers the Central government to suspend or relax, either for a specific period or indefinitely, the operation of all or any of the provisions of FEMA. The notification thus issued by the central government will have to be approved by parliament within a specified period.

6. The Act also stipulates that central government shall establish a Directorate of Enforcement to enforce the provision of this act. It has to detect cases of violation and also perform substantial adjudicatory functions to curb the above and other related malpractices. The followings are the main functions of the Directorate:

- ➢ Collecting and collating intelligence in respect of violation of the provision of FEMA and while doing so studying the circumstances of the case.
- ➢ Seizing incriminating materials (Including Indian and Foreign Currencies) by conducting searches of suspected persons, conveyance and premises.
- ➢ Enquiring into and investigating suspected violations of provision of FEMA.
- ➢ Adjudicating cases of violations of FEMA with a view of levying penalties departmentally and also for confiscating the amounts involved in contraventions
- ➢ Collecting the penalties imposed in departmental adjudication

10.5 CHECK YOUR PROGRESS

Fill In the Blanks:

(a) It is imperative for management of every business to obey the **--------** of land.

(b) A body of law that is allowed an injured person to claim compensation from the person responsible for their injury known as ---------------.

(c) The Consumer Protection Act, 1986 made the provision under section 9 for setting up a -------------------- of consumer courts at the national, state and district levels.

(d) The Competition Appellate Tribunal (COMPAT) is a statuary body established by the central government on -------------- to hear and dispose of appeals against any order passed by the ------------------- of Competition Act, 2002.

(e) An Appellate Tribunal for Foreign exchange shall be established by the central government to hear ------------ against the orders of the **-------------------** under the Foreign Exchange Management Act, 1999.

10.6 SUMMARY

The legal environment of a business refers to the relevant laws and regulations under which the business operates. In a country, the law can serve the following purpose such as maintaining peace, preserving individual rights, protecting minorities and promoting social justice. The laws should be followed by every business to sustain. The legal system of a country comprises certain types of laws which include the law of contract, law of torts, the common law, civil law, company laws and theocratic laws. Apart from these, certain other laws such as Consumer Protection laws, Competition Act, 2002, Foreign Exchange Management Act, 1999, and Environment Protection Act, 1986 should be known to a business person.

A Consumer Protection Act is piece of legislation that is passed with regard to the provision and administration of protecting the rights of consumers within a country or nation. The Consumer Protection Act, 1986 (COPRA) is an act enacted in 1986 to protect the interests of consumers in India. It is made for the establishment of consumer councils and other authorities for the settlement of consumer's grievances and matters connected therewith it.

The Competition Act, 2002 was enacted by the parliament of India to establish a commission known as Competition Commission of India (CCI) to prevent the activities that have an adverse effect on competition in India. Under this act, A Competition Appellate Tribunal was also established, which is a quasi-judicial body to hear and dispose of appeals against any direction issued, or decision made by the CCI.

The Foreign Exchange Management Act, 1999 (FEMA) is an act of the parliament of India. The main objective of this act is to formulate the law relating to foreign exchange for promotion, development, and maintenance of foreign exchange market in India. Reserve Bank of India (RBI) is playing an important role in the management and administration of FEMA 1999. Some of the rules, regulations, sections, and norms of this act are made by the RBI after consultation with the central government.

The Environment (Protection) Act was enacted in the year 1986. It was enacted with the main objective of the protection and improvement of environment and for matters connected therewith. The Act is one of the most comprehensive legislations with a pretext to protection and improvement of the environment.

10.7 KEYWORDS

- **Torts Law:** It is a body of law that allows an injured person to obtain compensation from the person who has caused the injury.
- **Theocratic Law:** Theocratic laws are the laws that are based on the religious codes like Islamic Banking System.
- **District Forum:** District Forum is a consumer court that deals with complaints of value of the goods or services and compensation, if any, claimed is less than twenty lack.
- **Competition Appellate Tribunal:** The Competition Appellate Tribunal (COMPAT) is a statuary body established by the central government on 15th May 2009 to hear and dispose of appeals against any order passed by the Competition Commission of India (CCI) of Competition Act, 2002.
- **Foreign Exchange:** Foreign exchange is the exchange of one currency for another or the conversion of one currency into another currency.

10.8 SELF-ASSESSMENT TESTS

1. What is legal environment? What are the various legal systems relevant for the business?
2. What is Competition Act, 2002? What is the objective of Competition Act, 2002?
3. What are the four pillars of Competition Act, 2002?

4. What is Anti-Competitive Agreements? What are the various types of Anti-Competitive agreements under Companies Act, 2002?
5. What is Foreign Exchange Management Act, 1999? What are the main objectives of Foreign Exchange Management Act, 1999?
6. State the penalties prescribed under FEMA for contravention of its provisions.
7. Enumerate some of the more important regulations made by the Reserve Bank of India (RBI) under FEMA?
8. Write a short note on the following:
   (a) Directorate of Enforcement
   (b) Appellate Tribunal
   (c) Authorised Person

10.9 ANSWER TO CHECK YOUR PROGRESS

Answer to Fill In the Blanks:

(a) It is imperative for management of every business to obey the **law** of land.

(b) A body of law that is allowed an injured person to claim compensation from the person responsible for their injury known as **law of Torts.**

(c) The Consumer Protection Act, 1986 made the provision under section 9 for setting up a **three-tier redressal system** of consumer courts at the national, state and district levels.

(d) The Competition Appellate Tribunal (COMPAT) is a statuary body established by the central government on **15th May 2009** to hear and dispose of appeals against any order passed by the **Competition Commission of India (CCI)** of Competition Act, 2002.

(e) An Appellate Tribunal for foreign exchange shall be established by the central government to hear **appeals** against the orders of the **adjudication authorities** under the Foreign Exchange Management Act, 1999.

(f) Whoever fails to comply with or contravenes any of the provisions, rules, orders or directions of Environment Protection Act, 1986 shall be punishable with imprisonment for a term which may extend to **five years** or with fine which may extend to **one lakh** rupees, or with both.

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Foreign Exchange Market

STRUCTURE

11.0 Learning Objectives

11.1 Introduction

11.2 Historical Background

11.2.1 Types of Foreign Exchange Markets in India

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11.3 Foreign Exchange Management Act

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11.5 Check Your Progress

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11.9 Answer to Check Your Progress

11.10 References/Suggested Readings

11.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know the meaning of foreign exchange rate.

- Understand the History and type of foreign exchange markets.
- Understand Regulation of foreign exchange transaction.
- Know Foreign Exchange Management Act.

11.1 Introduction

Exchange Rate Movement

Foreign exchange market is the market in which foreign currencies are bought and sold. Being a member of IMF, India followed the par value system of pegged exchange rate system. But when the Breton Woods system collapsed in 1971, the rupee was pegged to Pound Sterling for four years after which it was initially linked to the basket of 14 currencies but later reduced to 5 currencies of India's major trading partners. Currently India has adopted the managed exchange rate system. When exchange rates change, you will often hear terms used to describe that change like depreciation, devaluation, appreciation or revaluation. What do these different terms mean? Well they split into two parts. Two of the terms refer to an upward movement of the exchange rate which are explained below:

- **Appreciation** - Describes an upward movement in a freely floating exchange rate. This may occur day by day or perhaps even minute by minute.
- **Revaluation** - This also describes an upward movement in an exchange rate, but in a fixed exchange rate system. This will be a very infrequent event (if ever) and means the government has deliberately changed the fixed value of the exchange rate upwards.

The other two terms are similar, but describe a downward movement in an exchange rate which are:

- **Depreciation** - Describes a downward movement in a floating exchange rate.
- **Devaluation** - This means that the government has changed the fixed rate of a fixed exchange rate downwards.

An appreciation or depreciation in the exchange rate will lead to changes in the relative prices of imports and exports. Depreciation will make exports appear relatively cheaper overseas while imports will be more expensive. Exchange rate is simply value of a currency in terms of another currency. The buyers and sellers of foreign currency include the, brokers, students, commercial banks, central banks, individual firms, foreign exchange brokers etc. The system of exchange rate works through the facility provided by the key players of the markets. The major functions of the foreign exchange include:

I). Transferring currency from one market to other where it is needed in the transactions.

II). Providing short-term credit to the importers, and thereby facilitating the smooth flow of goods and services between the countries.

III). Stabilizing the foreign exchange rate through spot and forward market.

11.2 Historical Background

Since Independence, the exchange rate system in India has transited from a fixed exchange rate regime where the Indian rupee was pegged to the pound sterling on account of historic links with Britain to a basket-peg during the 1970s and 1980s and eventually to the present form of market-determined exchange rate regime since March 1993. The evolution of exchange management is discussed below:

Par Value System (1947-1971): After gaining Independence, India followed the par value system of the IMF whereby the rupee's external par value was fixed at 4.15 grains of fine gold.

Pegged Regime (1971-1992): India pegged its currency to the US dollar (from August 1971 to December 1991) and to the pound sterling (from December 1971 to September 1975).

The Period Since 1991: A two-step downward adjustment of 18-19 per cent in the exchange rate of the Indian rupee was made on July 1 and 3, 1991.

Liberalised Exchange Rate Management System: The Finance Minister announced the liberalised exchange rate management system (LERMS) in the Budget for 1992- 93. This system introduced partial convertibility of rupee. Under this system, a dual exchange rate was fixed under which 40 per cent of foreign exchange earnings were to be surrendered at the official exchange rate while the remaining 60 per cent were to be converted at a market-determined rate.

11.2.1 Types of Foreign Exchange Market in India

A. Spot Market: It refers to a market in which the sale and purchase of foreign currency are settled within two days of the deal. The spot sale and purchase of foreign exchange make the spot market. The rate at which the foreign currency is bought and sold is called spot exchange rate. For all practical purposes, spot rate is treated as the current exchange rate.

B. Forward Market: It refers to that market which deals in the sale and purchase of foreign currency at some future date at a presented exchange rate. When buyers and sellers enter an agreement to buy and sell a foreign currency after 90 days of the deal, it is called forward transaction. The exchange rate settled between buyer and seller for forward sale and purchase of currency is called forward exchange rate.

Types of Exchange Rate Management

A. Fixed Exchange Rate

B. Flexible Exchange Rate

A. The Fixed Exchange Rate

When the exchange rate between the domestic and foreign currencies is fixed by the monetary authority of a country and is not allowed to fluctuate beyond a limit, it is called fixed exchange rate. Under the IMF system, the monetary authority of a member nation fixes the official value of its currency in terms of a reserve currency (usually the US dollar) or a basket of 'key currencies.' The exchange rate so determined is known as currency's par value. It is also called 'pegged' exchange rate. However, flexibility is allowed within the upper and lower limits prescribed by the IMF, usually 1% up and down, under the normal conditions. The basic purpose of adopting fixed exchange rate system is to ensure stability in foreign trade and capital movements. Under fixed exchange rate system, the government assumes the responsibility of ensuring stability of exchange rate. To this end, the government undertakes to buy and sell the foreign currency-buy when it becomes weaker and sell when it gets stronger. Private sale and purchase of foreign currency is suspended. Any change in the official exchange rate is made by the monetary authority of the country in-consultation with the IMF. In practice, however, most countries adopt a dual system: a fixed exchange rate for all official transactions and a market rate for private transactions.

Arguments in Favour of Fixed Exchange Rate:

First, it provides stability in the markets, certainty about the future course of actions in the Foreign Exchange Market, and it eliminates the risk caused by the uncertainty.

Second, it creates a system for a smooth flow of foreign capital between the nations, as it gives assurance of fixed return on investment.

Third, it removes the possibility of speculative transactions in foreign exchange markets.

Lastly, it reduces the possibility of competitive exchange depreciation or devaluation of currencies.

B. Flexible Exchange Rate

When the exchange rate is decided by the market force (demand and supply of currency), it is called the flexible exchange rate. The advocates of flexible exchange rate have put forward equally convincing arguments in its favour. They have challenged all the arguments against the flexible exchange rate. It is often argued that flexible exchange rate causes destabilization, uncertainty, risk and speculation. The proponents of the flexible exchange rate have not only rebutted these charges but also have put forward strong arguments in favour of flexible exchange rate.

Arguments in favour of Flexible Exchange Rate:

First, flexible exchange rate provides a good deal of autonomy in respect of domestic policies as it does not require any obligatory constraints. This advantage is of great significance in the formulation of domestic economic policies.

Second, flexible exchange rate is self-adjusting and therefore it does not devolve on the government to maintain an adequate foreign exchange reserves to stabilize the exchange rate.

Third, since flexible exchange rate is based on a theory, it has a great advantage of predictability and has the merit of automatic adjustment.

Fourth, flexible exchange rate serves as a barometer of actual purchasing power of a currency in the foreign exchange market.

Finally, some economists argue that the most serious charge against the flexible exchange rate, that is, uncertainty, is not tenable because speculative tendency under this system itself creates conditions for certainty and stability. They argue that the degree of uncertainty under flexible exchange rate system, if any, is not greater than one under the fixed exchange rate.

11.2.2 Regulation of Foreign Exchange Transactions

Foreign exchange transactions were regulated in India by the Foreign Exchange Regulations Act (FERA), 1973. This Act also sought to regulate certain aspects of the conduct of business outside the country by Indian companies and in India by foreign companies. The FERA was widely described as a draconian and obnoxious law. Following the economic liberalisation ushered in 1991, some amendments to the FERA were effected in 1993. The main objective of FERA, framed against the background of severe foreign exchange problem and the controlled economic regime, was conservation and proper utilisation of the foreign exchange resources of the country. There was a lot demand for a substantial modification of FERA in the light of the ongoing economic liberalisation and improving foreign exchange reserves position. Accordingly, a new Act, the Foreign Exchange Management Act (FEMA), 1999, replaced the FERA.

11.3 Foreign Exchange Management Act

The FEMA, which came into effect from January 1, 2000, extends to the whole of India and also applies to all branches, offices, and agencies outside India, owned or controlled by a person resident in India.

The objectives of FEMA are:

- To facilitate external trade and payments
- To promote the orderly development and maintenance of foreign exchange market.

Dealing in Foreign Exchange:

Section 3 of FEMA imposes restrictions on dealings in foreign exchange and foreign security and payments to and receipts from any person outside India. Accordingly, except as provided in terms of the Act, or with the general or special permission of the Reserve Bank, no person shall—

(a) Deal in any foreign exchange or foreign security with any person other than an authorised person;

(b) Make any payment to or for the credit of any person resident outside India in any manner;

(c) Receive otherwise through an authorised person, any payment by order or on behalf of any person resident outside India in any manner;

(d) Enter into any financial transaction in India as a consideration for or in association with acquisition or creation or transfer of a right to acquire, any asset outside India by any person. Further, same as otherwise provided in this Act, no person resident in India shall acquire, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India.

Holding of Foreign Exchange:

Same as otherwise provided in this Act, no person resident in India shall acquire, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India.

- **Current Account Transactions**

FEMA permits dealings in foreign exchange through authorised persons for current account transactions. However, the Central Government can impose reasonable restrictions in public interest.

- **Capital Account Transactions**

Any person may sell or draw foreign exchange to or from an authorised person for a capital account transaction permitted by the Reserve Bank in consultation with the Central Government.

The Reserve Bank may, however, without prejudice to the generality of this, prohibit, restrict or regulate the following:

(a) Transfer or issue of any foreign security by a person resident in India;

(b) Transfer or issue of any security by a person resident outside India;

(c) Transfer or issue of any security or foreign security by any branch, office or agency in India of a person resident outside India;

(d) Any borrowing or lending in foreign exchange in whatever form or by whatever name called;

(e) Any borrowing or lending in rupees in whatever form or by whatever name called between a person resident in India and a person resident outside India;

(f) Deposits between persons resident in India and persons resident outside India;

(g) Export, import or holding of currency or currency notes;

(h) Transfer of immovable property outside India, other than a lease not exceeding five years, by a person resident in India;

(i) Acquisition or transfer of immovable property in India, other than a lease not exceeding five years, by a person resident outside India;

(j) Giving of a guarantee or surety in respect of any debt, obligation or other liability incurred—

1. By a person resident in India and owed to a person resident outside India; or
2. By a person resident outside India.

A person resident in India may hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India if such currency, security or property was acquired, held or owned by such person when he was resident outside India or inherited from a person who was resident outside India. A person resident outside India may hold, own, transfer or invest in Indian currency, security or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was resident in India. The Reserve Bank may prohibit, restrict, or regulate establishment in India of a branch, office or other place of business by a person resident outside India, for carrying on any activity relating to such branch, office or other place of business. The Reserve Bank shall not impose any restriction on the drawl of foreign exchange for payments due on account of amortisation of loans or for depreciation of direct investments in the ordinary course of business.

Export of Goods and Services

1. Every exporter of goods shall—

(a) Furnish to the Reserve Bank or to such other authority a declaration as specified, containing true and correct material particulars, including the amount representing the full export value or, if the full export value of the goods is not ascertained at the time of export, the value which the exporter, having regard to the prevailing market conditions, expects to receive on the sale of the goods in a market outside India;

(b) Furnish to the Reserve Bank such other information as may be required by the Reserve Bank for the purpose of ensuring the realisation of the export proceeds by such exporter. For the purpose of ensuring that export value of the goods is received without any delay, the Reserve Bank may direct any exporter to comply with such requirements as it deems fit. Every exporter of services shall furnish to the Reserve Bank or to such other authorities a declaration as specified, containing the true and correct material particulars in relation to payment for such services.

Realisation and Repatriation of Foreign Exchange

Where any amount of foreign exchange is due or has accrued to any person, he shall take all reasonable steps to realise and repatriate it to India within the time and in the manner prescribed by the RBI. Several exemptions are, however, granted to this clause.

- **Contravention and Penalties**

Under this chapter, penalty for any kind of contravention under this Act is liable to a penalty up to thrice the amount involved where it is quantifiable or up to 2 lakh where it is not quantifiable and where such contravention is continuing one, further penalty which may extend to five thousand rupees for every day after the first day during which the contravention continues. This provision is in total contrast to the respective provision in the erstwhile FERA which provided for imprisonment and no limit on fine. Under FEMA, a person will be liable to civil imprisonment only if he does not pay the fine within 90 days from the date of notice and that too after formalities of show cause notice and personal hearing. If he does not respond to the notice, there can be a warrant of arrest.

- **Administration of the Act**

The FEMA has assigned an important role to the Reserve Bank of India in the administration of this Act. The rules, regulations and norms pertaining to several sections of the Act are to be laid down by the RBI in consultation with the Central Government. The Act requires the Central Government to appoint as many officers of the Central Government as Adjudicating Authorities for holding inquiries pertaining to contravention of the Act. There is also a provision for appointing one or more Special Directors (Appeals) to hear appeals against the order of the Adjudicating Authorities. The Central Government shall also establish an Appellate Tribunal for Foreign Exchange to hear appeals against the orders of the Adjudicating Authorities and the Special Director (Appeals). The FEMA provides for the establishment, by the Central Government, of a Director of Enforcement with a Director and such other officers or class of officers as it thinks fit for taking up for investigation the contraventions under this Act.

11.4 FERA and FEMA – A Comparison

Important differences between FERA and FEMA have been summed up as follows:

1. In FEMA, only the specified acts relating to foreign exchange are regulated, while in FERA, anything and everything that has to do with foreign exchange was controlled. Also, the aim of FEMA is facilitating trade as against that of FERA, which was to prevent misuse. In other words, the theme of FERA was: ‘everything that is specified is under control’. While the theme of FEMA is: ‘everything other than what is expressly covered is not controlled’. Thus there is a lot of deregulation.

2. FEMA is a much smaller enactment - only 49 sections as against 81 of FERA.

3. In the process of simplification, many of the “lay downs” of the erstwhile FERA have been withdrawn.

4. Many provisions of FERA like the ones relating to blocked accounts, Indians taking up employment abroad, employment of foreign technicians in India, contracts in evasion of the act, vexatious search, culpable mental state etc., have no appearance in FEMA.

11.5 Check Your Progress

Multiple Choice Questions:

1. _______________ regulated the foreign exchange transactions in India and which sought to control certain aspects of the conduct of business outside the country by Indian companies and in India by foreign companies.

a. FERA
b. FEMA
c. Flexible exchange rate
d. None of the above

2. _______________ a market in which the sale and purchase of foreign currency are settled within two days of the deal.

a. Flexible exchange rate
b. Forward market
c. Spot market
d. None of the above

3. _______________this means that the government has changed the fixed rate of a fixed exchange rate downwards.

a. Appreciation
b. Devaluation
c. Revaluation
d. Depreciation

4. Reserve Bank without prejudice to the generality of this prohibits, restrict or regulate the following.

a. Deposits between person's resident in India and persons resident outside India.
b. Export, import or holding of currency or currency notes.
c. Transfer or issue of any security by a person resident outside India.
d. All of the above

5. What are the objectives of FEMA?

a. To promote the orderly development and maintenance of foreign exchange market
b. To facilitate external trade and payments
c. Both a & b
d. Only b

11.6 Summary

The Foreign Exchange Management Act (FEMA), 1999, replaced the Foreign Exchange Regulations Act (FERA), 1973, which regulated the foreign exchange transactions in India and which sought to control certain aspects of the conduct of business outside the country by Indian companies and in India by foreign companies. The FEMA, which came into effect from January 1, 2000, extends to the whole of India and also applies to all branches, offices, and agencies outside India, owned or controlled by a person resident in India. The objectives of FEMA are to facilitate external trade and payments; and to promote the orderly development and maintenance of foreign exchange market. The Reserve Bank of India is assigned an important role in the administration of this Act. The FEMA empowers the Central Government to impose restrictions on dealings in foreign exchange and foreign security and payments to and receipts from any person outside India. The Act imposes restrictions on persons resident in India on acquiring, holding or owning foreign exchange, foreign security and immovable property abroad and on transfer of foreign exchange or security abroad. The FEMA lays down that all dealings in foreign exchange or foreign security and all payments from outside the country to India shall be made only through authorised persons, except with the general or special permission of the Reserve Bank. The Act also prohibits any payment outside India except with the general or special permission of the Reserve Bank. The FEMA permits dealings in foreign exchange through authorised persons for current account transactions. However, the Central Government can impose reasonable restrictions in public interest. Any person may sell or draw foreign exchange to or from an authorised person for a capital account transaction permitted by the Reserve Bank. However, the Act empowers the RBI to impose a number of restrictions on capital account transactions. The FEMA permits a person resident in India to hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India if such currency, security or property was acquired, held or owned by such person when he was resident outside India or inherited from a person who was resident outside India. Also, a person resident outside India may hold, own, transfer or invest in Indian currency, security or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was resident in India. The Reserve Bank is empowered by this Act to prohibit, restrict, or regulate establishment in India of a branch, office or other place of business by a person resident outside India, for carrying on any activity relating to such branch, office or other place of business. However, the RBI shall not impose any restriction on the drawl of foreign exchange for payments due on account of amortisation of loans or for depreciation of direct investments in the ordinary course of business. The Act requires the exporters to furnish to the Reserve Bank or to such other authority certain details regarding the exports. For the purpose of ensuring that export value of the goods is received without any delay, the Reserve Bank may direct any exporter to comply with such requirements as it deems fit. Where any amount of foreign exchange is due or has accrued to any person, he shall take all reasonable steps to realise and repatriate it to India within the time and in the manner prescribed by the RBI. Several exemptions are, however, granted to this clause.

Under this chapter, penalty for any kind of contravention under this Act is liable to a penalty up to thrice the amount involved where it is quantifiable or up to ` 2 lakh where it is not quantifiable and where such contravention is continuing one, further penalty which may extend to five thousand rupees for every day after the first day during which the contravention continues. This provision is in total contrast to the respective provision in the erstwhile FERA which provided for imprisonment and no limit on fine. Under FEMA, a person will be liable to civil imprisonment only if he does not pay the fine within 90 days from the date of notice and that too after formalities of show cause notice and personal hearing. If he does not respond to the notice, there can be a warrant of arrest. An important difference between FERA and FEMA is that while in FEMA, only the specified acts relating to foreign exchange are regulated, in FERA, anything and everything that has to do with foreign exchange was controlled. Also, the aim of FEMA is facilitating trade as against that of FERA, which was to prevent misuse. In other words, the theme of FERA was: 'everything that is specified is under control'. While the theme of FEMA is: 'everything other than what is expressly covered is not controlled'. Thus, there is a lot of deregulation.

11.7 Keywords

Exchange rate: In finance, an *exchange rate* is the *rate* at which one *currency* will be exchanged for another. It is also regarded as the value of one country's *currency* in relation to another *currency*.

FERA: Foreign Exchange Regulation Act (also known as FERA), was **introduced in the year 1973.** The act came into force, to regulate inflow and outflow of foreign currency, foreign payments, securities and purchase of fixed assets by the foreigners.

Foreign Exchange Market: The foreign exchange market (also known as forex, FX or the currency market) is an over-the-counter (OTC) global marketplace that determines the exchange rate for currencies around the world. Participants are able to buy, sell, exchange and speculate on currencies.

Foreign Exchange Regulation Act: The Foreign Exchange Management Act, 1999 is an Act of the Parliament of India "to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India".

FEMA: Foreign Exchange Management Act (FEMA), provisions related to foreign exchange have been modified and liberalised so as to simplify foreign trade and payments.

11.8 Self-Assessment Test

1. What is exchange rate movement?
2. Explain the terms a. "Devaluation"
    i. b. "Depreciation"
    ii. c. "Appreciation"
3. "Revaluation"
4. Differentiate between FERA and FEMA.
5. Discuss the objectives of Foreign exchange management act.
6. Explain the flexible and fixed exchange rate.

11.9 Answers to Check Your Progress

1. FEMA

2. Spot market

3. Devaluation

4. All of above

5. Both a & b

11.10 References/Suggested Readings

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