CHAPTER II

THE ROLE OF RETAINED EARNINGS IN INDUSTRIAL FINANCE

The term 'reinvestment' denotes the ploughing-back of profits of the firm for its expansion. A part of the current earnings of a firm is retained and reserved for investment for future growth or to meet any contingencies that may arise in its onward progress. This phenomenon of retention for a rainy day or for a better prosperity in future, is part of human nature, particularly in 'economic man'. The firm representing the interests of its shareholders who have initially contributed for its establishment, naturally strives to keep up and perpetuate its capacity, just like an organic entity. The firm is no longer a profit maximisation abstraction, as in the traditional sense. It is "a unique administrative and social organisation possessing the capacity for initiating its own biological growth". The maintenance and growth, as far as possible, by one's own self-effort is the primary motive force behind the reinvestment plans of the firms. But, this does not mean that it is always possible and adequate for a firm to depend upon its own retained earnings for all its expansionary activities.

Retained Earnings and Reinvestment:

One is ex ante and the other is ex post. The retained earnings are the earnings withheld from distribution as dividends to the shareholders, after meeting the other commitments of payments of taxes, interest on loans etc. The earnings which are thus retained may be reinvested or may not be, depending on the future exigencies. Retained earnings emerge as reinvestment only when it is invested on the expansion schemes of the productive capacity of the firm. But this may not be the case always. The firm may use its reserve funds, i.e., accumulated retentions for the payment of dividends in the years in which it does not make any profit. The business conditions may warrant a disbursement of its past retained earnings in order to boost the morale or uplift its sagging reputation in the stock exchange. Or, at times, the reserve fund may be utilised partly for the altruistic, non-profit motive of a public cause, besides the welfare activities for its own workers. These measures, though may apparently look like unproductive expenditure, ultimately and indirectly help the concern to boost its image or to retrieve its lost reputation and thereby pave the way for its further progress. Hence, it is generally presumed in this study, that the retained earnings are meant for reinvestment and that they are synonymous for all practical purposes.
A constant and sizable proportion of the firm's gross earnings is set apart as depreciation charges in order to meet the replacement of the spare parts of the machinery and other fixed items of equipment which lose their value due to wear and tear. Though the depreciation reserves are not to be utilized for the procurement of any net addition to existing productive capacity (expansionary), it serves as an essential component of reinvestment in the up keep and maintenance of the plant and machinery and other fixed items. In fact, the depreciation fund provides for the smooth and uninterrupted functioning of the machinery. It is as important as the inventory investment in order to keep the concern going. In the case of inventory, the firm endeavours to keep it at the minimum possible level, whereas the depreciation funds are reserved to maximum possible level, to meet the increase in the prices of replacement items and also to foot the bill for the entire re-equipment, in times of scrapping the used ones.

The depreciation allowances form a major part of the "cash flow" that the modern corporations generate internally for investment in the modernisation and expansion. The growth of depreciation allowances over the years has made them much important part of cash flow than retained earnings. For
instance in 1969, cash flow of corporations in the U.S. totaled $73.7 billion, a record high, despite the fact that retained earnings were still well below earlier peaks.

Further, the significance of depreciation allowances has acquired a new dimension because the rapid advancement in technology outdates the machinery very fast and makes them obsolete despite their being intact in usage. As Simon Kuznets observes, "The consumption of durable capital, a measure largely of economic obsolescence, rather than of physical wear and tear, grew at higher rates than did gross capital formation; and its ratio to the latter rose from about four-tenths in the early decades to almost two thirds in the recent decade" (for the whole of U.S. economy).

At the macro-level a good proportion of depreciation reserves may be considered even as an item of national income because an economy with growing fixed capital is bound to accumulate surplus of depreciation reserves in excess of immediate requirements. The excess of depreciation reserves over the replacement needs is a constituent of the national income that eludes even the fastidious grip of the national income accountant. For an individual firm, depreciation reserves are not an income. But for a growing economy, a

---

ILLUSTRATIONS

Linear Trends in Ratio of Dividends to Net Profits:

Textile
Chemical
Engineering
Cement
Sugar

Linear Trends in Ratio of Retained Earnings to Net Profits:

Textile
Chemical
Engineering
Cement
Sugar

Bar Chart of the Ratios of Dividends to Net Profits.

Bar Chart of the Ratios of Retained Earnings to Net Profits.
portion of it is in the nature of income which can be used either for consumption or investment purposes. The greater the growth, the higher proportion of depreciation reserves is in the nature of income\(^1\). \(\ldots\) Romar has also demonstrated that in a growing economy there will be surplus element in the depreciation reserve which is in excess of the requirements for replacing the worn-out fixed capital\(^2\).

But, it should be noted that there is a general tendency among the firms to over-estimate the depreciation and record higher charges. The amount recovered over the life of an asset is planned to equal total cost of using the asset. If prices are rising, the cost of replacing the asset may be far greater than the original cost. Hence the depreciated charges should cover estimated replacement cost rather than actual cost. No matter, how it is determined, the balance in the accumulated depreciation shows only the total depreciation charged off. It does not represent (just) a replacement fund\(^3\).

However, such over-recording in their accounts, does not ensure the existence of actual funds in their vaults.

---

available for the replacement of machineries that become useless. The firms might have used the funds for building-up inventory stock, repair, expansion or even for repayment of loans\(^1\).

For the very same reason that the depreciation reserves are utilised for the various investment schemes including that of expansion, the depreciation charges are also included in the category of internal finance in the present study. Retained earnings are assumed to depend upon gross cash flow which consists of net profits and depreciation provision. If the depreciation provision is higher, the net profit will be lower and hence the lower retentions. Lower retention resulting from higher depreciation may not be a true index of internal funds. Hence the retained earnings plus depreciation are considered to be the gross value of internal savings.

Thus it is fully justified in recognising the depreciation allowance partly as a source of net addition to capital (re-investment) and partly as a fund for replacement. In the stationary conditions of the classical framework,

---

depreciation was designed just to cover the replacement and nothing more. The classical notion of investment is derived from the idea of capital as a revolving stock. If each capital item has a certain durability or service life, a certain replacement per unit of time is required to maintain the total stock. A part of gross current output must be "invested" each year in order to keep the stock of capital constant. The capital is "liberated" as it wears out, and is "reinvested". Under stationary conditions, this means zero net investment.\(^1\)

But, as per the modern theories, capital has to breed itself, besides self-sustaining. The nature and the rate of depreciation of the fixed asset need to be considered before making a decision on investment. The demand for any investment implicitly includes the demand for replacement as well as something of an extra-return available for reinvestment for expansion. "The rate at which the capital will depreciate, both in value and as a factor of production, plays a role in decisions concerning the amount of capital to be used at any time. Capital must be replaced, if it is

---

to remain constant, but it is equally true and trivial that capital must be more than replaced in order to grow.

SIGNIFICANCE OF RETAINED EARNINGS IN THE DEVELOPED ECONOMIES

Industrial finance may be divided into three broad categories. The short term funds comprise of trade credit and bank credit, both secured and unsecured; the secured credit is advanced against securities and the unsecured credit just on the strength of the business reputation. The medium term funds are advanced by banks, insurance companies and other government sponsored credit institutions. The long-term funds come from (a) common and preferred stock (b) internal financing (retained profits) (c) debt (d) convertible securities and warrants and (e) leasing. Among the various sources of funds, the retained earnings form a reliable long term source because it is within the capacity of the management to retain as much as possible for its re-investment in the long run.

Most of the success stories of industrial advancement bear ample testimony to the important role played by self-generated savings of the industrial sector. Almost all the developed countries of today in their initial stages

of development, enjoyed a fairly high rate of gross domestic capital formation of which the corporate savings formed a dominant share. Simon Kuznets who has made a study of the structure of Gross Domestic Capital Formation of the developed countries in 1956–60, observes that the capital consumption charges assignable to the private corporate sector constitute 36.4% of gross domestic capital formation or 35.7% of gross national savings; and private corporations must account, in developed countries, for at least half of this total. Using this latter proportion we can calculate the share of private corporations in gross national savings to be about 31.6%.1

In the case of U.S.A. the long term corporate retention ratio of before-tax profits, has not only maintained an average of about 30%, during the period, 1953–1970, but also it was fairly stable during this long period under observation2. Adding the depreciation with retained earnings, gross internal funds, in the total financing of all the manufacturing in U.S.A., accounted for about 85%, whereas the

external financing formed a paltry 15% in 1978. Again, the Simon Kuznets's assessment indicates a high ratio of internal financing to total financing, which ranged between 0.70 to 0.97 during 1900-1953.

Internal finance, similarly, occupied a dominant position in development of British Industries. During the long period of 1948-76, the gross internal funds contributed about 85% of total Industrial finance and the remaining met by the external sources. Though the brunt of the burden of industrial revolution was met by the low-paid workers, women and children, the "pioneers of the factory system had to draw almost entirely on their private savings or on the assistance of friends". As P. Mathias would observe, "the greatest


single source undoubtedly was the 'plough-back' of retained profits\(^1\).

Same was the case with Japanese industrialisation which relied completely on its domestic savings of mainly the industrial sector. Most of the capital for the Japanese industrial expansion was found by reinvestments of corporate savings and profits, loans and advances from banks and inflationary financing\(^2\).

Thus in the free market economies, where the incentive to save and re-invest being inherent, the capital formation was a self-sustaining phenomenon. And the centrally planned economies like U.S.S.R. which embarked on a rapid industrialisation program, was no exception. Tactically, a strategy which facilitated essentially a high degree of re-investment was followed. That is, a deliberate bias in favour of heavy industry, on the lines of Preobrashenski's theory\(^3\), was adopted in the Five year plans. During 1927-56, about 70 to 80% of the industrial investment was directed to the capital goods sector\(^4\).

---

Thus the historical experiences of the industrialised economies indicate the fact that the role of re-investment in development was crucial. However, the LDCs of today cannot hope to mobilise its major requirements of capital formation from retained earnings alone. Unlike the low-wage, high-profit conditions prevalent in the early stages of industrial development of most of the developed countries, in the LDCs the workers demand maximum wage income (which has generally the least re-investment coefficient) and the capital-owners face declining surplus available for reinvestment, on account of other factors such as demand for higher dividends, taxes etc. As Sutcliff observes, "If all the industrial surplus is reinvested, then even when wages are very low, this will not itself be enough in low income countries to finance rapid industrialisation. If the rate of profit on turnover were as high as 50% and of industrial output were 20% of total output, then still only 10% of total output would be invested in industry if the industrial surplus were the only source of investment, and if it were all reinvested. Of course, under these quite exceptional conditions, the industrial sector's output would grow very fast if the same rate of surplus and re-investment could be maintained".

INTERNAL FINANCE IN THE INDIAN CORPORATE SECTOR

An assessment of the role of internal finance in the Indian corporate sector, will provide a proper framework for the present study of Tamil Nadu industries. Historically speaking, the socio-cultural background in India was such that what India lacked, (or lacks even today) was not the high rate of savings but a misdirected utilisation of savings on the items of conspicuous consumption, ceremonial rituals and erection of monuments in perpetuation religious or egocentric sentiments. This was more pronounced during the pre-independence period, with an alien government uninterested in inducing the domestic investment, and the virtual absence of a developed capital market to mobilise the savings and channel them into profitable investments. As it is well said that India was borrowing from London market for railways and other purposes in the later-half of the 19th century while some Indians were rolling in wealth but would never think of investing on securities and stocks or on joint-stock banking and industries\(^1\). And it is a historical fact that the British colonial rule was instrumental in encouraging such extravagance. "The princelings and Zamindars were notorious for conspicuous consumption. Such wastage of the economic surplus was atleast partly functional from the point of view of the British imperial system\(^2\).


This being the characteristic of savings-utilisation in general, the corporate sector in India particularly since the planning era, has made the maximum possible utilisation of its internal savings. Most of the capitalists in India, despite their small and humble origins, have established themselves as industrial magnates mainly by their hard and fastidious pursuit of savings and re-investment, without dissipating their earnings on personal luxuries. It is only a high degree of comfort negation coupled with sustained effort that has led to significant break-through for achievement of the enterprise. The relevance of the internal savings become still more significant in the context of a shy capital market and the reluctance of the potential investors to invest in shares and securities.

According to the RBI estimates, reported periodically in the Bulletins, the finances of the non-government and non-financial public limited companies show the following trends (vide the Tables in the Appendix). In the period 1951-55, the gross internal funds (depreciation and retained earnings) accounted for 52.14% of the total industrial financing in the private corporate sector. This share, however, decreased to 41.7% in the period 1956-60. The trend continued in 1966-67.

when the share of internal funds stood at 41.34%, but it has registered an upward level to 58.83% in 1971-72\(^1\). By 1976-77, the share of internal funds has again declined to 52%, with an exceptionally peak level of 72.3% in 1972-73. But the amount of profits retained as percentage of profits after tax which will give a direct indication of the level of savings in the corporate sector, has been estimated as follows: it was about 38% in 1965-66 which rose to 51.1% in 1970-71; however it has decreased marginally to 48.7% in 1976-77. The level reached its peak of 70% in 1974-75\(^2\).

Thus the share of internal funds in the total financing of the private corporate sector, though interspersed with fluctuations, generally show an upward trend, and in most of the years during 1951-76, it has formed relatively higher share of finance than that of the external funds. It is because of the recessionary impact experienced during III plan period, the profit margins as well as the savings potential of some of the industries suffered a severe setback and hence the lesser reliance on internal sources of funds and corresponding increasing dependence on external sources, (during II & III plan periods)\(^3\).


The NCAER estimates of the finances of public limited companies give slightly a different picture. For instance, its estimate of corporate net saving amount to Rs.483 million whereas that of RBI amount to Rs.686 million in 1956-57.\(^1\) It all depends upon the nature of definition of the internal funds. Some studies restrict to retained earnings only and some other studies include depreciation allowances also as part of internal funds. The study by K. Krishnamurthy and M.U. Sastry concludes that the ratio of gross retained earnings (gross of depreciation) to gross profits (gross of depreciation but net of taxes) is about 70% above in some of the major industries such as Textiles, Jute, Paper & Paper products, Chemicals and Engineering. The percent of gross retained earnings to total investment, both fixed and inventory combined, is as high as 50 to 70%\(^2\). Reading the detailed empirical analysis of internal finances in relation to the dividend behaviour and the external finance of the select industries, it can now be fairly concludes that the share of internal financing in Indian corporate sector compares not very unfavourably with that of the developed countries like U.K. and U.S.A. In 1961, the share of internal finance formed about 55.9% in U.K., 66.3% in U.S.A. and 56.5% in India, which increased respectively to 70%, 72.7% and 58.4%, in 1966\(^3\).

---


RETAINED EARNINGS IN RELATION TO OTHER SOURCES OF FINANCE:

The retained earnings have got some special advantages over the external sources of finances like debt, equity and other types of advances from credit institutions. First of all, the reliance on retained earnings provides a free hand in the decision making with regard to expansion and other operations of the firm; whereas the capital obtained from other sources such as financial institutions or even equity shares carry with them an element of restraint on the sphere of decision making. The distinction between internal finance and external financing is "important because in internal financing, only the capital user's decision matters, but in external financing others share in making the decision". Hence, for instance, most of the enterprises in India which are family (industrial house) controlled, have preference for internal funds as opposed to equity as the former would enable continuance of such control.

Further, internal funds are preferred to external funds because the former are said to be cost-free or of low-cost, which can be used for an indefinite period. In other words the periodical interest payment on debt capital, flotation costs and necessity to 'under-price' the equity share.

issues and other incidental expenses incurred in mobilising external finance are generally absent if the firm resorts to internally generated funds. But it is a mistaken view to treat these funds as completely cost free. This view seems to rest on the assumption that the company is separate from the equity share-holders and that it costs the company nothing to withhold the earnings from them. The cost of re-invested profits to shareholders is the opportunity cost of such funds to them. It is equal to the income that they would otherwise obtain by placing these funds in alternative investments\(^1\).

And it is quite possible that the internal funds which are apparently cost-free, may really imply a huge cost-burden. As A. James Boness observes, "the explicit cost of internally generated funds is zero, since these funds are already available within the firm. But the implicit, opportunity cost of internally, generated funds may be very high"\(^2\).

Moreover, the internal finance involves a social cost at large, because ultimately it is the consuming public which shares this burden of capital-saving by paying a higher price. This is, in effect, a form of financing through price mechanism. The consumers of the product of the enterprise provide the capital by being compelled to pay a price for the product high enough to include a capital-charge\(^3\).

---

If the firm happens to be a small and new entrant to the field, it may find it difficult to raise additional capital from the equity market whenever it is in need of funds. Hence the savings rate tend to be usually higher in the small sized firms. There may be many reasons for this, but the most important seem to be that the small companies have to depend on their own funds in order to grow and that outside financing is too costly for them.1

There has been a constant temptation on the part of the management to keep a reserve of as much retention as possible. This may help them understate the profit and avoid claims for dividends. Also it enables the management to avoid tax burden of its shareholders who would otherwise be forced with capital-gains tax and dividend income tax. Or it is quite possible that the profits are retained just to satisfy the ego of the management or craziness for affluent reserves even beyond the demands of the business. Preoccupation with the prestige or other benefits that directors receive from the growth of their own companies has pushed the necessity for the free circulation of finance among companies according to the choice of shareholders, too far into the background. 'Cases can be found, indeed where surplus profits have been withheld from distribution not for the purpose of enlarging productive capacity but merely so as to increase a

company's liquid reserves well beyond the demands of reasonable prudence.

The retained earnings may better serve the long term interests of the shareholders if the firm is able to make a productive and frugal utilisation of these reserves. If the firm distributes the earnings, without retaining, the shareholders will get the short-run benefit in the form of cash dividend. Sometimes, the quick-yield may be over-compensated by the long term yield in the form of potential capital gains and higher future dividends if the retained earnings are properly reinvested to boost the growth of the firm. As long as the corporations can look forward with reasonable certainty, to earning a higher return on reinvested earnings than shareholders could expect to obtain by individually investing their cash dividends in other opportunities available to them, long-run stock-holder interests are better served by a policy of low or no cash dividends.

DEBT/EQUITY RATIO & OPTIMAL CAPITAL STRUCTURE

Notwithstanding the relative merits of retained earnings, it will not suffice the long term requirements of finance for expansion and diversification of its productive activities. And hence the necessity of looking outward for external funds arises. How far a firm will go in for debt and equity and what will be a desirable or optimum capital structure? While the firms depend for its short term:

requirements (working capital) upon the trade credit, advances from Banks and other such commercial credit, the long term funds are provided mainly by (a) retained earnings (b) debt and (c) equity. The debt financing involves payment of interest charges, whether the firm makes profit or not. If the rate of return is higher than the financing charges, then borrowing is considered to be worthwhile. The equity financing is of two types: preferred shares and common shares. The preferred shares with fixed rate of return have the priority over the distribution of earnings; the remaining returns only will be available for the appropriation among common shares and other reserve items.

Only a proper balance among the three items of long-term finance viz. retained earnings, equity and debt, can ensure minimum capital cost for the firm. The cost of capital must atleast be equal to the rate of return which is required by the firm to increase or maintain the value of the firm in the market place. The value of the firm in the market comprises of the three elements namely the market values of the firm's debt, preferred stock and common stock. If the rate of return does not cover the cost of capital, then it is ultimately reflected in the declining market value of the firm. Hence, the over-riding criterion of acquisition of debt or equity is whether it helps the firm cross the 'hurdle' or 'break-even' point or not. For example, a firm can borrow debt funds at relatively low rates of interest upto a certain point. Until
this point is reached, the use of debt financing will lower
the over-all cost of capital. When the debt-equity ratio
becomes too high, the firm may have to pay high rates of
interest to borrow. This will raise the cost of capital.
At a high debt-equity ratio, the firm may not be able to
borrow at all. In this situation, the firm may float stock
to bring the debt-equity ratio back into line with expectations.
Eventhough the stock may be offered at relatively low market
prices, the additional equity will reduce the amount of risk
faced by the firm's creditors.

The optimal capital structure is thus that particular
combination of debt and equity which maximises the value of the
firm's common stock in the share market and minimises the cost
of capital for the firm. This is, of course, better clarified
in the neo-classical theory of capital accumulation which
implies a theory of the cost of capital. The market value of
the firm is equal to the discounted value of cash flow net of
direct taxes. The appropriate after-tax rate of discount is
the cost of capital employed in the accounting price for capital
services used in the choice of an optimal level of capital
services at each point of time. Thus "the cost of capital can
be measured from net cash flow, the market value of the firm
and the change in the market value".


2. Dale W. Jorgenson & Calvin B. Siebert, "Optimal capital
accumulation and corporate investment behaviour", (Journal
of Political Economy - Vol. 76, No.6, Nov/Dec. 1968),
p.1126.
However, Modigliani and Miller have developed that the cost of capital is a constant, in the absence of taxation, and is equal to the rate of return required by investors in a corresponding firm which is not levered. The firm cannot alter this cost by dividing the earnings among different classes of investors. Thus, if the "leverage" (debt/equity ratio) increases, the rate of return required by the shareholders from the residual profits will also change to offset the effect of greater debt on the firm\(^1\). But the M.M. view of irrelevance of capital cost to the value of the firm for the existing stock holders, is obviously based on too-restrictive a set of assumptions which are not to be found in a real world situation.

Moreover, the financial leverage has got its own implication on the profitability of the concern. "Since the usual measure of profitability was the ratio of net income to the book value of stockholders' equity, two firms could have similar assets, output and even prices, yet have differing profitability measures only because of the amount of financial leverage utilised"\(^2\). Lower the degree of leverage, higher will be the rate of profitability and lower the cost of capital.

---


That is why, some of the monopoly industries show a higher level of profitability, by their lower leverage.

The equity financing, in relation to debt and retained returns, has to be approached in all its implications on the cost of capital or the market value of the firm. Raising the equity capital by means of floating the stock in the market finally depends upon the preference of the potential investors. They make the choice among the fixed interest bonds (debt), preferred stocks and equity shares so as to maximise their expected return. The firm on the other hand has to choose whether and how much to resort to each of the items of retained earnings, debt and equity. Having arrived at a desired level of leverage ensuring minimum cost of capital, the firm has to decide on the retention of its earnings, depending upon its position in the stock market, and on the preference of the existing stockholders either for future capital gains or for immediate cash dividends. Higher the ratio of retention, lower will be the new issues of stock and vice versa. Thus "any normative approach to dividend (financing) policy intended to be operative under real world conditions should consider the firm's investment opportunities, any preferences that investors have for dividends as opposed to capital gains or vice versa, and differences in 'cost' between retained earnings and new equity issues".1

Once the debt/equity ratio is carefully reached, it is not frequently changed. Short-run fluctuations in the debt/equity ratio may arise not so much due to any fundamental changes in the desired level of gearing, as it is due to the fluctuations in profits and the retained earnings. The ratio between the latter would be influenced largely by the firm's propensity to save and the stockholders' demand for cash dividends. (The different norms behind the disposition of income into retained earnings and dividends are discussed in detail in the next chapter). The fraction of equity which will on average be raised in the form of new issues of stock is essentially a choice of a fraction of average earnings to pay as dividends. For any program of investment expenditures, the larger this pay-out ratio, the more the new stock must be sold; the smaller this fraction, the less must be the reliance on new stock sales.

However, since there is a strong tendency among the firms to stabilise the dividends towards a targeted pay-out ratio, the corresponding new issue of equities also tends to be small and marginal. For instance, net new issues of common stock in the well-developed U.S. corporate sector has provided only about 3% of its total financing needs over the period 1956-73. As W.L. White observes, "new issues of stock seem to be unrelated to the pattern of asset acquisition followed by

business firms. This is not surprising in view of the fact that much of the new stock is issued by smaller business firms in response to their own particular needs ..... attempting to stay within prescribed debt/equity or equity/asset ratios. These specific needs seem to be related in no direct way to the pattern of investment by business firms as a whole

Thus the interdependence among the three sources of long term finance which constitutes the evolution of an optimal capital structure in the firm, requires a diligent and cautious financial planning. This may not be immediately achieved. Corporate financial planning should be a continuous process and hence no plan is ever final; it is always subject to revision. A plan therefore is not the final product of the planning process, it is an interim report. It is a record of complex set of interacting decisions. The decision making in financial control, also involves certain intuitive capability of 'integrating information into a judgement'. Many aspects of investment analysis are said to be psychological in nature. Because of lack of relevant psychological knowledge security analysts have too often been forced to become amateur psychologists themselves. It requires patient adjustment and

re-adjustment in due course of the operation. The speed of
adjustment, that is, to align actual capital stock to the
desired level and structure, will be faster in those firms
which have easy and quick access to the external sources of
funds viz. debt and equity, than in the firms which deliber-
tely restrict to their internal funds only. In this respect,
the external funds prove to be a significant variable.

CAPITAL STRUCTURE: SOME PRACTICAL CONSIDERATIONS:

The actual capital structure attained by the firm
has certain implications, with regard to the nature of industrial
structure, level of development of the capital market and the
institutional considerations such as tax system and the prevalent
financial practices.

If the firm is caught-up in the oligopolistic structure,
then it may have to seek funds from external sources, even if
they are not expected to be marginally profitable. This becomes
essential, when the internal funds are not sufficient to protect
its market share, as it is often true. Generally the public
sector units rely heavily upon the external funds, either
because of their poor profit margins or because of the ready
availability external funds from the public-sponsored credit
institutions. 'External sources of funds as a percentage of
total funds worked out at 30% in 1972-73 for the private sector,
against 71.7% for the government companies in India'.

1. Hair, A.P. & S.C. Sanatiya, "Changing Corporate Sector"
The development of monopolistic trends in the industry is likely to be facilitated by accumulated retentions over the period, if further encouraged by preferential tax treatment of retained earnings. A differential tax treatment leads to less efficient use of savings by those firms who have more money than they can use and makes difficult raising of new capital by rapidly growing firms. This strengthens the tendency towards monopoly and technological stagnation by reducing opportunities for new business to challenge and replace the old business.

The firms which are on the expansion spree enjoying substantial external economies of scale mainly are fed by their own finance. In this sense, 'the expansion of the corporate sector has a multiplier effect on the growth rate of the economy in so far as it largely finances its own expansion'.

If the firms are supported by the infrastructure of a well-developed stock-market which is very sensitive to the financial pulses of the corporate sector, they are likely to rely on external capital for their rapid expansion, which would otherwise be not feasible within their means. Most of the LDCs with no so sensitive capital markets, are unable to provide the

necessary financial overheads to supplement the internal funds of the corporate sector.

Thus there are possible linkages between a firm's financial structure and its industry class, size, variability in income and operating leverage.¹ But these linkages are not uniform and identical for the various firms under diverse setting, historical and conjectural. So, it is not easy to strictly generalise for all the firms for all the circumstances. Moreover, "the nature of relationship is sensitive not only to the dynamics of investment process but also to the industry market structure.......since alternative structures have different implications for the rate of exploitation of industry investment opportunities over time"². If the market conditions do not permit profitable investment channels, the firms may have to be content with the existing financial structure without making major alterations.
