INTRODUCTION

Economic development is a multidimensional process involving major changes in social structure, popular attitudes and national institutions as well as acceleration of economic growth, the reduction of inequality and the eradication of absolute poverty (Todaro, 1977). Economic development is the advancement of a community along with the evolving of new and better methods of production and acquisition of capital resources. It has been realized that there is no alternative to eradicate poverty except rapid economic development. Pattern of economic development involves economic, social and behavioral changes that take place in an underdeveloped country. Among the many structural changes such as changes in composition of output, technology, input combination, trade, self reliance, import substitution and participation of the people in the nation building activities etc., the most important is industrialization.

Industrial development is an important aspect in the process of economic development of an economy. Industrialization is an effective instrument of growth and welfare. Only rapid industrialization of the country can effectively solve the problems of the efficient use of the vast human and natural resources, rising unemployment, inflation, removal of mass poverty, giving people satisfactory standard of living and above all ensuring the defence to the country. Holub (1970) treated industrialization as a process which is statistically observable as a structure decomposition of economic activities both among and within sectors, causing the industrial sector to shift in relative importance from a minor to a leading role in the macro-economic process.

According to U.N Committee Report (1963), industrialization is a process of economic development in which growing part of the national resources is mobilized to develop technically up-to-date, diversified, domestic economic structure characterized by dynamic manufacturing sector having and producing means of production and consumer goods and capable of assuring high rate of growth for the economy as a whole and of achieving economic and social progress. Industrialization has, therefore, become one of the greater world crusades of our time. It is an effort in which the underdeveloped countries place a major hope of finding a solution to their problems of poverty, insecurity, over population and ending their newly realized backwardness in the modern economy (Bryce, 1960). Industrialization is the process of social and economic change where by a human group is transformed from a pre-
industrial society into an industrial one. It is a wider modernization process, where social change and economic development are closely related with technological innovation, particularly with the development of large scale energy and metallurgy production. Industrialization is a process in which changes of a series of production function are taking place. It involves those basic changes that accompany the mechanization of an enterprise. The building of new industry, the opening of new market and the exploitation of new territory.

The term industrialization is used to designate the growth of manufacturing industry. It is thus, a part of the much broader process of economic development, which involves raising of standard of living, through a steady increase in the efficiency of factors of production. Industrialization provides a wide range of consumer choice, increases productivity and standard of living, creates industrial skills, promotes innovation and technological development, promotes capital formation through higher wages and diverts surplus farm labor to modern industry. To realize these benefits and hasten up required socio-economic changes, top priority has been assigned to industrialization in underdeveloped countries.

Industrialization is considered as the hub of economic development because it has the employment potential for rising workforce, is typically associated with the creation of external and internal economies and with the rise of factor productivity and hence with rising per capita income and living standard (Kaur, 1997). Industrialization may be defined as a process which accelerates economic growth, affects structural changes in the economy, particularly in respect of resource utilization, production function, income generation, occupational pattern, population distribution, foreign trade and introduces social changes.

The common view is that high level of income cannot be attained without industrialization and the underdeveloped countries have little choice except giving priority to the development of industrial sector. The structural changes in favor of industrialization can be justified on the following grounds:

- With economic development the structure of wants changes and new wants are generated for industrial goods, which may be satisfied through domestic production of such goods.
• The emerging industrial sector with high marginal productivity of labor makes a net contribution to the national product by employing workers with zero or very less marginal productivity in the industrial sector.

Diversification of the production structure is necessary to create new export products since the existing primary exports of LDC's have been found to be facing a relatively inelastic world demand (Chennery, 1960).

According to Sutcliffe (1977) “A country may be regarded as industrialized if at least 25 per cent of GDP arises in industries of which 60 percent should be in the manufacturing and which had at least 10 per cent of its population employed in industry”. Industrialization involves a number of changes in the economic structure including:

• Rise in the relative importance of manufacturing industry;
• Change in the composition of industrial output; and
• Changes in the production techniques and sources of supply from industrial commodities.

Industrial development is more inter-complementary and represents more forward and backward sector linkages relative to other sectors. It leads to the production of large range of goods and services and increases economic flexibility. Industrial development is generally considered having much faster growth relative to agriculture development, which suffers from many factors like natural handicaps. Also, industrial sector represents higher labor productivity as compared to agriculture sector and growth ensures higher wages and hence higher standard of living.

Industrialization has now become the need of the LDC's leaning towards economic development. Myrdal (1956) emphasized the indispensability of industrialization to achieve higher productivity, higher per capita incomes and standards of livings. In his words, “Manufacturing industry represents, in a sense, a high stage of production. In advanced countries, the development of manufacturing industry has been concomitant with these countries’ spectacular economic progress and rise in levels of living; many of its products are indeed almost symbolic of a high standard”.

Efficient industrialization is a means of rapid economic growth and has become a permanent feature of the less developed countries. Industrial development has a wider connotation than the establishment of productive industries; it includes also the
mineral base, energy, transportation, scientific research and the supply of technical and scientific manpower. Together these account for much of the greater part of investment as well as foreign exchange expenditures. In strategic management, business portfolio planning techniques suggest that firm should invest in industries with high and profitable performance and attractive characteristics.

Several studies indicate closer and more pronounced relationship between levels of income and industrial output. As modern growth theory contains arguments against continued specialization in primary production stemming from the uncertainty of export demand and the interdependence among sectors of production. Thus, industrialization cannot be separated from economic development because it is the consequence and means to higher productivity.

The rationale for industrialization has been fully accepted in India. During the planning era, there has been a phenomenal growth of the industrial sector. Rapid industrialization of the country has been one of the important objectives of planning since the second plan. The last decade of 20th century was momentous in the economic history of India as it witnessed a successful transition of India from a controlled inward looking and slow growing economy to a liberalized and open economy that has now found a place amongst the fastest growing economies in the world.

Chenery and Taylor (1968) also found that a statistically significant relationship exists between per capita income and the degree of industrialization. Without industrial development, economic progress has a relative low ceiling. A consensus has arisen among development theorists and planners that, for most countries, economic development must be viewed primarily in terms of industrialization. The process of economic development reflects ‘an increase in income per head or is an increase in the role of industrial activity than in agriculture’ (Jorgenson, 1967).

Industrialization has invariably accompanied the economic development, as an increase in the national and per capita income change the demand and the output pattern in favor of industrial goods and hence it leads to a larger share of the industrial output and increased employment in the industrial sector. It is due to this reason that industrialization and economic development are usually viewed as synonymous terms. Kuznet (1965) in his experience of the developed countries found that those are the countries where per capita income grew significantly, the proportion
of labor force engaged in agriculture declined and that engaged in industries increased. It follows that productivity of workers in industry tends to be considerably greater than in agriculture. Hirschman (1958) advocated the need of industrialization on the ground that industry is superior to agriculture with respect to linkage (backward and forward) effects. He has argued that opportunities for economic development are to be found primarily in the expansion of non-farm industries. In nutshell, it can be stated that high level of income cannot be reached without industrialization remained uncontested and underdeveloped countries understandably gave high priority to the development of strong industrial sector. The record of history demonstrates that to eliminate techno-economic backwardness, it is necessary, first of all to diversify the pattern of the economy by equipping it with the latest machinery and utilizing modern technologies and techniques of production. Thus, a number of structural changes such as rise in the share of industrial output and employment, changes in the production techniques, etc. are needed for achieving industrialization.

Thus, industrialization cannot be separated from economic development because it is the consequence and means to higher income and higher productivity. The rationale of industrialization has been fully accepted in India. Now, it has been accepted that the high level of income cannot be achieved without industrialization and industrialization cannot be achieved without substantial investment. So, it becomes pertinent to define the concept of investment. Investment means the commitment of resources to the formation of capital assets, which in turn allows a stream of new resources to be generated in future. The value of capital assets created in the form of plant or construction, depends upon the value of these future flows, and for the investment to be acceptable, the value of asset must exceed its cost. Investment is to commit money in order to earn a financial return or to make use of the money for future benefits or advantage. People commit money to investments with an expectation to increase their future wealth by investing money to spend in future years. Investment is also the commitment of money or capital to purchase financial instruments or other assets in order to gain profitable returns in the form of interest, income or appreciation of the value of the instrument.

An investment is spending money on assets having a long life i.e. something that is to the best advantage of the enterprise for more than one year. This may be land,
buildings, machinery –called fixed assets (Wissema, 1985). Investment may be defined as the sacrifice of certain present value for the uncertain future reward. It entails arriving at the numerous decisions such as type, mix, amount, timing, grade etc. of investment and disinvestment. Broadly speaking, an investment decision is a trade off between risk and return. All investment choices are made at points of time in accordance with the personal investment ends and in contemplation of an uncertain future. Investment is the employment of funds with the aim of achieving additional income or growth in value. The essential quality of an investment is that it involves “Waiting” for a reward. It involves the commitment of resources which have been saved or put away in the hope of receiving benefits.

According to financial experts “investment is the allocation of monetary resources to assets that are expected to yield some gain or positive return over a given period of time”. For the financial experts, it is not important whether money is invested for a productive use or for the purchase of second hand investments such as existing share and stock listed on the stock exchange. To the economists “Investment means the net additions to the economy’s capital stock which consist of goods and services that are used in the production of other goods and services”. Inventories and human capital are included in the economist’s definition of investments (Kaptan, 2001). The financial and economic meaning is related to each other because investment is a part of the savings of individuals, which flow into the capital market, either directly or through institutions divided into new and second hand capital financing. Investors as “suppliers” and investors as “users” of long term funds find a meeting place in the market. So, there are basically three concepts of investments. First is economic definition of investment that is an economist’s definition of investment. Second is the investment in a more general or extended sense, which is used by the “man on the street” and the third is financial investment (Singh, 2001).

Any investment expenditure by firms is made only if the firm expects that expenditure will be profitable. However, the expectation held for any contemplated investment outlay change overtime. There are two types of expectations, one is long-term expectations and the other are short-term expectations. Short term expectations affect investment in inventory and long term expectations affect investment in plant and equipment. Thus, the quantity and quality of investment flow in any country depends upon the investors’ expectations and the uncertainties around those returns.
It is useful to think of three broad and inter-related components that shape these expectations.

- First, there is a set of macro-or country level issues concerning economic and political stability and national policy towards foreign trade and investment. By these, we generally refer to macroeconomic, fiscal, monetary and exchange rate policies as well as political stability, trade liberalization, investment policies and judicial systems.

- Second, there is the issue of efficacy of country’s regulation framework. As far as firms are concerned, these are related to the issues of entry or starting a business, labor relations and flexibility in labor use and efficiency, transparency of financing and taxation and efficiency of regulations concerning the environment, safety, health and other legitimate public interests. The question is not whether to regulate or not, but whether such regulations are designed in incentive compatible ways, avoid adverse selection and moral hazard, serve the public interest, are implemented expeditiously without harassment and corruption and facilitate efficient outcomes.

- Third, and no less important is the quantity and quality of available physical and financial infrastructure such as power, transport, telecommunication, banking and finance. When one survey entrepreneurs about their problems and bottlenecks, they often consider infrastructure issues such as power reliability, transport time and cost and access and efficiency of finance as key determinants of competitiveness and profitability (World Bank - CII Report, 2002).

Pernia (2006), states that three broad sets of factors make up the overall investment environment: macro fundamentals, institutions, governance and infrastructure. Macro fundamentals include social and political stability; macroeconomic stability (e.g. sustainable fiscal and external balances, realistic exchange rate, low inflation and interest rates); and competitive markets. Institutions and governance refer to transparency and efficiency in regulation, taxation and legal system, strong and well functioning financial sector; labor market flexibility and skilled labor force. Another variable of investment climate is infrastructure concerned with the availability and quality of physical infrastructure, such as transportation (roads and ports), telecommunications, power and water supply. Thus, all the above said components
collectively constituted the business friendly investment climate. At this stage, it becomes necessary to define the concept of investment climate.

Investment climate is the institutional, policy and regulatory environment in which firms operate. A productive investment climate can be broadly thought of as an environment in which governance and institutions support entrepreneurship and well-functioning markets in order to help generate growth and development. If the local government is highly bureaucratic and corrupt, and if governments owned provision or regulation of infrastructure and financial services are inefficient, then firms cannot get reliable services, then returns on potential investments will be low and uncertain, and one would not expect much accumulation and growth in these environments (David, dollar 2005). A good investment climate is characterized by standard good governance requirements together with the adequate supply of certain type of infrastructure, such as electricity and telephone lines. Good governance in turn is measured by the stability of the property rights and according to some, the depth of democracy and public accountability. The theory is that stable property rights (measured by the number of factors, including a low risk of expropriation and a low level of corruption) induce high investment rates and ensure efficiency in investment allocation (Khan, 2002).

A good investment climate is a state that protects property rights, is subject to rule of law, does not intervene in markets, and provides key services, such as electricity and telephone lines. A good investment climate also plays a crucial role in growth and poverty reduction by ensuring that contracts are enforced, basic infrastructure is provided and people (especially poor people) are empowered to participate and manage better in the global economy. Better investment climate is not just about generating profits for firms. If that were the goal, the focus could be limited to minimizing costs and risks. It is about improving outcomes for society. It also includes the reduction in barriers to competition, expands opportunities, spurs innovation and ensures that the benefits of productivity improvements are shared with workers and consumers (World Bank, 2004).

Thus, a good investment climate creates opportunities and jobs for people. It also expands variety of goods and services available and reduces their costs, to the benefit of consumers. It supports sustainable sources of tax revenue to fund other important social goals (World Development Report, 2005). A good investment climate also
encourages firms to operate efficiently and competitively by decreasing risks, costs and barriers to competition. Such an environment strengthens incentives for firms to innovate and to increase their productivity. A more productive private sector, in turn, expands employment and also contributes taxes that are necessary for public investment in health, education and other services. In contrast, a poor investment climate increases the obstacles in conducting business activities and decreases country’s prospects for reaching its potential in terms of employment, production and welfare (World Bank, 2005).

The investment climate influences the decisions of firms of all types: the decision of the farmer to sow more seed, the decision of the micro entrepreneurs to start a business, the decision of the local manufacturing company to expand its production line and hire more workers, the decision of the multinational to locate its next global production facility. Thus, investment climate in various locations has become a decisive factor. Although every country confronts different constraints, the main elements to get right are security and stability, regulation and taxation, finance, infrastructure, and labor markets. Therefore, governments should focus on creating a good climate for finance and infrastructure through sound regulation and for this private participation also helps to improve productivity and growth.

Thus, a good investment climate improves outcomes for society as a whole. The contribution made by firms and entrepreneurs to the society depends largely on the way that government shapes the investment climate in each location through the protection of property rights, taxation, strategies for providing infrastructure and interventions in finance and labor markets. Thus, a good investment climate encourages growth, helps to reduce the cost of goods consumed by poor people. Looking at growth and poverty reduction through an investment climate lens several insights are offered.

- It recognizes the firm’s investment opportunities and related government policies and behavior as a part of package. This emphasizes the importance of looking at property rights, regulation, taxes and finance, infrastructure, corruption and other areas of government policy and behavior as a part of an integrated whole rather than in isolation.

- It highlights the forward looking nature of investment activity. Investments are based on the expectations about the future and not on current conditions. This
underlines the importance of government in fostering stability and credibility, which are critical elements of sound investment climate.

- It treats as the fundamental need for policy makers to balance the goal of encouraging productive private investment with other social goals (World Development Report, 2005).

**Investment Climate and Economic Growth**

There is now almost universal consensus that a sound investment climate is critical for private sector which leads to economic growth. In recent years, policy makers and multinational organizations have focused increasingly on the importance of sound investment climate in developing countries for economic growth (Stern, 2002). Various studies by Cao et. al (1999), Easterly (1999), Stern (2002), State Planning Commission (2000), and Gordon and Li (2005) found positive relationship between investment climate and economic growth. Investments are naturally attracted to areas with adequate roads, ports and other essential infrastructure because such facilities affect firm’s profitability due to reduction in production costs and ability to reach wider markets and it will also help in enhancing economic growth.

Investment climate drives economic growth by encouraging investment and higher productivity. Investment underpins economic growth by bringing more inputs to the production process. Good investment climate encourages firms to invest by removing unjustified costs, risks and barriers to competition that helps to increase economic growth. A better investment climate is good for the long-term development of the private sector and the economy, in general; foresighted businessmen would see wisdom in cooperation in the policy reform effort, such as reducing corruption and improving infrastructure through public-private partnership. Business friendly investment climate encourages firms to invest in new ideas and new facilities that strengthen the foundation of economic growth and prosperity. Another study by Pernia (2005), found that capital accumulation depends critically on the investment climate, countries with better investment climate tend to have higher rate of capital accumulation. Higher rate of capital formation in turn, fuels productivity of economic growth. A good investment climate encourages higher productivity and economic growth by providing opportunities and incentives for firms to develop, adapt and adopt better ways of doing things.
Dollar (2005) found the strong relationship between investment climate, firm performance and economic growth. The study found that Chinese cities that have created good investment climate in the sense of reducing bureaucracy and corruption and providing appropriate infrastructure and financial services tend to produce more value from given capital and labor, pay higher wages and earn higher profits and hence more economic growth.

**Investment Climate and International Integration**

Various studies like Wheeler (1992), Knack (1995) and Stein (2001) found the positive relationship between business friendly investment climate and international integration. David (2003) found that a sound investment climate as reflected in low customs clearance times, reliable infrastructure, and good financial services attract foreign investment. These foreign firms generally bring superior technology and management and hence raise the average productivity of firms. Thus, international integration makes the domestic firms to export more and also enables the existing firms to expand their scope and scale. Foreign investment is more common where customs clearance is quick, power losses are low, time to get a fixed phone line is low and availability of overdraft facilities is high. International integration can boost productivity by increasing the degree of competition and forcing the producers to be more efficient and more innovative. In short, a sound investment climate is a necessary condition to attract foreign investment.

International integration also encourages the flow of ideas and managerial know-how to domestic firms. Improved access to inputs and capital equipment can boost productivity and the prospect of serving larger market through exports can improve scale economies and affect firm’s decision regarding investment, training, technology and the quality of inputs. The crux of the matter is that business friendly investment climate is necessary for economic growth, industrial growth, to achieve higher level of productivity and profitability of the firms. It is against this background that the present study tries to measure investment climate in two major states of India (Punjab and Haryana) with the following specific objectives:

1. To measure investment climate prevailing in industrial sectors of Punjab and Haryana.
2. To find out the factors determining the quality of investment climate in industrial sectors of Punjab and Haryana.
3. To study the relationship between investment climate and total factor productivity of major firms of Punjab and Haryana.

4. To examine the relationship between investment climate and profitability of sample firms of Punjab and Haryana.

5. To examine the inter-relationship between investment climate and growth pattern of major firms of Punjab and Haryana.

6. To draw some conclusions and policy implications from the analysis.

**Organization of the Study**

The present study is divided into eight chapters. The first chapter introduces the study, Literature survey of the present study is given in chapter second. An attempt is made in this chapter to give a brief review of the important analytical studies on the variables measuring investment climate, factors affecting the investment climate, relationship between investment climate, industrial growth, profitability and also the relationship between investment climate and total factor productivity has been studied. Third Chapter deals with the data base and methodology used in the study. Fourth Chapter gives an overview of the states (Punjab and Haryana). In chapter fifth, analytical analysis of investment climate of Punjab and Haryana is given. In chapter sixth, an attempt is made to find out the relationship between investment climate, growth and profitability of firms of Punjab and Haryana. Seventh Chapter deals with total factor productivity and investment climate in Punjab and Haryana. Eighth chapter gives the summary of the findings of the study and policy implications.