CHAPTER III
THE BACKGROUND - A COMPARATIVE STUDY
Principles of Financing Public Sector Undertakings

Public sector undertakings obtain their finance either from the budgetary appropriations of the government or the government can set up a government company in accordance with the provisions of the Companies Act or a statutory corporation, which may itself undertake capital funding either by issuing its own shares or bonds or by floating government loans through it to the general public. The nationalised industries in Great Britain that came into existence between 1945-49 had been financed also by this method. Another method that the government may adopt for providing initial capital to the public sector undertakings is through the creation of Special Development Fund for the purpose, though India has not been found to resort to it.

Flow of fund from the state coffer out of the budgetary sources for providing initial capital to the public sector undertakings may take diverse forms viz., outright grant, interest bearing repayable loan, interest bearing but non-repayable loan and dividend paying share capital. If, however, special institutions are established for providing for initial capital to the public sector

undertakings, then flow of funds from such institutions usually take the form of loan. These different techniques of financing public sector undertakings may be tried by a government either in isolation or by a combination of them taking any two or more of them together.

There are other important factors which cannot be ignored in the selection of the sources of capital for the public sector undertakings. One of them is the predominance of non commercial obligations that require their reconciling with the commercial needs. The presence of long gestation lag* in many of them, especially in the embryonic stage, is another feature of the undertakings of the public sector in the developing economies of countries like India. This is because, in the embryonic stage, the primary task before the public sector undertakings in the developing economies is, firstly, to provide for the basic services to the vast multitude of poverty stricken population which had hitherto

* The term gestation may denote - I) the period upto the point when the construction of the plant is completed; or II) the period upto the point when the plant is commissioned; III) the period upto the point when the plant is fully utilised; or IV) the period upto the break even point or V) the period upto the point when the plant operates at the maximum rate of profit. Gestation lag if defined as per last three versions lack precision. Hence to be more precise and specifically meaningful for the public sector undertakings, gestation may be defined as the period which begins with the construction of the plant and ends when the plant or all the sub-sections of the plant reach the point of production. (Source) Pramanand Prasad, in his talk on "Research on Gestation Finance" in the Summer School on Public Enterprise." Osmania University, Hyderabad, April 1964, Quoted from B.S.Sharma Op.cit. pp.18-19.
been neglected or restricted by the private sector and, secondly, the laying of the infrastructure for the further industrial development of the country as rapidly as possible. The latter consideration obviously calls for the investment by the public sector in the basic and key industries which are usually characterised by long gestation lag and low profitability. In the circumstances, it seems necessary that the initial capital to the public sector undertakings of a developing economy should be provided in a manner that it can offer scope for maximum flexibility in their operations and simultaneously enable the government to appropriate their profit, should there be any. This twin objectives can be secured if capital is sought to be supplied to the public sector undertakings either in the form of grants with necessary powers in the hands of the government to appropriate their profit should there be any, or in the form of equity shares. In the former case the enterprise is able to procure capital free of any charge and in case of the latter the enterprise obligation in respect of servicing capital is dependent upon its ability to earn profit on the one hand and upon the inclination of the Board of Directors to apply the same in payment of dividend on the other. If the supply of capital is to take the form of loan, in order to impart the desired degree of flexibility in the operation of public sector undertakings, it seems that the enterprises receiving their capital in the form of such loans should
be allowed to enjoy interest holidays, at least in the initial years of their formations. Else service charge in respect of loan should be kept at a very low level, at least in the short run. In favour of adopting this technique of financing it is argued that public sector undertakings are created out of 'tax payers' money. Tax payer's reward lies first in the creation of the enterprise itself and secondly in the contribution of these undertakings to the development of the national economy. It is also stated that, since state enterprises are not established to obtain commercial return but to contribute new and presumably necessary establishments essential for the nation's economic development, these undertakings should be given the scope to establish themselves even at the expense, if necessary, of considerable initial shortcomings.

Financing Technique for the Central Government Companies

It is in this backdrop that we are to consider the technique of financing the Central government companies in India between 1960-61 and 1969-70 and the capital structure that emanated therefrom. Incidentally, it may be mentioned that the period between 1960-61 and 1969-70,

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by all logic, constitutes the formative stage for the public sector in India. The determined policy to have a public sector in this country as a means to secure a socialistic pattern of society, as adopted by the Parliament in December 1954, can be traced back to the Industrial Policy Resolution of 30th April, 1956. Further, an analysis of the distribution of the total investment in the commercial and industrial undertakings, other than the departmental ones, in the public sector under the Central Government over the period of ten years between 1960-61 and 1969-70, has been shown in Table 10. It indicates that, Central Government investment in the period under review had been in the industries like Steel, Engineering, Shipbuilding, Chemical, Petroleum, Mining and Minerals, Aviations and in Financial Institutions. Presumably there was a desire to create necessary infrastructure for the future industrial development of the country.

Prima-facie, therefore, on the basis of accepted principles of financing public sector undertakings, as stated earlier, there was a case for the Central government companies to receive their capital either as outright grant from the government or as subscription or contribution in the form of equity or interest free loan. An interesting point to note in this connexion is that, while the acts setting up public corporations in India indicated the sources from where the initial capital was to be
obtained by those corporations, none of the Articles of Association of the government companies incorporated under the Companies Act 1956 prescribed the sources from where the companies were to obtain their initial capital. This implies that while establishing public sector units in the form of company, the government felt no necessity for prescribing any special mechanism for supplying capital to those undertakings. In the circumstances, Central government companies, like their counter-parts in the private sector, received their capital from the same sources viz., (i) from the subscription of their equity shares by the government or private parties i.e., individuals or institutions, national or foreign; (ii) from borrowings and (iii) from retained profit i.e. internal finance.

Loan, however, as a source of capital had a distinctive feature in the cases of Central government companies. Normally, in the cases of the companies in the private sector, loan as a source of capital is avoided in the beginning. Till a company has established itself in the confidence of the investors by its performances and has also acquired sufficient assets to be pledged as security for loans, it is with difficulty that it can raise its capital by borrowing. But the position had been altogether different for the Central government companies

in the period of our study. The government has been financing Central government companies both by equities and debts. It was not only that. For the sake of uniformity or some other stated purpose, the government in a circular issued in June 1961 advised the different ministeries remaining in charge of the public sector undertakings to maintain, as far as possible, even a debt-equity ratio of 1:1 in each case while providing funds to those public sector undertakings. Thus, it is clear that, unlike companies in the private sector, the Central government companies could, if they had so desired, resort to borrowing for the purpose of obtaining their capital from the very inception of the company. In reality also, as the present study in this regard reveals, though not all, at least some of the Central government companies received their capital, along with equity in the form of loan from their very start. For instance, Bharat Heavy Electricals Limited. This company was registered as an exclusively owned Central government private limited Company in November 1964. The annual report of the company for the year 1964-65 showed that the company received an amount of Rs.526.8 Lakhs in the form of loan from the Central Government towards the capital of the company. Similarly,


Hindusthan Aeronautics Ltd. another private limited company exclusively owned by the Central Government which was registered in October 1964, and formed by the amalgamation of erstwhile Hindusthan Aircraft Limited and Aeronautics India Limited received an amount of Rs. 103.2 lakhs (Rs. 13.6 lakhs from the Central Government and Rs. 89.6 lakhs from others) as loan towards the capital of the company, according to the annual report of the company for the year 1965-66.8

Another instance was that of the Indian Oil Corporation Limited, a private limited company owned jointly by the Central Government and the State Government and registered in September 1964 and formed by the amalgamation of Indian Refineries Limited and the Indian Oil Corporation Limited. This company, according to its published annual report, received an amount of Rs. 5433.4 lakhs (Rs. 4582.1 lakhs from the Central Government and Rs. 881.3 lakhs from others) as loan towards the capital of the company. Thus it is clear that, in sharp contrast to the accepted principle of corporation finance, loan as a source of initial finance was resorted to on many occasions in the cases of Central government companies. It does not possibly suggest that, trading in equity as it is found to obtain in case of private sector companies was the objective behind adopting

8. Ibid. p. 256.

9. Ibid. p. 151 and also refer to Commerce Year Book on Public Sector 1974-75. p. 369.
this type of financing technique for the Central government companies. On the contrary, it was rather the outcome of the government's obsession of having a uniform policy of financing the capital requirement of the Central government companies. The government appeared to have further been guided by the belief that it would help to ascertain the true economic cost. Equity alone would suppress the cost of capital as Central government companies are supposed to incur heavy loss at least in the beginning in achieving the non-commercial objectives. But debts would bring out at least a part of the cost in the open as they are fixed cost securities. The government by requiring the companies to finance their capital requirement by debt and equity issues in the ratio 1:1, at least as an ideal, from the very inception without co-relating it to trading in equities in case of high profits or the abilities of the companies to assume fixed charges under opposite circumstances deviated from the accepted principles of corporation finance, either of the public or the private sector. In the latter case it burdened the companies with the responsibilities of servicing the loan with all their harmful effect on their capital structure and performances as will be shown later on. It may be found later on, how the total amount of interest may even turn to be excessive for which a part of it might have to be forgone, capitalised or interest holidays being declared for the full amount.

Factors in the Capital Structure of Central Government Companies

Corporate undertakings in the private sector in their use of capital from different sources viz., from shares, from borrowings and also from retained earnings, are guided by certain objectives. It may be well within the possibility of a corporate undertaking to finance its capital requirement from a single source, e.g. from the issue of equity share, and thereby keep its capital structure 'simple'. But, in view of the fact that those who are at the helm of the management of a corporate undertaking strives to attain apart from flexibility and simplicity of capital structure, the objectives of retaining maximum control over the firm, and minimising the cost of capital, they presumably go for having a 'complex' capital structure. A corporate undertaking is said to have a complex capital structure, as already stated, when it derives its capital from more than one sources not of identical nature.

It has already been observed that the Central government companies in India over the decade between 1960-61 and 1969-70, received their capital not from a single source, such as the issue of shares or from

12. Ibid.
borrowings. It is true that, till the beginning of June 1961, there was no uniform predetermined policy regarding financing of Central government companies, and ascertaining their capital-mix. But from June 1961, the lack of uniformity in this regard was cleared and the government by a circular as already mentioned, required the companies to finance their capital requirement at the rate of 50% by the issue of equity shares and 50% by borrowings. What is however most interesting in this case is that their objective of 1:1 debt-equity ratio was in actuality hardly attained either in any single Central government company or in the case of all the Central govt. companies taken together. It would be revealed later on that the said objective was achieved only in some rare cases that also not in entirety. Moreover the meaning of the fiction 1:1 debt-equity ratio is also not clear. May be that equity refers to its current value which is equal to nominal value of equities plus retention of profits. Nevertheless, it cannot be denied that adherence to the principle or setting it as an ideal had an effect on the growth of the debt-equity ratio of Central government companies in actuality. At least the said ratio in case of Central government companies was not the effect of a free managerial activities which are directed only at achieving an optimum capital structure by the process. In other words, as against

the capital structure of private sector companies which are both complex and flexible, the capital structure of Central government companies are no doubt complex but to a certain extent as though, rigid. It, therefore, requires to be known how this kind of rigid financing of Central government companies, compares with the so called flexible financing of the private sector companies. Moreover a careful examination deserves to be made as to the financial consequences, together with the effect on operation of the capital structure of Central government companies owing to its so-called rigidity or limitations as intimated above.

**Cost of Capital and the Capital Structure of Central Government Companies**

Companies in the private sector proceeds to change debt-equity mix, in order to devise an optimum capital structure that may ensure a minimum cost of capital. It is at this minimum cost point that the market value of shares is expected to be maximum so far as a given financing decision alone may allow. The minimum cost point with reference to optimum capital structure, is taken to be as one, at which marginal real cost, that is the actual cost of each available method of financing is the same. While taking financial decision in a corporate undertaking in the private sector, if it is found, that the said real cost

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15. Ibid.
of financing from borrowed capital is lower than financing from equity, it is then taken as the green signal for inducting more borrowed capital in the capital structure of the company. But this induction of borrowed capital in the total capital mix of a company cannot be continued ad infinitum. It can be carried only to the point at which real cost of financing from debt on the margin becomes equal to that of financing from equity. The debt-equity mix in the capital structure, at this point, is taken to be the optimum or ideal and the resultant capital structure an optimum structure.

It is pertinent to question in this connexion whether the concept of minimum 'cost of capital' and its marginal equalisation as suggested has equal application in the cases of formulation of capital structure of Central government companies, a form of public sector undertakings in India. It equally deserves examination whether the decision of the government requiring the administrative ministries, as already pointed out, to finance the capital requirement of these companies in the ratio of 1:1 between debt and equity right from their very inception was guided by the consideration that this would minimise and at the same time equalise marginally the 'cost of capital' and ultimately lead to have thereby an optimum capital structure in them. To get the answer one has to realise how 'cost of capital' emerges as a factor to be reckoned with in the formulation of the capital structure of a company.
How Cost of Capital Arises

The financial capital of a company remains employed in the fixed assets and net current assets i.e. in the working capital. In the production process there is consumption of both fixed assets and the net current assets. The consumption of fixed assets is measured by the amount of its depreciation and the consumption of net current asset is measured by the depletion of inventory together with liquid assets that are used to pay for labour and other expenses in a production cycle. Therefore costs that are usually known as product cost and sales cost are virtually found to coincide with the consumption of real capital.

To the extent fixed assets and the net current assets are consumed into production cost and sales cost there is consumption of financial capital as well because the non-financial portion of the total capital that was so consumed was also obtained in exchange of finance one day. In the circumstances there is the question of replacement of financial capital if the capital stock of the company is to be kept in tact. This is true irrespective of the nature of the ownership of the company, i.e. whether it is in the private sector or the public sector or whether it is under the ownership of the Central Government or anybody else.

The employment of financial capital in production,

its degeneration into cost and subsequent recovery of the said capital through the recovery of the cost involve delay and there is a 'timelag' in the process. The actual benefit of the company in using capital, therefore, lies in the delay that it can make in recovering or returning capital. Thus the employment or use of capital involves the period of 'time' for which the owner actually is deprived of its possession and for this a price becomes obviously payable. This price is in fact the 'cost of capital'. Evidently it is said to be a 'time cost'. It is synonymous with the 'cost of finance' because price payable by a company as 'cost of capital' is received by the suppliers of the different categories of financial capital. They are the transfer owners of the real capital item in a company. To sum up, therefore, cost of capital as obtained from different sources, ultimately resolves itself into the payment that a company is to make to the suppliers of financial capital for holding back their capital in the production process. It is a phenomenon common for all types of companies. The socially owned undertakings, in the present case, the Central government companies cannot ignore this aspect since they have also the necessity of maintaining capital intact whether the problem is considered in the micro or the macro sense. Therefore, there appears to be no logic in minimising the role of 'cost of capital' vis-a-vis capital structure in the Central government companies because

19. Ibid.
of the 'Time-lag' involved in the said maintenance of capital just like other concerns.

But so far as Central government companies are concerned there are some difficulties in the way of minimising and equalising marginally the unit cost of capital. They arise out of the facts that (i) these companies have no discretion over their own capital mix in as much as it is decided, as found in case of the 1:1 debt-equity ratio, as stated earlier, by the administrative ministry on the lines chalked out by the government; (ii) that the public sector firms did not or could not pay dividends or interest on borrowed capital fully because of huge losses suffered by them in the decade between 1960-61 and 1969-70; (iii) lastly that, unlike what may be possible in case of private sector undertakings, the Central government companies fail to enjoy the facility of a capital market in which equities may be expected to be exchanged for debts or the latter for the former under perfect competition.

It may be recalled that, so far as the third limitation mentioned above is concerned, the government itself acts as the sole supplier of both debts and equities in case of Central government companies. Thus, in consideration of all the three limitations stated above, the question of obtaining an 'optimum capital structure' cannot apparently arise in case of Central government companies. Therefore, in case

of them a minimum cost of capital may not be achieved at which, the unit cost of both debt and equity may be equal in the margin.

**Determination of Cost of Capital in case of Central Government companies**

Under the circumstances it may even be argued that the 'cost of capital' is, either non-existent or it cannot be determined in case of Central Government companies. Of course, opinion may differ regarding the method of calculation of cost of capital accurately in case of other companies also. But the Central government companies suffer from some additional handicaps. For instance, the real cost of capital may be unduly affected by the possibility of the imposition of low interest rates on the borrowed capital contributed mainly by the Central Government coupled with the possibility of holidays being granted in respect of interest payment, as already hinted at. In respect of the possibility of low interest rates being charged on the borrowed capital of the Central government companies, should there be any, it may be argued that when so much emphasis is laid on the non-commercial obligations of the public sector undertakings of which government companies are only a particular variety, one should not wonder if the said interest rates are concessional in amount. Moreover, prevalence of low interest rate cannot be a hurdle in the calculation of the cost of borrowed capital. It will only reduce the cost. Similarly,

If holidays are declared in respect of the interest payment on the borrowed capital of the Central government companies, as had been in the cases of Heavy Engineering Corporation of India, Mining and Allied Machinery Corporation Ltd, and Hindusthan Steel Ltd, the borrowed capital will only be considered costless in the years of such interest holidays. In reality, however, the position has been otherwise. The rate of interest that was charged from the industrial and commercial undertakings of the public sector for loans granted by the Central Government was by and large, comparable with the interest paid by the first class companies in the private sector for borrowings. Besides, the rates of interest that are charged for borrowings by the Central government companies from the Central Government are also revised from time to time in sympathy with the ups and downs in the bank rate. In any


* The rate of interest was once revised in 1966 on and from 1st May. Interest rate was increased from 5% to 6% for loan repayable between 2 to 4 years, 5½% to 6½% for loan repayable between 5 to 9 years and 6% to 7% for loans repayable between 10 to 15 years. Another revision was made on and from 1st June, 1971. The rate of interest was increased from 6% to 6½% for loan upto 4 years, 6½% to 7% for loan repayable between 4 to 9 years, and from 7% to 7½% for all loans repayable between 9 to 15 years. The rate of interest was again revised from 1st May, 1973 and it was placed at 7% to 7½% and 8% respectively. Further revision in the rate of interest has been made from 1st August, 1974 and it has been placed at 9½, 10% and 10½% respectively. (Annual Reports 1965-66, 1970-71, 1972-73 and 1973-74. Vol.I, p.5).
case, borrowed capital of Central government companies may be low-cost or even cost less in some cases. But that does not mean that the said cost is non-existent or indeterminable. It should be stated that a nil-cost is still a cost. On identical planes the determination of the cost of equity capital tends to be tainted by the absence of profits and dividends in case of the Central government companies. For instance, at the end of March, 1970, out of the 64 running Central government companies other than financial institutions, only 35 of them could make profit to the extent of Rs. 5417.3 lakhs. Even then, not all the companies did declare dividend. Dividends ranging between 3% to 21% were declared by only 21 companies.

But absence of profit or dividend cannot be a problem in the estimation of the cost of capital in case of Central government companies once we accept the premises, that, in the year there is no profit or dividend in case of a company there is no payment to the equity holders. As such, there is no cost of equity capital. An alternative to the solution of the problem may be the finding out of the cost with reference to the dividend paid by an identical company in the same industry under the ownership of the Central Government. This is specially true in respect of internal equity. The latter technique is not at present difficult to adopt as the number of profit making companies have increased to 81

26. Ibid. p.33.
out of the 121 running concerns at the end of March 1975, as against 35 out of 64 running companies at the end of March 1970.

Another apparent drawback in the estimation of the cost of equity capital of the Central government companies, as already pointed out, appears to be the difficulty in ascertaining the market price of shares of such companies particularly when save and except a very few companies, the shares of the Central govt. companies are not quoted in the National Stock Exchanges. This difficulty perhaps can be overcome by resorting to the accounting valuation of shares.

Nevertheless, a real problem that tempts to render any attempt to recognise or estimate the cost of equity capital in the Central government companies ineffective is the difficulty in the estimation of the rate of growth in their dividends with reference to which cost of equity capital is calculated. The said difficulty arises because of three special phenomenon affecting the activities of the Central government companies. First of them is the absence of profit in many undertakings for years together. As such no trend

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study is possible in them. As for instance, Hindusthan Steel Ltd., a giant Central government company could not make any profit in the years between 1960-61 and 1962-63 and again between 1966-67 and 1968-70. Heavy Electricals (India) Ltd. another leading giant Central government company was in the red in all the years between 1965-66 and 1968-69, since it had started production in 1965-66. Bharat Heavy Electricals Ltd. is another example. It had gone into production in 1966-67 but could not make any profit in all the years between 1966-67 and 1969-70. Instances can be multiplied.

Secondly there were many Central government companies which did not declare any dividend between 1960-61 and 1969-70, despite making profit. That also renders any trend study impossible. Hindusthan Shipyard Ltd. made profits in the years between 1960-61 and 1969-70 excepting the year 1966-67. Nevertheless it did not declare any dividend in these years. Tungabhadra Steel Products Ltd. despite profit being earned in 1969-70 did not declare any dividend in that


32. Ibid.

33. Ibid.


In the same way Hindusthan Aeronautics Ltd. made huge profits in the years between 1965-66 and 1969-70 but it did not declare any dividend and used the whole of the profit for retention purposes. Thirdly, there were also companies which despite good performance in terms of percentage of profit to capital employed paid the dividends at a very low rate. Such acts had evidently the effect of rendering the calculation of the true cost of equity capital difficult. The percentage of net profit to equity capital in case of Bharat Earth Movers Ltd. in the financial years 1967-68, 1968-69 and 1969-70 had been 11.2%, 13.9% and 16.8% respectively. But the dividend declared by the company over the period did not exceed 3%. The percentage of the net profit to equity capital in case of Mogul Lines Ltd., another Central government company over the years 1967-68, 1968-69, 1969-70 had been 49.3%, 26.1% and 34.0% respectively. But the dividend declared by the company over these years had been only 7.6% in 1967-68 and 10% in both the years 1968-69 and 1969-70. Analysed in terms of pay out ratio i.e., ratio of dividend to total net


40. Ibid.
profit, the pay out ratio in the case of Bharat Earth Movers Ltd., had been 26.9% in 1967-68, 22.9% in 1968-69 and 17.4% in 1969-70. The same had been 27.8%, 32.6% and 13.7% respectively in the year 1967-68, 1968-69 and 1969-70 in the case of Mogul Lines Ltd.

The factors that contributed to this special phenomenon in the cases of Central govt. companies are viz. First, absence of clear cut government Policy as to the objectives and financial obligations of the public sector undertakings coupled with the over emphasis on the non-commercial obligations of such undertakings. Secondly, zeal on the part of some undertakings to finance their capital expenditure in relation to expansions or establishment of new projects out of profits so as to minimise further borrowings. As for instance, Fertiliser Corporation of India had accumulated a reserve and surplus of Rs.1224 lakhs at the end of 1965-66 without declaring any dividend: since inception. The same had been utilised towards financing expansion. Thirdly, absence of any possibility of the flight of capital from such companies arising out of the persistent nonpayment of dividend or payment of dividend at a low rate because of holding of their equities by the Central Government.

41. Ibid.
42. Ibid.
For all that have been stated above, it has to be rightly concluded that, in case of Central government companies, equities like debts, are also subject to 'cost'. At the time of incurring of 'losses', the equities may very well be costless. As in case of debts so in case of equities also a nil cost does not necessarily mean no-cost. Under a situation of no-dividend or inadequate-dividend in spite of profit, non-cash dividend does reflect rise in cost of equities. But the difficulty in that there is no possibility of the same being reflected in the prices of the shares quoted in the stock market as the securities, as already said, are not listed there. It has been suggested earlier that an accounting valuation of the shares may be resorted to in such cases. Still accuracy of results obtained under that process cannot after all be guaranteed.

Thus the conclusion that may be, arrived at in respect of determination of cost of capital of Central government companies is that it is not a fact that those companies have no 'cost of capital'. The said cost of capital does exist and in some cases it may even be correctly determined. But in many cases the said cost is however, not what may be said competitive or comparable with the opportunity cost of capital. For instance, where the profit owing to adherence to non-commercial aims, is low or non-existent, the cost of capital is non-competitive or falls far below the opportunity cost. Reduction or forbearance of interest on borrowed capital, at least in those cases
where it was actually done, could, similarly not lead to the emergence of a competitive cost. Thus the question of optimum capital mix cannot arise particularly where, as already told, there is no capital market for free conversion of debt into equity and vice-versa.

Again, it has already been pointed out earlier how the fiction of insistence by the govt. of a debt-equity ratio of 1:1 is also puzzling. It is not clear whether the government, in its introduction of the scheme in 1961, wanted to apply it in financing the expenditure of a particular capital project or expansion, or wanted that the capital structure of the company as a whole should be subject to it. As a matter of fact, it would be revealed later on that none of the govt. companies either individually or collectively did ever reach actually the target of 1:1 of debt-equity ratio in their capital structure. The said ratio is not available even if retention is considered a part of the valuation given to equities. Furthermore the govt. wanted to introduce this debt-equity ratio in order to bring in a check in the operational activities of the government companies in as much as they would exert themselves at least to meet the fixed cost of debts. But how does the contemplated pressure actually work if the said interest is ultimately forgone either partly or fully? In consideration of all these factors the firm conclusion that may be ultimately arrived at is that unlike companies in the private sector, there was no scope for the Central government companies for trying for an optimum capital structure. The structure was the result
of various factors on which the management had practically no hand.

Again, the managers of the Central government companies have practically no control in the shaping of the internal rate of return or IRR of the firm also. In response to the non-commercial claims, as pointed out in the beginning of this chapter, the IRR of the Central government companies is comparatively very low and sometimes negative even. In order to reach the objectives of a welfare state there is no escaping from it. But under a situation of perfect competition a minimum cost of capital may be possible by changing the capital mix in such a way that it may not exceed the IRR. The private sector companies, in order to achieve this end generally have the capacity of regulating both the capital mix on the one hand and by affecting the operational activities of the firm, the IRR on the other. But the Central government companies have the full freedom of regulating none of them. Recently attempts are being made to see that public sector or govt. companies may improve their respective IRR by running the institutions more economically. Speaking in a general way, it may be said that different countries have reacted in different ways to the achievement of the said end. For instance in U.K., the financial and economic obligations of the nationalised industries are defined by the issue of successive White Papers. This enables the industries to know what is expected of them by the government. It also serves both as an incentive
to the management and also as one of the standards by which the success or failure of an enterprise over a period of years can be assessed. White papers issued in November 1967 requires an investment project to show a satisfactory return unless they are justifiable on wider criteria involving an assessment of the social costs and benefits involved or are provided to meet the statutory obligation. Subject to these the Government considers, the nationalised industries as commercial bodies and intends to control the nationalised industries by a rate of return as it believes that most efficient distribution of goods and services in the economy as a whole can be secured only if investment are made where return to the economy is the greatest. Accordingly, it prescribed the nationalised industries to earn a rate of return ranging from break even point to 12.4% the specific rate for each enterprise being fixed in consultation with the individual enterprises and the ministries.

The study team of the Administrative Reforms Commission while examining the problems relating to the public sector undertakings in India noticed that the budget estimates of the Central Government include, among other sources, the dividend paid on the share capital of the running public sector undertakings, as a source of revenue to the government.

In this connection the estimates are however, made on an adhoc basis. In consequence, this goes off the mark in many cases. There was also found an absence of any guideline for determining the division of profit of the public sector undertakings into what was to be retained and what was to paid-out as dividend to the Government. To remove these anomalies the commission felt that the Government should come out with a comprehensive and clear statement on the objective and obligations of the public sector undertakings. The areas to be covered in the statement would include, broad principles for determining the precise financial and economic obligations of the enterprises in matters such as creation of various reserves, the extent to which enterprises should undertake the responsibilities of self financing, the anticipated returns on capital employed, and the basis for working out rational wage structure and pricing policies. The guiding principles in this regard according to the Commission, are to be formulated in consultation with the public enterprises.

In a subsequent seminar on 'Public Sector Accountability


48. Ibid.
and Management organised by B.P.E.* and attended by chief executives of many public sector undertakings a view was expressed that any statement of the objectives and obligations of public sector undertakings will have to be primarily formulated by individual enterprises themselves and then approved by the Government.

In order to enable the public sector undertakings to adopt a sound policy toward the appropriation of profit and declaration of dividend, the B.P.E. in a circular dated,

* B.P.E. - The Bureau of Public Enterprises was established in April 1965 with the object of integrating and strengthening the arrangements for co-ordinating and examining the technical economic and financial aspects of public undertakings and their working. The Bureau acts as a service, co-ordination and evaluation agent for public undertakings. The Bureau is organised into five divisions namely, Construction, Production, Finance, General Management and Information and Research. The Bureau is a part of the Ministry of Finance and functions in close association with the Administrative Ministries concerned with the management of public undertakings. The Bureau is continuously studying the problems affecting these undertakings and every endeavour is made to devise ways and means to improve their performances (Vide Annual Report 1969-70).

19th January, 1968 inundated a guideline for the consideration of the Board of Directors of different public sector undertakings. The circular also urged upon the companies to strive for declaring the dividend of at least 6% going up to 15% in case of manufacturing enterprises and 10% going up to 15% in case of trading companies. The Committee on Public Undertakings (Fourth Loksabha) in its 15th Report, suggested the fixation of the maximum percentage of profit that can be utilised for building up internal resources so that a minimum portion of surplus could be declared as dividend. It may be recalled here that in U.K. also nationalised industries are required to fulfil their financial obligations over a run of years taken together and not necessarily to meet their target every year.


All these activities whether undertaken by U.K. or India may be said to have been desired to the achievement of an improved IRR by regulating the activities of a government owned or nationalised firm. After all the Central government companies are to function on business and commercial principles. Perhaps they cannot avoid it specially when they have been styled as companies and are recognised as commercial undertakings. Therefore, it is but natural to expect that they will have to strive for having optimum capital structure in them so that the same may lead to a minimum cost of capital. How far the said optimality may be obtained only by regulating operational activities for a better IRR without any change of the said capital structure is however a different question. In fact, from the study of the data that will follow it will be difficult to suggest whether optimality of capital structure in a manner as suggested above was obtained in case of the Central government companies in India. But there cannot be any doubt that honest attempts may be made by directing the activities of the Central government companies for achieving the said end. The alternative for the failure of achieving the desired optimality even after achieving improved IRR as far as possible as suggested above is obviously to wilfully reduce or avoid entirely the payment of dividend on equity shares and or payment of interest on borrowed capital. In the latter case however the question will arise, how far the said reduction of dividend or interest or both was
reasonably justified. Apart from the broad question of cost-benefit adjustment from the social point of view there is a simple and immediate scope for the quantification of loss involved in a said reduction of dividend or interest on borrowed capital. It may be pointed out that the source of fund available to the government for financing equity or debt or both of the Central government companies is mostly public debts, incurred by floating bonds in the market. Therefore, the income derived from the investment of the said fund should at least be equal to the interest payable on the corresponding public debt plus the reward for the risk involved in the said investment in case the maintenance of the opportunity rate is not taken into account.

It may be recalled that immediately before the discussion of the identification of what is cost of capital, the question was posed whether the government decision to insist on a 1:1 debt-equity ratio in financing Central government companies was inspired by the desire for having an optimum capital structure. The discussion, that has hitherto been made following the same, will evidently give the answer in the negative. It goes without saying that impossibility for an optimum capital structure necessarily implies non-availability of a minimum cost of capital.

Though the available circulars of the B.P.E. on the financial management of the public sector undertakings do not hint any thing in this regard, government decision
to induct borrowed capital in the capital structure of the Central government companies, thus to have 'complex' capital structure in them, appears to have been the outcome of the feeling with the government as already stated, that, without appropriate burden of interest charges, the cost will remain understated in government companies, there will be no check on their operational activities and the managers in them will be having an easy-time making profits. While prescribing 1:1 ratio between debt and equity for the capital structure of Central government companies the government has failed to take into cognizance of the fact, the indifference point (that is the level of earnings at which earning per share are the same regardless of the debt equity mix) for all the Central government companies is not necessarily at that level of debt equity-mix. And that what extent there can be borrowed capital in a company depends on the earning capacity of a company. It is not a matter of straight jacket type policy.

Examination of Other Factors in the Capital Structure of Central Government Companies

A further elaboration on the justification of Central government companies having a complex capital structure may be necessary. It is known to all that one of the objectives for which a corporate undertaking in the private sector prefers to raise its capital by the issue of non-voting right

shares, when the question of financing capital requirement arises, is its desire to have undiluted control over the company. In other words capital structure is sometimes affected by factors relating to the control over company. But this cannot be accepted as the motive force behind the decision of the government for introducing a 'complex' capital structure for the Central Government companies. Since under the existing provisions in the Companies Act, 1956, relating to the composition of the government companies at least 51% of the paid up share capital is always to be in the Government's hand. As such there is no possibility of dilution of control over such companies.

If the consideration of retaining control over the company was not a cause for having 'complex' capital structures in the Central Government companies, then could this be explained in terms of their desire for the maximisation of return to the shareholders i.e. namely the Government? In other words was the mixed capital structure introduced with a desire for trading on equity by the Central government companies? In the cases of companies in the private sector, the suppliers of borrowed capital and equity capital are two distinct separate classes. As the management of the company lies with the owners of the equity shares they function with their eyes riveted on the singular objective of maximisation of return to the equity shareholders as such,

for the maximisation of the value of their equity holdings in the company. This they accomplish by grafting borrowed capital into the companies' capital structure. That is to say by giving a complex shape to the capital structure of the company what is desired is greater benefit for equity holders. The grafting of borrowed item to the capital structure continues, as it was pointed out earlier, so long as it goes to add to the earning of the equity holders of the company and until the point of indifference is reached when earning per equity share remains the same irrespective of debt-equity mix.

An altogether different situation prevailed in the cases of Central government companies over the decade between 1960-61 and 1969-70. First, unlike the companies in the private sector, both equity and borrowed capital in most cases for the Central government companies came, as once indicated in the past, from the same source viz., the Central Government. In the circumstances doubts have been expressed whether the distinction between debt and equity is at all relevant in the capital structure of public sector undertakings, of which government company is only a variety.


Secondly, there was no clear cut Government policy, as already pointed out as to the objectives and obligations of the public sector undertakings. Very often the management in the public sector undertakings were enjoined upon to pay more heed to the social considerations such as the creation of employment opportunities and wages, cheap and plentiful consumer goods, import substitutions, export promotion, consideration of regional development etc. With these benefits in view profit goals in terms of return on capital was relegated to the secondary place in the case of the public sector undertakings. While discussing the meaning of 'cost of capital' in the past it was pointed out that the change of capital mix is effected in order to minimise cost of capital. It is necessary that the average cost per unit of capital should be lower than the internal rate of return. But if the said return is intentionally reduced in the name of social good as enlisted above the need for minimising cost of capital becomes meaningless. It is a fact that, recently, as already pointed out attempts are being made in improving IRR of Central government companies. But they are not enough for the purpose. In the circumstances it will be illogical to presume that the policy to have 'complex' capital structure in the Central government companies was the outcome of any desire to maximise the return to equity

holders of such companies. Especially so, when it is believed that the rationale for a wholly owned state enterprise cannot be sought in terms of return on capital in the micro sense.

The term is applied to a private enterprise. Therefore, unlike what was stated for private sector companies, the introduction of 'complex' capital structure cannot be aimed at for reducing cost of capital.

Corporate undertakings in the private sector always strive for minimizing business risk which emanate from investment decision and the financial risk, which arises from the financing technique. Financial risk, when broadly defined, encompasses the risk of possible insolvency and the variability in the earning available to the equity holders. Therefore while taking decision whether capital with fixed charges, i.e. borrowed capital or preference shares will be inducted in the capital structure of corporate undertaking thus making the capital structure 'complex' one, possible cash flow from investment has to be assessed so that the fixed charges can be met squarely and the control of the company does not pass on to the creditors because of its inability to service the borrowed capital. In the cases of Central government companies though financing the capital requirement by borrowing was ordered as early as in June 1961, there was preparation of no systematic cash flow analysis right from the construction of a project until a circular

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was issued by the B.P.E. in April 1970 on the basis of the recommendation of the Administrative Reforms Commission Report in this regard in 1967. Besides, Central government companies were permitted to capitalise the interest on loan due during the period of construction to the extent provisions was made for this purpose in the approved project report. This not only aggravated the loan position in the capital structure of Central government companies, but also goes to inflate their capital structure artificially. Moreover, the fact that Central government companies receive their ownership capital and borrowed capital from the same source viz., the Central Government goes to neutralise the impact of possible financial risk on the capital structure of the Central government companies. Hence the 'complex' capital structure in the Central government companies cannot be explained in terms of desire on the part of the Central Government to minimise the financial risk particularly when all shares are fully paid up shares. The explanation for 'complex' capital structure in the Central government companies has to be sought elsewhere. As already mentioned, the 'complex' capital structure in the Central government companies was the outcome of the feeling with the government that without appropriate burden of interest changes, the cost will remain understated in case of government companies, there will be no check on the operational activities of

such companies and their managers will be having an easy time making profit. This point has already been briefly mentioned while 'cost of capital' was discussed. One may conclude that the 'complex' capital structure in the Central government companies in the decade between 1960-61 and 1969-70, therefore, was neither the outcome of any attempt for optimality in the capital structure nor was it prompted by consideration for expediency in financial management commonly faced in the cases of corporate undertakings in the private sector.

Conclusion: The discussion hitherto made regarding management of capital structure of Central government companies as compared with that of private sector companies may be put in a nutshell thus:

Private sector companies can regulate cost of capital by adjusting capital-mix. Similarly they can regulate themselves the IRR by properly managing the operational activities. While both the cost of capital and IRR remain under the control of private sector companies the criterion observed is that the former is not allowed to exceed the latter. They have however to operate under changing economic condition. Moreover sometimes other conditions such as securing majority of voters are given greater weight as already mentioned. As a result one cannot guarantee that the optimality is always obtained in their cases. Nevertheless, it cannot be denied that an attempt, with varying degree of perfection, is always made in every case in that direction. Therefore the capital
structure takes a given shape at the beginning under a given situation. But the drive for attaining optimality under changing economic conditions makes the original capital structure also go on changing accordingly. Consequently particular trend is observed within a given period of time in this change in the capital structure over time. It has to be observed that reduction of cost of capital in all these activities undertaken by private sector companies is always sought by changing the capital mix under a process of gearing or other means. It is never achieved by avoiding payment of fixed rate of interest on borrowed capital either partially or fully.

In the same context Central government companies work under conditions which are fundamentally different. They can neither influence the cost of capital by changing the capital mix nor they can regulate the IRR at their own initiative. For both the purposes they have to depend more or less on the guidelines prepared by the government. The government in its term is often influenced by economic and political consideration of a welfare state. For procuring funds for financing government companies the government has often to float bonds in the market at a given rate of interest. While meeting the need of a welfare state the government does not even require the IRR to cover the said rate of interest not speake of any opportunity rate. As a result IRR is often intentionally reduced for making the products cheap and the government also tries to prescribe
as already pointed out a rigid capital-mix. It is a fact that recently measures have been taken for more economical management of the Central government concerns. The said measures are even required by the government to be taken in consultation with the management of Central government companies. Still as pointed out earlier their outcome seems to be inadequate for the purpose. Consequently the government companies have a kind of peculiarity according to which interest on borrowed capital is avoided fully or partially for adjustment with a lower IRR. Accordingly the cost of equity is either improved by improving IRR or the loss that at any amount would mean the said nil cost for equity is reduced. In other words the burden on the future profit is accordingly reduced. Owing to this working of the government companies on absolutely different basis it is expected that the capital structure and the trend of its change would be different in case of Central government companies.