CHAPTER II

PROJECT AND FINANCIAL PLANNING

The work of launching any project, whether in the public or private sector, begins with the discovery of a business opportunity and the subsequent organisation of funds, property and managerial ability into a business concern to achieve the objective in view. Discovery of an idea is nothing but a dream, a flash that an opportunity exists for exploitation and the promoter takes steps to find out if his dream can be put into practice. Discovery is essentially a matter of investigation regarding the feasibility of the idea by an expert whose training and experience fit him to weigh impartially the pros and cons of the projected venture. The promoter collects a team of experts and seeks their opinion in the matter. Firms of industrial engineers examine the project from technical standpoint and advise him in this regard. Legal experts may examine it from legal point of view and help the promoter in achieving his objective. Sometimes the promoter may discover just in the beginning, as a result of these investigations, that the project is not feasible and may drop it thus saving himself from a huge wasteful expenditure. Thus scrutiny of any industrial project from its feasibility point of view is very essential before a detailed programme can be chalked out. In the very nature of things a promoter is an optimist
and an enthusiast and his viewpoint may be prejudiced and therefore the need of an impartial investigation.

The above principles of planning are applicable for both the private and public sector undertakings, rather these are of universal application to all sectors of economy. Talking of public sector undertakings in the Indian context the idea of starting a particular project is conceived in the Ministry or Department concerned of the Government where it is examined with a view to find out if it fits in the declared economic policy of the nation. The ultimate decision to set up the project is generally taken on the basis of a techno-economic feasibility study or a preliminary project report where the project is examined in a reasonably detailed manner.

Project formulation is a preliminary examination on the need for the product, and the possibility of resources being allocated for taking up such a project in a particular plan period. It involves the examination of all issues including demand, raw materials, costs, prices, location, engineering aspects, foreign collaboration, etc., in a preliminary manner.

Feasibility examination, as the term implies, deals with several broad alternatives in regard to demand, competition, product-mix and size, raw materials and technology, location and modes of transportation, economics of costs and prices, and financing. The feasibility report
enables the Government to take basic decisions on all such issues and funds required and nature of financing. Several alternative sizes and product-mix, are considered in various combinations in order to arrive at a most advantageous combination. Feasibility examination leads to the determination of broad parameters on these issues for more detailed planning at the next stage of project preparation.

This techno-economic feasibility report is examined by an expert Committee comprising of technicians and economists, the Ministry of Finance and Planning Commission of the Government of India. The benefit of outside experts is also made available and if the project is considered viable it is brought before the Cabinet for approval. But it has been found that in certain cases, e.g., Hindustan Photo Films Manufacturing Ltd., Oil Refineries, the Cabinet's approval had been obtained on very meagre data and in the following other cases the approval was obtained without awaiting for the techno-economic feasibility studies:\footnote{C.P.U. (Third Lok Sabha) 13th Report- December, 1966 para 31.}

\begin{itemize}
  \item[i)] Gauhati and Barauni refineries;
  \item[ii)] Heavy Electricals Project, Hardwar;
  \item[iii)] Heavy Power Equipment Plant, Hyderabad; and
  \item[iv)] High Pressure Boiler Plant (of Heavy Electricals).
\end{itemize}

In the case of Alloy Steels Project of Hindustan Steel, no economic feasibility study was conducted and as such Government did not have adequate data on the economic viability of the project, the cost of production and
profitability or otherwise of the project as a whole. Government merely decided to set up an alloy steel plant in the public sector of a specified size without going into the economics of it.  

In view of the importance of techno-economic feasibility studies which give a clear picture of the projects, it is imperative that reports of such studies must be presented to the Cabinet before a project is placed for approval. Any lapse at any stage of this scheme of techno-economic feasibility study may prove to be very harmful and cause a heavy loss, as it happened in the case of the Phyto Chemical Project of the Indian Drugs and Pharmaceuticals Ltd. Although techno-economic feasibility study was carried out, the project had to be abandoned after the preparation of a detailed project report and after incurring other expenses because it was found to be uneconomic.

On investigation it was found that there was no uniformity in the preparation of feasibility reports and the Government had not yet evolved a list of items to be included in the techno-economic feasibility studies. Although absolute uniformity was not possible but information such as demand projections, raw materials, size and technology of the project, location, profitability, however, is basic and should be included in all techno-economic feasibility studies. Since the feasibility study is the only basis on

2 C.P.U. (Third Lok Sabha) 31st Report April, 1966. para 76.
which future course of action is dependent a check list of all the aspects that a techno-economic feasibility study should incorporate be drawn up for the guidance of all those who have to deal with the planning of projects.

The objectives with which an undertaking is set up must be very clearly defined. It is desirable if suitable instruments of instructions are prepared by the concerned Ministries at the time of setting up public undertakings indicating the specific objectives, the precise targets which such undertakings have to achieve and also indicate the time schedule for completion and the cost estimate. It will then become the responsibility of the management to achieve the prescribed objectives. It is found that for the public sector undertakings in India no standing agency is available to undertake advance feasibility studies except for steel plants and a few other industries with the result that considerable time is lost on preliminary investigations before a firm decision could be taken on them. It is suggested that an agency should be set up with a continuous programme for undertaking feasibility studies in various industrial spheres so that such studies may be used as soon as the resources are available and more promising among them may be chosen for the preparation of detailed project reports.

After the technical and economic feasibility study the next step in the planning of a project is the drawing up of a detailed project report. This report provides the basis
for the detailed planning of the construction of the project and as well as the cost estimates and time schedules for going into production. It is through the detailed project report that the progress of the project can be watched and evaluated. The absence of a detailed project report may prove to be as harmful as the absence of a feasibility report and may result into heavy losses. As for example the Committee on plan project on Trombay project of the Fertilizer Corporation of India reported that the absence of detailed project report led to scheduled slippages, cost over-runs and contractual difficulties. The Estimates Committee's Report on Indian Telephone Industries Ltd., would show that the absence of a detailed project report had led to excess purchase of Plant, delays in getting manufacturing data, etc. Detailed project report should be quite comprehensive and cover all aspects of the project. A deficient project report is as harmful as the non-availability of it. Such deficient reports, in the past led to the prolongation of the period of construction, delays in the attainment of production targets and much higher investment than was originally envisaged. Sufficient evidence to this effect is available from the reports of the Estimates Committee of Parliament. While examining the affairs of Heavy Engineering Corporation the Estimates Committee came across that a sum of Rs. 65 crores concerning the cost of consultancy fees, customs duty, port trust charges, foreign experts,

5 E.C. 11th Report (Second Lok Sabha).
training of Indian engineers, enabling works, sand washing plant, railway siding, etc., etc., had not been provided for in the detailed project report. The Committee remarked that the total commitment on such projects should be prepared as realistically as possible in the beginning and should be available to Government and to Parliament before a project is approved.  

Again in their 157th report the Estimates Committee remarked that the steep increase in the estimates of the project obviously indicates lack of proper planning and sound management in the early stages of the project. Its repercussions have been loss of valuable time, increase in costs and delay in commencement of production.  

A scrutiny of the various detailed project reports (listed in the statement given below) would reveal some of the glaring omissions in these reports.

<table>
<thead>
<tr>
<th>Name of the Undertakings</th>
<th>Aspects omitted from detailed project report</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Hindustan Photo Films Ltd.</td>
<td>Capital outlay (including requirements of working capital etc.)</td>
</tr>
<tr>
<td>2. Coal Washeries Project.</td>
<td></td>
</tr>
<tr>
<td>1. Nangal and Gorakhpur projects of the Fertilizer Corporation of India Ltd.</td>
<td></td>
</tr>
<tr>
<td>2. Khetri Project of N.M.D.C. Ltd., and</td>
<td></td>
</tr>
<tr>
<td>3. Hindustan Photo Films Ltd.</td>
<td>Manpower requirements.</td>
</tr>
</tbody>
</table>

6 E.C. (Third Lok Sabha) 51st Report para 150.
<table>
<thead>
<tr>
<th>Name of the Undertakings</th>
<th>Aspects omitted from detailed project report</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Instrumentation Ltd.</td>
<td>Economics of the project/Unit cost valuation/Profitability analysis/Production cost/cost &amp; profit calculation for the determination of the economic price and the products etc.</td>
</tr>
<tr>
<td>2. Korba Project of the Fertilizer Corporation of India Ltd.</td>
<td></td>
</tr>
<tr>
<td>3. Guwahati Refinery, and</td>
<td></td>
</tr>
<tr>
<td>4. Coal Washeries Project of Hindustal Steel Ltd.</td>
<td></td>
</tr>
<tr>
<td>1. Nangal Unit of the Fertilizer Corporation of India, Ltd.</td>
<td>Location of sites/site of plant/choice of site and site information etc.</td>
</tr>
<tr>
<td>1. Foundry Forge Project and Heavy Machine Building Project of H.E.C., Ltd.</td>
<td>Availability of raw materials/consumption figures of raw materials/cost and source of supply of raw material.</td>
</tr>
<tr>
<td>1. Instrumentation Ltd.,</td>
<td>Time schedules of delivery/construction and erection as well as the initial operation of the plants.</td>
</tr>
<tr>
<td>2. Indian Drugs &amp; Pharmaceuticals Ltd.,</td>
<td></td>
</tr>
<tr>
<td>3. Neyveeli Lignite Corporation Ltd., (Mining scheme)</td>
<td>Requirements of transport/comparative costs of transportation/possible modes of transportation/equipment and machinery from Indian ports to work site.</td>
</tr>
<tr>
<td>1. Neyveeli Lignite Corporation Ltd.</td>
<td>Organisation</td>
</tr>
<tr>
<td>1. Pyrites and Chemical Development Co., Ltd.</td>
<td></td>
</tr>
<tr>
<td>2. Coal Mining Machinery Project and Heavy Machine Building Plant of H.E.C.</td>
<td></td>
</tr>
</tbody>
</table>

The following undertakings have themselves pointed out certain omissions in their detailed project reports:
<table>
<thead>
<tr>
<th>Name of the Undertakings</th>
<th>Aspects omitted from detailed project report</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Heavy Electricals(India) Ltd.</td>
<td>Absence of cost and profit calculation for each product or by-product due to which selling prices fixed by the factory could not be compared with those assumed in the detailed project report.</td>
</tr>
<tr>
<td>1. Hindustan Photo Films Manufacturing Co., Ltd.</td>
<td>Machinery layout which have a direct bearing on Civil Works and Services not planned.</td>
</tr>
<tr>
<td>1. National Instruments Ltd.</td>
<td>Technical assistance during construction and erection, construction equipments and training of Indian personnel, not included.</td>
</tr>
<tr>
<td>1. Instrumentation Ltd.</td>
<td>Absence of implementation time schedule.</td>
</tr>
</tbody>
</table>

The above statement brings out some very serious deficiencies of these reports which should not have been there. No detailed project report should lack basic information such as the cost and profit estimates, manpower requirements, source, cost and consumption of raw materials, etc., etc. To obviate such omissions it is suggested that Government should evolve a standard check list of items to be included in all the detailed project reports. This will be very much in the interest of proper execution of the projects. In view of the experience so far gathered in the matter of setting up of public sector projects it should not be difficult to compile such a check list. The Planning Commission has prepared a Memorandum on 'Feasibility Studies
for Public Sector Projects', and it is suggested that the Memorandum should be adopted as a guide for the purpose.

On the receipt of detailed project report, a piloting committee should be set up consisting of the representatives of all the Ministries and agencies concerned and this committee should undertake a concurrent and collective examination of the detailed project report so that delays due to successive examinations by different agencies may be avoided and the report is thoroughly examined from all angles. Once a project has been approved after the thorough examination as suggested above, systematic and thorough planning of the construction programme should be chalked out before starting actual construction. When such a master plan of construction has been drawn up a suitable agency should be set up to see the plan through. The network techniques like the Programme Evaluation and Review and Technique (PERT) and Critical Path Method (CPM) should be adopted for monitoring the progress of construction. If these steps are taken, there appears to be no reason why a project should not be completed as efficiently and speedily as planned.

Further it is suggested that, based on past experience, detailed information about the construction of various projects should be compiled. On the completion of each project, a Project Completion Report should be drawn up; and such detailed information and report may be found of
immense use for other projects in future.

Another important point in regard to detailed project report, is that in most of the cases of Indian projects, detailed project reports have been prepared by foreign experts and sometimes a project report, which had relevance to some other under-developed country, was quietly passed on by the foreign collaborators for use here. All under-developed countries are not in the same situation and a project report that suits one country may not be found suitable for another. Where such a report was adopted it took a lot of time, energy and money, for the management to get down to real business after making necessary adjustments in the report. In this connection, at this stage, it can be suggested that Indian talent may be associated effectively with the preparation of project reports. One of the most vital benefits of such association will be the minimising of time and expense involved in the project report so as to accord with the Indian conditions.

Sometimes, it so happens that outside reviewers of project reports are not easily available and much delay is caused in taking a decision on the project. To cite an example a report prepared in a foreign country ran into 17 volumes and 9 schedules, each schedule consisting of 5 drawings and maps. This was sent for review to persons who were too busy to undertake the task with responsibility. Another example is of a report received from an American expert, on which
full discussion was not found possible at this end.  

To overcome these difficulties it is suggested that now India has a sufficiently competent set of persons in the country, a forum of experts should be created, who would constitute the nucleus for going through these project reports. Such a forum will prove very helpful in taking decisions on detailed project reports.

**FINANCIAL PLANNING:**

One of the most important aspects of project planning is the estimation of capital requirements of the projects. Once the question of feasibility of a project has been cleared by expert opinion, further steps are taken to evaluate the capital requirements of the project. The problem of capital brings in its train a number of other important issues such as:

a) how much capital is needed for the project? —- Capital Requirement.

b) where should it come from? —- Sources of Capital.

c) in what form it should be raised? —- Capital Structure.

To deal with all these aspects of the project a financial plan is required to be prepared. Financial planning may be described as a forward looking appraisal of the financial aspect of the business programme, leading to decisions regarding the most effective course of action to
be taken over a future period. The core of financial planning, as indicated above, lies in making an objective estimate of the capital requirements of a project. Planning means looking ahead, visualising things a few years in advance so that a clear picture of the project can be conceived and a scheme may be formulated to give it a practical shape. It is not to think of problems over a short period but to take a long term view and to chalk out a blueprint for its execution in an effective and efficient manner. According to Hanson, both determination of prices and calculation of capital requirements are part of the process of planning.10

A) CAPITAL REQUIREMENTS:

The main objectives of financial planning are to ensure the financial stability and soundness of the concern and to earn satisfactory profits and guarantee a reasonable return on capital invested. Capital needs of a project are estimated on the basis of forecasts made with the aid of scientifically prepared budgets of anticipated sales or production capacity, promotional, developmental and research expenses, capital expenditure in the nature of land, building, plant and machinery, furniture and fittings, etc., administration, selling and distributions expenses, cost of raising capital and any other expenditure peculiar to the nature of the

10 Hanson A.H. (Ed.)- Nationalization (1963)-- p. 209
project. The purposes for which funds for new enterprises will be needed may be classified as under:—

1) Preliminary investigation of the project.
2) Cost of feasibility report.
3) Cost of detailed project report.
4) Consultation charges.
5) Preliminary engineering, legal, accounting and marketing advice.
6) Incorporation expenses.
7) Cost of fixed assets, such as land, building, plant, machinery, furniture and fittings, etc., etc.
8) Working capital requirements.

Such an estimate must make adequate provision for the capital needs of the concern and avoid taking a plunge into an era of over trading with all its inherent dangers.

FINANCE FUNCTION:

In a modern, money-using economy, finance may be defined as the provision of money at the time it is wanted. Inflows and outflows of money are so arranged that it is always available in a required quantity when needed. Finances are to be conserved as squirrel's store of nuts or the bee's store of honey. Money is the back-bone of any business activity and without adequate provision of funds no business can be carried on. It is like the fuel of a motor car; as no motor can run without petrol so no business can function without money. Viewed narrowly, the finance function is simply the task of providing funds needed by the enterprise on terms that are most suitable
and favourable in the light of the objectives of the business. Keeping the business supplied with enough funds is the hard core of finance function. In broader sense it is much more than the mere supply of funds; it concerns itself with the effective utilisation of funds in the business. It is making the maximum use of money in the business. Money is scarce and has a cost. Therefore, whenever additional funds are needed in a business, the business-man should take into account the costs and problems involved in procuring the funds and balance these with the added profits or other advantages accruing from the use of added funds. Therefore, financial function cannot be separated out and divorced from questions of the effective use of funds in business. "The successful financial man in business must be not only a money man; he must be a business-man".11 It is the responsibility of the Chief Financial Officer that the business does not run short of funds. By funds we mean not cash or money--- rather means of payment. "You have got to have money to make money."12 This business adage is a simple recognition of the fact that most enterprises need funds in order to operate profitably and such funds are to be gainfully employed.

The success of a business depends on the financial plan thus prepared. Many businesses have come to grief due to insufficiency of capital. Reference may be

12 Ibid. p.-12.
made in this connection to a significant observation made by Prof. Hoagland of Ohio State University. He says, "Perhaps the more prolific source of failure of business undertakings is the lack of a definite financial plan. Bad production management and bad sales management have slain their thousands but faulty finance had slain its tens of thousands". Thus planning and forecasting is inevitable from the very start of a project. After enquiring into non-financial aspects such as location, sources of materials and labour, technical and legal aspects a financial plan is prepared to achieve the objective. "The object of a forecast is to reduce to black and white the details and basis of this conjectural situation. In place of a nebulous dream financial outlines are drawn".

In connection with the finances of public enterprises Prof. Ramanadham suggests that financial organisation should be such as to work automatically towards the pricing and profit policies declared as appropriate to it. It should be conducive to the right allocation of the nation's resources and be compatible with the national financial policies. Every efficient Government would like to ensure that all economic activities, whether in the private or public sector, are compatible with its

13 Cost Accountant - December, 1953.
14 Guthmann and Douggal - Corporate Financial Policy.
15 Ramanadham V.V. - Finances of Public Enterprises, (1963), p.-100.
It is imperative that public enterprises ought not to act in a way that clashes with the overall national interests such as a properly phased and conserved utilization of foreign exchange resources. In fact the need for utilizing funds with the maximum economy is an inherent qualification to the very success of the Indian plans of economic development; and financial organisation of the public sector should not be such as to disrupt that objective. He further suggests that public enterprises ought to be provided with adequate financial autonomy, consistent with the necessary degree of Government influence. There ought to be sufficient consistency in the financial behaviour among different enterprises. This does not call for bluntly standardised pricing and profit policies, but does emphasize the propriety of uniformity in such substantive matters as the provision of depreciation, the provision of interest on capital and welfare expenditures.

Before proceeding with the discussion further a brief reference to a few terms commonly used in business finance is very necessary.

**CAPITALIZATION:**

This term is sometimes used to indicate the total amount of securities outstanding in the form of capital stock and long term bonds. For practical purposes, capitalization means the total accounting value of all
the capital regularly employed in the business. This capital is represented by the capital stock, surplus and funds or long-term debt. Thus capitalization comprises (1) owner-ship capital, which includes capital stock and surplus in whatever form it may appear and (2) borrowed capital, which consists of bonds or similar evidences of long-term debt.

**CAPITAL STRUCTURE:**

Capital structure or financial structure, as it is sometimes called, refers to the make up of the capitalization; i.e., whether it consists of a single class of stock, several classes of stock with different characteristics, various issues of bonds, a large or small surplus and the like. Equity securities and long-term debt securities are usually the principal parts of a company's capital structure. Capital structure should be flexible and flexibility is affected by the terms of the securities that are outstanding.

In the case of private sector enterprises where fundamentally the motive is profit earning the question of capital is viewed from two angles (1) what amount of securities shall be issued? (2) what kind of securities shall be issued? Decisions regarding the amount of securities are reflected in the capitalization and the kind of securities in the capital structure. In arriving at a decision regarding the capitalization of a concern the earnings theory or the
cost theory of capitalization is brought into play and thus having fixed the figure of capitalization the capital structure is determined.

These theories of capitalization are of not much use in the case of public enterprises; because such undertakings are not brought into existence only to earn profits. Public enterprises have many other social obligations to perform. The estimation of capital requirements of public enterprises is the responsibility of those agencies who are to prepare the detailed project reports of such projects. The framers of the detailed project reports must make a detailed analysis of capital needs of a project right from its inception to its ultimate completion keeping in view the extension or expansion of the project if any. A faulty project estimate may land the project into financial difficulties and invite criticism and condemnation at the hands of the public. Parliament and other public bodies do not look with favour the affairs of such concerns whose estimates prove to be wrong.

Experience of Indian public sector undertakings has not been happy in this respect. A statement showing important cases of revision of project estimates is given below:

<table>
<thead>
<tr>
<th>Name of the Undertaking</th>
<th>Original Estimates</th>
<th>Actual/anticipated expenditure</th>
<th>Percentage Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hindustan Steels: Durgapur Steel plant.</td>
<td>115</td>
<td>205.25 (Revised 1963)</td>
<td>78</td>
</tr>
<tr>
<td>Rourkela Steel plant.</td>
<td>128</td>
<td>230.48 (Revised 1963)</td>
<td>80</td>
</tr>
</tbody>
</table>
It will be observed from the above table that the actual expenditure incurred exceeded original estimates by about 40 per cent in several cases and in some cases (e.g., Steel Plants) the rise has been as high as 80 per cent. On investigation it was found that several important items were not taken into account at the time of detailed project reports.
Apart from the increase in the cost of construction etc., omission of certain basic items such as consultancy fees, customs duty, training of personnel, townships, financing charges, working capital, enabling works, etc., is responsible for subsequent revisions. In the case of Alloy Steel Project and Coal Washeries Project of Hindustan Steel the capital cost of the project was initially estimated at Rs. 38.4 crores in the detailed project report submitted in 1960. Since this estimate omitted to include several items, it was revised to Rs. 64.77 crores in February, 1962. Since February, 1962 the estimates of capital cost were revised eight times and the latest estimate stands at Rs. 73.21 crores as revised in August, 1964.\textsuperscript{16}

The Estimates Committee of Parliament repeatedly pointed out that project estimates should be prepared as realistically as possible and should include total commitments. The Committee deprecated the revisions of estimates of Fertilizer Corporation of India Ltd., and Rourkela Steel Plant because they vitiate the basic assumptions on which the project was sanctioned in the first instance. It is suggested that project estimates should be prepared realistically and efforts made to adhere to them.

The above analysis brings to light several deficiencies from which Indian public sector undertakings have suffered due to defective planning and deficient Project

Reports. Now what remedies can be suggested to save the public sector undertakings in the future. It may be suggested that besides the measures already suggested there should be a standing committee of experts in the field of engineering, finance, economics and statistics to scrutinize the public sector project not only at the planning stage but also afterwards. The advice of this committee should be available to the Cabinet. They should not function from their headquarters rather they should tour throughout the country visiting various public projects at site and look into their working and progress.

(B) SOURCES OF CAPITAL:

It now becomes quite evident that the establishment, running and expansion of a business enterprise require money. The money that is sunk in it is called capital. Now the question arises from what sources may this capital be raised?

The private sector enterprise may raise funds by the issue of share capital and debentures to the general public, bank overdrafts and by ploughing back profits. But all such sources of finance are not equally available to the public sector. Main object of private enterprise is the maximization of profits within the minimum possible time. Consequently, they so tailor their capital structure as to achieve this objective. But this principle is not applicable to public sector undertakings where profit making is not the sole objective. As discussed earlier,
public enterprises are brought into existence with different objectives in view. In a developing economy these are set up to give a push to the economic development and to achieve the economic growth. In such sectors where either the projects are of basic and strategic importance and therefore cannot be left in the hands of the private sector, or require huge capital investment much beyond the capacity of the private sector, or such projects have a long gestation period not likely to be remunerative over a short period and private sector feels shy to take up such projects, public sector has to come in to take initiative to start such projects. Moreover, public sector undertakings have a large capital programme, for which they have to raise money. Sometimes losses on current account have also to be financed. How all these requirements are to be provided is a big task before them. Therefore, for public sector enterprises, the sources of capital have got to be different from that of the private sector.

Before discussing the sources of capital for the public enterprises, the organisational aspect of such enterprises has got to be looked into, because the sources of capital will very much depend upon the type of organisation under which the particular enterprise is working. Generally speaking, public enterprises may be organised:

i) Departmentally;
ii) As a Statutory Corporation; or
iii) As a Government Company.

When a project is organised under the aegis of a department of the Government, then it is treated or rather
it forms the part and parcel of the department itself. Capital requirements of the project are estimated by the department concerned for each financial year and the requisite amounts are appropriated in the normal way at the time of annual budget. The statement of affairs of such a project are merged with that of the department. The usual financial controls are imposed on disbursements, without distinction between capital and operational expenditure. Any loss incurred by the enterprise is made good by the exchequer, which also receives any profits that it may make. Therefore, in the case of such projects there is only one source of capital and that is the Government Treasury. In India some projects have been organised departmentally and finances for them are provided annually in the departmental budget. The names of some of such departmental enterprises are—Indian Railways, Post Office, Chittaranjan Locomotive Works, Perambur Integral Coach Factory, Ordnance factories, Posts and Telegraphs Workshops, All India Radio, etc., etc.

In regard to some of these departmental enterprises, however, some modifications have been made. Railway finances were separated from the General Revenues in 1924. Railways have now their separate finance and budget. A fixed rate of interest is paid by the Railways to the Central Government on their Capital-at-charge at the rate to be decided by the Railway Convention Committee from time to time. The Post Office has also maintained
accounts on commercial basis since 1925 although its revenue and expenditure was part and parcel of the General Revenue upto 1960. Since April 1960 the Posts and Telegraphs Department like Railways simply pays a dividend to General Revenue at the rate in force from time to time for the Indian Railways on the mean Capital-at-charge during the year.

Such methods of providing funds to public enterprises are not appropriate for industrial or commercial enterprises in the public sector. Enterprises of industrial and commercial character require a separate and distinct financial basis to enable them to conduct their affairs in a business-like manner, i.e., entirely different from the activities of a Government Department. 'The main weakness of the departmental arrangement is that it is not conducive to initiative and flexibility.' Such departmental organisation leads to red-tape delays, inadequate service and indifference to consumer's needs. Therefore, it is suggested that an initial capital should be provided that passes under the control of the enterprise and further sums may be provided, from time to time in accordance with the requirements of the enterprise.

Of all the non-departmental forms of public enterprises the Statutory Corporation is the most respected form of organisation in developed and underdeveloped countries alike. Such a Corporation is wholly owned by the State and is created by a special Act of the Legislature.

17 (E.C.A.F.E. Seminar held in Rangoon 1961)
It is a body corporate and acquires a distinct legal entity. It is independently financed and generally obtains its funds from the Government in the form of equity capital or borrowings from the public and by ploughing back its profits. Such a form of business organisation is found suitable for such activities of the State which otherwise would have been performed by a Government department. It does not suffer from red-tape and inflexibility of a Government department, rather on the other hand, it acquires independence of action and decisions can be taken more speedily. In the words of President Roosevelt a public Corporation is one "which is clothed with the power of Government but possessed of the flexibility and initiative of private enterprise", or in the words of Herbert Morrison, "a combination of public ownership, public accountability and business management for public ends."

In India, the corporation form of organisation has been followed, but on a limited scale. Out of a total of 74 Central Government enterprises (existing as on 31.3.1966) the following six have been organised as Statutory Corporations:—

1. Air India, Bombay.
2. Indian Airlines Corporation, New Delhi.
3. Oil and Natural Gas Commission, Dehradun.
5. Food Corporation of India, Madras.
Funds to all these Corporations have been provided by the Government either in the form of equity or initial capital or in the form of loans. The following table shows the amounts so provided up to the end of March 1966.

(₹. in crores)

<table>
<thead>
<tr>
<th>Name of the Corporation</th>
<th>Equity Capital</th>
<th>Loans from</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Air India</td>
<td>26.82*</td>
<td>-</td>
<td>9.03</td>
<td></td>
</tr>
<tr>
<td>2. Indian Airlines Corporation.</td>
<td>21.94*</td>
<td>-</td>
<td>9.24</td>
<td></td>
</tr>
<tr>
<td>3. Oil &amp; Natural Gas Commission.</td>
<td>111.69</td>
<td>21.65</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>4. Central Warehousing Corporation.</td>
<td>7.94</td>
<td>6.16</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>5. Food Corporation of India.</td>
<td>9.00</td>
<td>30.00</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>6. Life Insurance Corporation.</td>
<td>5.00</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>

* Note I: In the case of Air India and Indian Airlines, of the total Capital provided 50 per cent is treated as equity capital and 50 per cent as loan capital.

Note II: Loans from others represent foreign loans obtained for the purchase of aircrafts and spares, etc., etc.

From the above table it becomes clear that to all the Statutory Corporations initial capital, in the form of equity or otherwise, has been provided by the Central Government. Further loans have been provided by the Government to enable them to discharge their functions.

Another form of organisation for a public enterprise is to get it registered under the ordinary Company law of the country and such a company is called a Government company. In India a special provision was included
under Section 617 in the Company Law to enable such
Government companies to register themselves. In such
a company the Government has a controlling interest
through its ownership of all or majority of the shares.
Under this type of organisation even "Mixed Enterprises"
can also be floated where Government may enter into a
partnership with private owners of capital, as Government
may wish to start a new enterprise in conjunction with a
private firm which is ready to provide capital as well
as technical know-how or, perhaps, is not prepared to
supply the one without the other. Rourkela plant of
Hindustan Steel, established by the Indian Government in
cooporation with the German firm of Krupps- Demag is an
outstanding example of this nature.

Here again we find that either the whole or major
part of the share capital is provided by the Government.
The Government control is exercised by the appointment
of the Government nominees to the Board of Directors or
Governing Body and by certain other provision made in the
articles of association. In India this form of organisa-
tion has been very much recognised as 68 out of 74, i.e.,
92 per cent of the public enterprises have been started
in the form of Government companies registered under the
Company law.

In the case of Statutory Corporation or Government
Companies the possible sources of capital for public
enterprises may be the following:

(a) Public issue of shares and State guaranteed loans;
(b) Government grants, loans or share participation;
(c) Loans from Banks and other Financial Institutions;
(d) Ploughed back profits.

PUBLIC ISSUE OF SHARES:

In the case of Statutory Corporation or Government Companies, regarding the public issue of shares there are two schools of thought. One school led by Mr. Hanson is of the view that no part of equity capital be issued to the general public because such a policy will be against the genesis of the public sector. It is argued that the main object of private investment is the maximization of profits and if public issue is to be made attractive, the public enterprises shall have to earn sufficient profits, but that may not be the objective of such enterprises. Further private investors will claim representation on the Board of Management which may not always be in public interest. Moreover, when private shareholders were made members of the Board, then the enterprise will automatically cease to be fully public. Conversely, if investment is unremunerative or if private investors are denied representation on the management, it is doubtful if such an issue will ever be touched by them. Therefore, according to Hanson "the issue of equities is ruled out as a means of raising capital" for public sector enterprises.  

public enterprises do issue equity shares, most likely, these may not be subscribed at all because of fluctuating yield or perhaps no yield at all for some years.

Prof. E.V. Morgan suggested the issue of a modified form of equity, in some of the nationalized industries, where dividends would be linked not to profits but to sales, subject to a guaranteed minimum, and without any voting rights. He suggested that the shareholder would have the advantage, compared with the holder of fixed interest stock, of a fairly good hedge against inflation and a prospect of sharing in an increase in the sales-capital ratio resulting from increasing efficiency. According to him such an issue would overcome the difficulties of private investors discussed above and make the issue attractive. It is doubtful if such an issue would be found attractive except in industries of expanding sales, and under this scheme a major portion of profits will be distributed to such shareholders and inevitably reduce the scope of ploughing back profits out of current revenue.

In 1956, the British Government decided that, for the time being, all external capital financing should be 'below the line' (i.e., Budgetary Funds). This method of provision was considered by the "Redcliffe" Committee on the working of the Monetary System, which reported on if favourably. In this it differed from the 'Herbert'

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19 British Committee on Working of the Monetary System Radcliffe, August 1959, Cmnd. 827 para 593.
20 Ibid para 595.
Committee which, reporting three years earlier, had expressed the view that nationalized industries should 'go to the market' and there attempt to raise their requirements in equal competition with other business.\(^{21}\)

Thus various proposals have been made for the issue of some kinds of equity by the nationalized industries in Great Britain, but none of these proposals were to be found either appropriate or feasible. It is in the very nature of the nationalized industry that it cannot offer a share of the ownership of the business to private investors, and that the benefits of the success and development of the business accrue not to private shareholders but to the nation.

On the other hand, the point of view of the other school is that capital should be collected from all sources. Capital is very scarce and it may not always be possible for the State to provide funds to the growing public sector. Krishna Menon Committee\(^ {22}\) suggested public participation in the share capital of public enterprise to the extent of 25 per cent only. The reasons and justification for inviting or permitting such private investment are:

1. It is a way of finding capital for any concern;
2. It is a way of mopping up of additional earnings of lower income groups. It is an anti-inflationary measure in a context wherein


\(^{22}\) Parliamentary Supervision over 'State Undertakings': being the report of the Sub-Committee of the Congress Party in Parliament under the Chairmanship of Shri V.K. Krishna Menon (1969) P- 34 para 99 and 101.
more money finds its way to smaller people on account of expansion of industry; and

(3) It enables members of the community to participate in profits of Government enterprise or to share its burdens.

Such shares could preferentially be made available to the employees of the enterprises. Regarding the question of giving representation to such shareholders on the Board of Directors the Committee was of the opinion that a director could be drawn from the ranks of the investing employees or the private shareholders.

So, Menon Committee advocates public participation in the share capital and management of public enterprises. By issuing share capital to the public the State can divert its resources in some other fruitful channels which may not be otherwise possible. Further if some representation is given to private shareholders on the Boards of Management no harm will be done, rather the representatives of private shareholders bring with them welcome managerial initiative. Moreover, such minority shareholding can not affect the management policies because State shall always be the majority shareholder and have the dominating voice.

The Estimates Committee of the Indian Parliament have also made recommendation for limited public participation in the share capital of public enterprises. 16th Report\textsuperscript{23} of Estimates Committee suggested that "at least

26 per cent of the total capital investment must be available for the public". The Committee also recommended that 'While inviting private capital, Government should in order to avoid individual or group monopolies and other abuses of the kind, fix a ceiling for individual holding of shares.'

This issue was once again considered by the Estimates Committee in 1968 and Committee said that 'recent events have highlighted the importance of the various questions raised (including the issue of public participation to the extent of 25 per cent in the share capital) by the Committee in their earlier report. The Committee felt more convinced than ever about the soundness of the various recommendations made particularly about the suggestion of 25 per cent public participation. The Committee further observed that 'this recommendation would evoke the enthusiasm of the public for participation in the national development and would also enable the undertakings to function effectively under the vigil of a body of shareholders, who would in their own interest keep a watchful eye on the working of the undertakings'.

Having discussed the two divergent views on the public issue of share capital, it is proposed to examine them keeping in view the needs and conditions of developing countries, particularly India. Arguments put forth by British writers seem to be sound and convincing. On the face

of it, public enterprises should not permit any public participation in their share capital and must not allow private investors to share their fortunes. But the question arises whether conditions prevailing in the developing countries are much the same as those in England. It has already been explained that public enterprises in the developing countries do not stand on the same footing as the nationalized industries in England. In Britain industries before nationalization, were fully developed, efficiently managed and properly financed. There were no problems of promoting new concerns or of obtaining technical know-how. The country was sufficiently advanced in science and technology and did not depend upon any outside agency in any of these matters. When such fully developed industries were nationalized the only question was that of payment of compensation which was settled on a different plan by issuing fixed rate of interest bearing bonds. For further development or expansion there was no need to issue share capital to the general public and hence this view of British authorities.

All such conditions as obtainable in England are not to be found in India or such other developing countries. Here public enterprises have been started from the scratch. "The rationalisation and socialisation of existing industries is a very different matter from the establishing and running of new industries. It is also a much less onerous task; the personnel being available and the necessary experience and technique having been developed through a long period of private enterprise". Under properly prepared plans projects

FOREIGN COLLABORATION IN INDIAN PUBLIC ENTERPRISES UPTO THE END OF 1965-66

<table>
<thead>
<tr>
<th>Rupees in Crores</th>
<th>Equity Capital</th>
<th>Loan</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>77</td>
<td>3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>No. of Undertakings</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
</tr>
</tbody>
</table>

IN CRORES
FOREIGN COLLABORATION IN INDIAN PUBLIC ENTERPRISES UPTO THE END OF 1965-66

IOO
90
SO
70
60
EQUITY CAPITAL
LOAN

No. of Undertakings
0
10
20
30
40

<table>
<thead>
<tr>
<th>Rupees in Crores</th>
</tr>
</thead>
<tbody>
<tr>
<td>80</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rupees in Crores</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
</tr>
</tbody>
</table>
in the public sector were conceived, and launched. All such projects have to undergo the teething trouble. Essential elements necessary for the growth of projects such as capital goods in the nature of plant and machinery, technical know-how to set up plants, necessary foreign exchange for importing equipment and hiring technicians were not available. How with all such deficiencies could public enterprises be developed without outside aid and collaboration. Outside collaboration could be either arranged on hired or on partnership basis. If technical know-how is hired where is the guarantee that you will get the best of it? It is a sound principle of business that best results can be obtained when financial interest is at stake. Hence in countries like India foreign collaboration with share participation/credit assistance is almost indispensable. Krishna Menon Committee did not speak of foreign participation but if India was to get the best of foreign collaboration it must be accompanied with share participation/credit assistance, so that the foreign collaborator knows that his financial interests are also involved in the successful and speedy execution of the project. Right of purchasing over the foreign interest may be reserved in the agreement of collaboration. The extent to which, India has to depend on such foreign collaboration is revealed by the table (annexture VI) that provides details of such collaborations.

The total investment, in all the public enterprises stood at Rs. 2,415 crores at the end of the financial
Sources of Total Investment:

- Private Parties (Foreign): 3.3%
- Private Parties (Indian): 1.0%
- State Governments: 0.3%
- Central Government: 95.4%
Year 1965-66. The break-up of this total investment is as under:-

(Rs. in crores)

<table>
<thead>
<tr>
<th>category</th>
<th>amount</th>
<th>percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Government</td>
<td>2,304.2</td>
<td>95.4%</td>
</tr>
<tr>
<td>State Governments</td>
<td>8.0</td>
<td>0.3%</td>
</tr>
<tr>
<td>Private Parties (Indian)</td>
<td>22.9</td>
<td>1.0%</td>
</tr>
<tr>
<td>Private Parties (Foreign)</td>
<td>79.9</td>
<td>3.3%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2,415.0</td>
<td>100.0%</td>
</tr>
</tbody>
</table>


In the above table a sum of Rs. 79.9 crores is represented by foreign investments. Of this foreign investment, Rs. 3.3 crores were in the form of equity and the balance of Rs. 76.6 crores in loans. The bulk of the investments by foreign parties was in Cochin Refineries Ltd., Fertilizers and Chemicals Travancore Ltd., Triveni Structural Ltd.

Speaking of internal finance, the suggestions made by Menon Committee and Estimates Committee of Parliament that general public should be invited to participate in the share capital of public enterprises to a limited extent are very much in the fitness of things. There are very strong reasons to support this viewpoint. Firstly, such participation will go to relieve the Government funds to that extent and such funds could be gainfully employed by the Government elsewhere. Secondly, general public will also have a sense of belonging and participation in the national development projects. Particularly, such partici-
participation should be allowed to the employees of public enterprises. In a developing country like India such participation should be encouraged with the object of increasing productivity which determines the economic progress of the country. There are a number of advantages which accrue to the employees and to the enterprises which are as under:-

a) **Incentive to save**

Such a scheme provides an incentive to save and develop well-rounded investment programme. They encourage saving habits of the employees, especially of the lower classes of employees whose investment in the shares of their companies will be a sort of saving to their families.

b) **Efficiency in work**

Employees with such investments will tend to work more efficiently than before to earn more dividends and that will be a big achievement by itself.

c) **Employees morale**

Such a participation will improve the morale of the employees, promote interest in the company and its welfare.

d) **Improvement in industrial relations**

Such a participation will give rise to the sense of belonging to the employees and will lead to better industrial relations, fewer strikes and will to work on the part of the employees.

Doubts are expressed that such a policy may give rise to practical difficulties in its implementation or because of fluctuating yield or perhaps no yield at all for some years, most likely, such a public issue may not be subscribed at all. There are cases when such participation
In capital at the hands of the public did not work. The withdrawal of the Scindia Steam Navigation Co., Ltd., from the Western Shipping Corporation Ltd., as well as from the Hindustan Shipyard Ltd., poor response in the case of Ashoka Hotels Ltd., etc., etc., are glaring examples on the point.

The attitude of the Government of India is inconsistent in this matter. On the one hand it finds no objection to a minority participation. On the other hand it thinks that sufficient private capital would not be forthcoming for participation in public enterprises. It further argues that private investor is always prompted by the return on his investment whereas in certain cases the profits may be deliberately limited for reasons of public policy and in other cases the larger monopoly profits of public enterprises could not justifiably be shared with groups of private people.

Conceding all these arguments, still it is suggested that if the employees of projects are invited to participate in the share capital the response will be encouraging. With a view to sustain their interest in the scheme and to make it attractive a certain reasonable minimum return may be guaranteed to them till the projects become remunerative. No effort has so far been made in this direction and if an honest and sincere attempt is made the scheme is bound to succeed.

In the private sector of U.S.A. and U.K. and other Western countries such employees' share participation schemes are very popular, but in India there is no such scheme. However, there are a few companies in the private sector here in India, also, in which employees have acquired the shares of their companies either by the purchase at the time of issue from the company or by purchase in the open market. A study of the first 100 public limited companies of the entire corporate sector in India as on March 31, 1965 revealed that only six companies had offered shares to their employees in one form or another. Recently, another pharmaceutical company offered such a facility to its employees and went to the extent of advancing money to enable them to purchase shares. If such plans can be tried in the private sector, there can be no harm if the same is tried in the public sector.

Of late there is a definite trend, in several European countries to transfer blocks of shares in State owned enterprises to private investors. Austria, Norway, West Germany, Italy and the Netherlands are some of the continental countries, where the Governments have already offered blocks of shares to individual investors or inviting private ownership in State-owned enterprises.

In Austria, for instance, a State-owned chemical company is to join hands with a big private West Germany Company to put up a plastic resin plant. Also, a Government oil company and six foreign private concerns propose to
set up an oil refinery complex at a cost of over $40 million. The Austrian Government is said to be deeply concerned over the fall in growth rate of the 40 State-owned companies since 1964. Whereas between 1945 and 1964 these companies generated the bulk of their own capital needs, they are not now earning enough to meet their capital requirements with the result that the Government contribution has increased considerably.

In Norway, the Government has already sold half of its interest in a big aluminium works to the well-known Canadian firm, Alcan Aluminium Ltd. The State-owned steel mill has proved itself so unprofitable that the country finds it cheaper to import steel from Sweden than to get it from the indigenous source. In West Germany, too, Volksevagenwerk AG, VEBA, a holding company with wide mining interests, and the State-owned airlines, Lufthansa have all offered shares to individual investors. The State-owned Italian firm ENI has joined hands with private firm in joint exploration ventures and is thinking of having private shareholders on its rolls. The KLM Dutch airlines, in which the Government has a 50 per cent interest, is being run as if it were a private company.

All these instances only indicate that the policy adopted in the immediate post-war years of treating the State-owned enterprises as easy sources of revenue to the exchequer does not pay any longer. It also proves that industrial enterprises cannot survive without competition and profit motive.
Another way of raising funds for public enterprises is by the issue of fixed interest-bearing bonds. As a matter of fact, in Great Britain this method was adopted by public corporations. The nationalized electricity, gas and transport industries were authorised by their respective statutes to borrow by the issue of stock guaranteed as to capital and interest by the Treasury. The Electricity Board issued electricity stock; the British Transport Commission issued Transport Stock; the Gas Council issued Gas Stock and so on. The stocks issued by these industries were all fixed-interest and fixed-term stocks and were regarded as gilt-edged securities, in that they were formally issued by prospectus in stated amounts. The main exception to this rule was the National Coal Board which had always raised its money through loans from the Government.

In 1955 the authorities experienced increasing difficulty in selling nationalized industries stocks to the public, and a succession of such issues had to be taken up almost entirely by the Issues Department. It was, therefore, decided to suspend issue of nationalized industries stock and finance the industries from the Exchequer; the Finance Act 1956 gave powers for the Treasury to make advances of long-term capital to these industries as it had done from the outset for the National Coal Board.

and authorised the Treasury to borrow for the purpose of so doing. The powers conferred by the 1956 Finance Act were renewed annually in subsequent Finance Acts until a series of separate Acts in the early sixties gave the Treasury permanent powers to make issues from the Consolidated Fund for advances to each of the nationalized industries within the borrowing limits authorised by Parliament.

Generally speaking, in a developing country of mixed economy type, the issue of public loan is not always practicable method of raising capital because of lack of public response. In India only the State Electricity Boards have raised funds by issuing fixed-interest-bearing loans to the general public. Otherwise, no other public enterprise has issued such public loans. The total private investment in public enterprises as on March 31, 1966 amounted to Rs. 22.9 crores, of which Rs. 18.23 crores were in loans.

**INDUSTRIAL DEVELOPMENT BANK:**

Another alternative to provide funds to the enterprises is the creation of a Government owned Development Bank to advance loaned capital. The sources of funds in the hands of the Bank will be:

a) Initial capital provided by the Government.
b) Loans advanced by the Government or Central Bank of the country.
c) Profits earned in its operations such as profits and income of interest, etc.
d) Deposits that may be received from the public.

Hanson suggests that it is a good system provided Government retains sufficient control to ensure that its assistance is extended in accordance with planning priorities and that it confines itself to the financing of these enterprises that need loans as distinct from grants. But he feels doubtful about the efficacy of the bank as a general capital providing agency.

In India, such a bank called The Industrial Development Bank of India (IDBI) was established on July 1, 1964, in terms of the Industrial Development Bank of India Act of 1964. This Bank was set up as part of a reorganised and integrated structure of industrial financing institutions in the country, geared to the needs of rapid industrialization. The main object was to bring into existence an apex institution to coordinate the activities of other financial institutions, including banks, providing term-finance to industry as well as to provide direct financial assistance to industrial units to bridge the gap between the supply of and demand for medium and long term finance. The bank may finance all types of industrial concerns, whether in the private or the public sector, engaged in the manufacture or processing of goods, mining, transport, generation and distribution.
functioning of the bank will be derived from various sources. The authorised capital of the bank is Rs. 60 crores which may be raised to Rs. 100 crores. The issued and paid-up capital of the bank (at the end of the financial year on 30th June, 1967)\textsuperscript{32} was Rs. 20 crores. This has been supplemented by a long-term interest-free loan of Rs. 10 crores from the Central Government.

Although under its regulations, the Bank is permitted to finance all industrial concerns, both, in the private and public sectors, but during its existence and operations of three years, (ending June 30, 1967) it has provided sizeable assistance to industrial units in the private sector only. No financial assistance has so far been provided to any Central Government public enterprise.

Permanent capital, therefore, is usually raised from the Government in the form of grant, loan or equity. Full discussion on this issue is given under 'Capital Structure'.

**LOANS FROM BANKS AND OTHER FINANCIAL INSTITUTIONS**

As discussed earlier, all financial requirements of public enterprises are to be provided by the Government. But this applies to the long term capital requirements. Commercial banks do not come forward to invest their funds in public enterprises on long term basis, particularly in mixed economy when other avenues of investment are

\textsuperscript{32} IDBI Report of the Board of Directors for the year 1966-67.
available to them.

But the working capital requirements are invariably met by cash-credit arrangements with the State Bank of India. The total borrowings as on 31st March, 1966 from the State Bank of India under the cash-credit arrangements amounted to Rs. 90.48 crores. While this policy of getting working capital requirements from banks without Government guarantee is sound, the fact remains that many projects, particularly in the initial stages, experience great difficulty in doing so. The Committee on Public Undertakings referred to such a difficulty experienced by the Bharat Heavy Electricals and suggested that Government should provide such a guarantee in case of need. Moreover, why should public enterprises be restricted to have their dealings with the State Bank of India alone. "Public enterprises should be free to have cash credit arrangements with any scheduled bank. Government should be kept informed of such arrangements." 34

PLOUGHED BACK PROFITS:

It is a matter of common knowledge that in the private sector many of the most successful concerns have been largely built up from profits ploughed back. Such private concern make huge profits and keep back a substantial portion of such profits for employment in the business. When

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such profits are ploughed back in business it virtually amounts to compulsory investment of the shareholder's money because otherwise these profits would have been available for distribution as dividends to them. It is by no means compulsory provision of future capital requirements by the consumers.

Does the same principle apply to public sector undertakings? Obviously this method is ruled out as a source of original capital for public enterprises for quite some time. Because, as explained earlier, in developing countries the purpose of starting public enterprise is to exploit the natural resources of the country and to accelerate the rate of economic growth. The projects started are of basic and strategic importance involving huge capital outlay. Generally, such industries do have a long gestation period where the question of earning profits does not arise. Therefore, as a source of original capital, it has no significance.

**FINANCING FOR EXPANSION**

Although profits may not be available for public enterprises as initial capital but it will be in the fitness of things that public enterprises be asked to accumulate resources out of their earnings for their own expansion. In a developing economy, when funds at the disposal of the Government are limited and demands upon them are too many, public enterprises cannot be allowed to depend for their finances for all times to come on Government resources.
This issue of self financing was examined by the 'Herbert Committee' which expressed the opinion that such raising of capital for expansion would not be just. In the opinion of the Committee to use prices charged to the consumers as a device for raising capital for expansion is to impose compulsory saving on electricity users; to make them pay, so to speak, a tax in proportion to their electricity consumption so that the community may build up the electricity industry for the benefit of future consumers. To make present consumers subsidize in this way the capital requirements of future consumers would be quite inequitable. Although the Herbert Committee was opposed to the idea that present consumers should subsidize the capital requirements of future consumers but it suggested that the industry (electricity) should carry sufficient reserves to cushion it against short-run changes in demand and costs, and to avoid the need for violent or frequent alteration of tariffs. It suggested that the industry should aim to earn (after providing for full depreciation and interest) say one per cent on capital employed. This view of the Committee was very widely criticised at the hands of various authorities as involving the piling up of excessive debt and the sacrifice of the financial viability of the public sector.

Sir Roy Harrod suggested that the nationalized

36 Policy against Inflation, Macmillan 1968 p. 238, as quoted by Hanson- Nationalization, page 252.
industries be told that in future they will have to find all their capital requirements by internal finance. The Radcliffe Committee\(^{37}\) came to the conclusion that it would not be realistic to look for a solution of the problem of capital supply along these lines. In the case of electricity opportunity might be taken to find some additional capital by refraining from the price reduction as costs fall, but it may not go to solve the problem of additional finances required.

The British Government in its White Paper\(^{38}\) accepted the need for a measure of self-financing. The paper concluded by saying that "the nationalized industries are, from their size and nature, bound to play a major role in the economic life of the country.........." The nationalized industries should make the maximum contribution towards their own development and the well-being of the community as a whole.

The arguments put forth by the Herbert Committee do not hold good in the context of developing countries. There is great dearth of funds in the hands of the Government for investment in the public sector undertakings. The Government has to strive hard to tap all resources to raise funds. Such measures may be intensive direct taxes, excise and customs duty, pricing policies of public enterprises. Present generation has to make sacrifices for the prosperity


\(^{38}\) The Financial and Economic Obligations of the Nationalized Industries, April 1961, Cmnd. 1337 para 33.
of the future posterity by paying heavy taxes and high prices. There seems to be nothing wrong about it. But any one principle cannot be applied to all industries. Policy of retention of profits for expansion will depend upon the state of economy, nature of industry and the stage of its development. The over-all view should be that public enterprises should conserve their resources for expansion purposes. It is obviously desirable, and in the long run essential, that public enterprises should contribute to the Government's capital resources, or alternatively make sufficient profits to finance their own capital expansion.

**INTERNAL RESOURCES GENERATED BY PUBLIC ENTERPRISES**

The Third Five Year Plan laid considerable emphasis on public sector undertakings realising adequate surplus and envisaged a contribution of Rs. 300 crores on this account from the Central Government concerns. Surplus, in this context, means the internal resources of the enterprises, available for financing the Plan. This is the amount available from the operations of these undertakings after providing for their working expenses, current replacements, interest and dividends. In other words, internal resources which may be retained by an undertaking for financing its capital outlay, will cover mainly depreciation provided, appropriation to different reserves (including development rebate reserve and capital reserves, if any). The internal resources generated by public enterprises are treated as plan resources and these amounts
INTERNAL RESOURCES GENERATED—
DEPRECIATION AND RETAINED PROFITS
UPTO THE END OF
1965-66.

IN CRORES
INTERNAL RESOURCES GENERATED—
DEPRECIATION AND RETAINED PROFITS
UPTO THE END OF
1965-66.

RUPEES IN CRORES

1960-61
1961-62
1962-63
1963-64
1964-65
1965-66

DEPRECIATION
RETAINED PROFITS
are deployed partly for asset formation and partly to meet working capital requirements. The internal resources generated by the Central Government industrial and commercial enterprises during the Third Plan aggregate Rs. 287 crores as detailed below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation</th>
<th>Retained profits</th>
<th>Total Internal resources</th>
</tr>
</thead>
<tbody>
<tr>
<td>1961-62</td>
<td>21.3</td>
<td>7.6</td>
<td>28.8</td>
</tr>
<tr>
<td>1962-63</td>
<td>22.7</td>
<td>13.2</td>
<td>35.9</td>
</tr>
<tr>
<td>1963-64</td>
<td>47.2</td>
<td>14.4</td>
<td>61.6</td>
</tr>
<tr>
<td>1964-65</td>
<td>57.2</td>
<td>18.0</td>
<td>75.2</td>
</tr>
<tr>
<td>1965-66</td>
<td>69.4</td>
<td>16.1</td>
<td>85.5</td>
</tr>
<tr>
<td>Total</td>
<td>217.8</td>
<td>69.2</td>
<td>287.0</td>
</tr>
</tbody>
</table>


The total internal resources generated by different running concerns up to 1960-61 was Rs. 72.7 crores. Thus total internal resources generated upto the end of 1965-66 amounted to Rs. 359.7 crores.

In the absence of any satisfactory alternative method of raising capital, it is, therefore, suggested that public enterprises should get all their permanent capital requirements from the Government in the form of outright grant, loan or equity. There are some distinct advantages of the Government being the main supplier of funds. Such advantages are firstly that the Government can control the capital expenditure programmes of a public enterprise. Although the Government can otherwise use its
power of approval of capital budget and of giving directions to regulate the extent and timing of public enterprise borrowings in the open market; yet it may prove to be a more effective device. Secondly, the Government can confer the advantage of cheapness of capital because of the Government's credit in the market. Thirdly, a public enterprise can be relieved of the test of the capital market and funds made available even in the circumstances in which borrowings in the open market fail it.

(C) CAPITAL STRUCTURE:

In the scheme of financial plan of an enterprise its capital structure has an important place. The strength of a building is determined by the strength of its structure and the bricks and mortar which has been used for its construction. In the case of the financial structure of an enterprise the material from which it will be raised and constructed will consist of the different type of securities, which are issued from the capital market. In the case of a private enterprise the amount and the type of securities to be issued will be determined upon the size and nature of the enterprise and the conditions prevailing in the capital market. In formulating a sound financial structure it is desirable that not only the current requirements of an enterprise be taken into consideration but an eye should also be kept on its future needs. Thus the approach must be realistic and forward looking.
The construction of the capital structure for public enterprises is dependent upon the broad financial policy of the Government. There are several constraints under which the Government has to take a decision. Some of such constraints are the monetary policy, balance of payments, foreign exchange, phasing of capital expenditure, depreciation, profit pricing and taxation policies. In the case of private enterprises, whatever financial framework that may be formulated, is capable of prompt correction, wherever necessary, because of the dominating instinct of self-interest on the part of the investors, but the public sector lacks comparable strength in this respect. Hence the need of a sound financial framework to be decided upon by the Government. Capital structure is considered to be an important segment of industrial organisation. Efficient organisation and management of finance is the rock upon which public enterprise must stand, grow and develop. A sound financial structure is formulated in terms of certain fundamental economic and financial principles.

It has already been concluded that all permanent funds to public enterprises are to be provided by the Government either in the form of grant, equity or loan. Which of these alternate methods should be employed is a very important question. Generally, funds may be provided by the Government in the following different ways:

(1) As an interest bearing and repayable loan;

(2) As an interest bearing but non-repayable loan;
(3) As a non-interest bearing but repayable loan;
(4) As Equity share capital; and
(5) As an outright grant.

These five methods can be employed by the Government in any combination suiting the requirements of each enterprise. In whatever form capital may be provided but it should not be motivated solely by the return on capital basis. For, public enterprises return on capital can never be the only criterion. It does not mean that return on capital, by public enterprises by way of interest or dividends to the Government can never be justified but along with this there are other and more important considerations also.

In the private sector return on capital is based on the theory of 'abstention', but in the case of public enterprises where Government acts as the entrepreneur such a theory has no justification. Government spends the tax-payers' money and not her own. The tax-payers' reward, if any, is the creation of the enterprise itself, and the contribution that it makes towards the development of national economy. Government does not establish an enterprise to obtain a return but to constitute a new and necessary unit to the nation's equipment. The earning of a return is of secondary consideration. Government should not abstain from establishing a new and necessary enterprise simply because the latter will be unable, in the immediate future, to pay interest or dividend on its capital. In an under-developed country, percentage yield rarely provides a useable or even a sensible developmental
criterion. In the case of infra-structure industries it is only the State that has to take initiative to start and maintain such projects which are either inherently unprofitable or insufficiently profitable for a long time. Therefore, Government will have to content itself with low return or no return at all during the early years of such projects.

In deciding on the terms on which capital is to be provided the Government has to bear in mind two considerations. The first of these is that infra-structure industries cannot be expected to yield a surplus during the early years of their life. The second is that in the longer run public enterprise must become capital-creating and capital-absorbing, if the proportion of the national income saved and invested is to be stepped up.

To achieve the object of flexibility Government may give straight-forward capital grant, provided that the Government retains the authority to itself of disposing off the surplus, if any, or capital may be provided in the form of equity. In practice, there is little difference between the two methods. In doing so, we have to safeguard against another menace and that is "the danger of easy money". Straight-forward grant or equity capital may tell upon the efficiency of the enterprise. Free Capital can breed irresponsibility. Transfer of surplus to Government funds or distribution of dividends are appropriations of net profits and do not form a charge on revenue and,
therefore, an enterprise may become careless and indifferent in the matter of earning profits. Fixed interest loans on the other hand have an advantage in the sense that these compel the public enterprises to recognise that capital is scarce and has a price and, therefore, not to be wasted. Furthermore, such interest payments become a source of revenue to the State that can be further employed for economic development. Thus the enterprise, if successful becomes a source of Government controlled development fund. But such interest payments may become a headache and prove to be burdensome for the enterprises in the earlier stages of their development which may not be a healthy feature. Therefore, if the Government is of the opinion that this is the case, it can provide an outright grant or an interest-free loan or an interest-bearing loan with a moratorium on interest payments and capital repayment during the early years.

To sum up it can be said that in tailoring a suitable capital structure Government should ensure (a) that an enterprise is not burdened with heavy capital charges particularly during its early life; (b) that it is given such financial incentives as are necessary to ensure its smooth progress within the minimum time; and (c) that it contributes to the process of capital formation as soon as possible.

**DEBT-EQUITY RATIO:**

The relationship between equity and loan capitals is of great significance for the private enterprises. Firstly, if the rate of earning is higher than the rate
of interest payable on the loan capital, the excess profit will enable larger dividend on the equity. This phenomenon is called "Trading on Equity". Secondly, financially successful enterprises can refund the loan capital out of their reserves when it is no longer required and enjoy higher dividends on their investments. Equity capital, on the other hand, cannot be repaid to the shareholders under the provisions of Company Law. Thirdly, hold of equity shareholders is not diluted by raising funds on loans because loan capital carried no voting rights.

But whether all these considerations are of any value, in the case of public enterprises, is very doubtful. Firstly, the principle of 'Trading on Equity' is of no importance when all funds come from Government sources. Whether payment is made by way of interest or dividend to the Government is of little concern. Regarding the second point of refunding of loans, when not required, it is doubtful whether public enterprises in India will be able to repay the loan capital in the foreseeable future. Most of the enterprises are in the process of construction and expansion and need of funds is all the more greater. Therefore, the question of refunding of loan capital seems to be out of question. The third point of maintaining the hold on the affairs of the company is of no relevance because in a Government company majority shares will always be held by the Government and any dilution in the hold of the Government on the company can never happen.
Though this proposition between equity and debt is of no importance from these points of view but from several other angles it is of significance. As discussed earlier an enterprise should be saved from heavy interest burden during the early years of its life, therefore, the desirability of providing equity capital. But at the same time, we have to safeguard against the evils of 'Easy Money'. The enterprise should not grow irresponsible towards its investors. Therefore, the need of fixed-interest-bearing loan. What should be the ratio between the two is a very important question? It appears that no blanket decision applicable to all types of enterprises can be taken in this regard. Enterprises differ in various ways. Some belong to such industries which are heavy capital based or with a long gestation period such as Iron and Steel, Heavy Engineering, Fertilizer, and Machine Tools industries, etc. There are others, which begin bearing fruit earlier. Therefore, an enterprise's capital structure and financing programme should be adapted as nearly as possible to its particular earnings characteristics and needs at the time, as well as its future needs and capacities. For example, enterprises with greater stability of earnings, such as public utilities as electric, gas, water distribution or road transport may have a debt ratio upto 60 per cent without exceeding the bounds of sound financial practice or safety; while on the other hand for an enterprise with unstable earnings or of speculative nature it might not be safe to have any loan capital. For ordinary industrial and commercial enterprises, generally, a debt
ratio of 25 per cent of the total capitalization may be considered to be reasonable.

Therefore, decision in this respect will be taken keeping in view the following basic principles, i.e.:-

The greater stability of earnings, the higher may be the ratio of loan to equity. Also, the capital structure should have a sufficient equity cushion to absorb the shocks of business cycle and to afford flexibility.

At the start of a new business the higher proportion of equity capital is desirable. As the business progresses and gets momentum the loan capital may be introduced or gradually increased. This ratio is not a matter to be decided and fixed once for ever. Rather it is to go on changing from time to time as per needs and then only a satisfactory capital structure may be available to the business. Safety, comfort, convenience and health of a business depend to a great extent on the capital structure in the same way as those of the inhabitants depend on the structure of the building they live in. The capital structure of a business may be compared with a machine with several gears. As for the successful running of the machine, the engineer has to make use of the gears, so the financial engineer has to make use of the different types of securities in his capital structure.

**PATTERN OF CAPITAL STRUCTURE OF INDIAN PUBLIC ENTERPRISES:**

Funds to Central Government enterprises have been provided by the Government herself. The total investment of
Rs. 2,415 crores as it stood at the end of the financial year 1965-66 (this year is significant as it coincides with the end of the Third Five Year Plan), the share of the Central Government was to the tune of Rs. 2,304 crores. Of this investment of Rs. 2,304 crores, equity capital accounted for Rs. 1,352 crores and the long-term loans amounted to Rs. 952 crores, giving an over-all ratio of 1 : 0.7 between equity and debt.

For the purpose of making a detailed and purposeful analysis all the undertakings of the Central Government have been broadly classified into five categories. This classification is also desirable because these undertakings differ from one another not only in the scope of activity but also in regard to the stage of construction and development attained. A few deal with purely promotional and developmental activities while others are of industrial and commercial nature. To appreciate the working of these diverse type of undertakings it would not be proper to lump all of them together. The five categories are:

1) Undertakings under construction;
2) Running concerns- Hindustan Steel;
3) Running concerns- other than Hindustan Steel;
4) Promotional and Developmental; and
5) Financial Institutions.

**Undertakings Under Construction:**

This category includes 17 undertakings (Annexure VII) which are still in the process of construction and
yet to be completed and also projects in which some units had been commissioned and were in partial production.

The total investment on these undertakings stood as ₹. 331.76 crores at the end of the year 1965-66. This investment consisted of ₹. 198.46 crores in the form of equity and ₹. 133.30 crores as loan capital. The ratio between equity and loan comes to 1 : 0.67. Some of these undertakings are heavy capital based projects and have been under construction for the last several years, as is indicated by the annexure. Such a heavy dose of loan capital in such industries is not a sound financial policy.

**RUNNING CONCERNS:**

'Running concerns' have been divided into two categories, the first comprising the Hindustan Steel and the second other undertaking of this type. In order that the working result of the other running concerns are correctly presented, Hindustan Steel has been treated as a distinct category as the investment in it forms about 40 per cent of the entire investment in all the public sector undertakings.

The total investment in the Steel project stood at ₹. 960.1 crores made up of equity ₹. 528 crores, and loan ₹. 432.1 crores. The loan capital was about 82 per cent of the equity. Here again the capital structure is highly loan intensive which is not in accordance with the basic principles of finance. This defective capital structure is one of the reasons of unhealthy financial state of affairs of the company.
RUNNING CONCERNS (OTHER THAN HINDUSTAN STEEL LTD.):

These 39 running concerns have been classified according to the industrial groups as given in annexture VIII.

The total investment in these 39 undertakings amounted to Rs. 899.2 crores as at the end of the financial year 1965-66. This investment consisted of Rs. 502.5 crores as equity and the balance of Rs. 396.7 crores as loan. The loan capital was 79 per cent of the equity. Even in this case percentage of loan to equity is very high. As discussed earlier, loan capital should not exceed 25 per cent of the equity capital in ordinary industrial and commercial concerns.

PROMOTIONAL AND DEVELOPMENTAL UNDERTAKINGS:

Fourteen undertakings (Annexure IX) have been established by the Government with the object of sponsoring specified development activities requiring, in the formative stage, financial assistance from the Government.

The total investment in the above undertakings, as on 31st March, 1966 stood at Rs. 217.1 crores consisting of equity Rs. 132.00 crores, and Loans Rs. 85.10 crores. The loan capital was 64 per cent of the equity. There seems to be no justification to have any loan capital in such undertakings, because such concerns are established to promote and develop certain specified activities requiring Government help. In the ordinary course such Undertakings are not likely to make profits.
Three institutions (given in Annexture X) have been set up wherein equity capital has been provided by the Government. The total investment in these institutions as on 31st March, 1966 was Rs. 6.9 crores. The bulk of this investment is in the form of equity Rs. 6.5 crores and the balance Rs. 40 lakhs as loan.

With a view to maintain a balance between equity and loan capital, the Government of India decided in June, 1961 that the Government companies should maintain a ratio of 50 : 50 between equity and loan capitals. But, as we can see from the details given above, this parity is not being maintained. It is given out that the present imbalance between equity and loan is mainly due to past investments, repayment of loans by some of the undertakings and investments in new units being initially in the form of equity.

This policy of keeping a parity between equity and loan capitals if made applicable to all types of enterprises does not appear to be sound or based on reason. As discussed earlier, capital structure for each enterprise shall have to be formulated keeping in view the nature of each project. For undertakings under construction there appears to be no justification for the loan capital being 67 per cent of the equity. Such concerns are still under construction and should not be burdened with the fixed interest charge.

The capital structure of a Public Enterprise ought to be geared to the procurement of capital funds.
as per need, time-wise, amount-wise and interest rate-wise without any dogmatic approach.

This issue of Equity-Debt ratio was considered by the Committee on Public Undertakings while examining the affairs of Heavy Engineering Corporation Ltd. The total block capital requirements of the Corporation are expected to be of the order of ₹ 250 crores. According to the policy of the Government the capital requirements are to be financed on the basis of 50 per cent equity and 50 per cent loan. At the end of the financial year 1965-66 the equity capital of the Corporation stood at ₹ 88.95 crores and loan at ₹ 44.77 crores giving a ratio of 1 : 0.5 (i.e., loan capital being 50 per cent of the equity). The Corporation representatives in their evidence before the Committee stated that they had represented to the Government to allow the entire capital requirements as equity capital because heavy engineering was a capital-intensive industry with a long gestation period and manufacturing custom-built products. The financing of requirements on the basis of 50 : 50 would saddle the Corporation with an interest liability long before the project went into production. The matter was still under consideration of the Government. The Committee opined that in view of the nature of the industry and long gestation period involved, it might be necessary to vary the pattern to some extent. This issue was once again examined by the Committee on Public Undertakings.

while looking into the affairs of Fertilizer Corporation of India. The Committee suggested the desirability of taking an early decision regarding the correct proportion between equity and loans.\(^{40}\)

In regard to Hindustan Steel Ltd., P. Prasad\(^{41}\) wrote recently that the question of 50 : 50 ratio must be reopened and discussed in the full light of known facts and the difficulties of each enterprise carrying heavy loads of unjustified debt burden from year to year, a sizeable part of which had better been converted into equity.

This study of planning of Indian public enterprises reveals that these undertakings suffered from defective planning in general and inappropriate capital structure in particular. These initial drawbacks, in turn, adversely affected the working and profitability of these undertakings and tarnished the image of public sector.

To stop the recurrence of such deficiencies and to take corrective measures it is suggested that:

1) Feasibility report, being the very basic document, should be got prepared with all care and caution. No project should be approved by the Cabinet without obtaining the feasibility report.

2) Preparation of the detailed project report which is the next step in project planning should be entrusted to experts. Indian talent should be associated with the preparation of these reports and too much reliance

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should not be placed on foreign experts. After the approval of the detailed project report a suitable agency should be set up to see the project through. The net-work techniques like PERT and CPM should be adopted for monitoring the progress of construction. Project completion report should be drawn up for use in future.

3) Preparation of financial plan of the projects requires much more care and attention. Financial requirements should be objectively estimated after taking into account all possible items of expenditure to obviate revisions afterwards.

4) To look after all such problems of project and financial planning a Committee of experts in the areas of engineering, finance, economics and statistics should be set up in the Cabinet Secretariat to scrutinize public sector projects and to advise the Cabinet before approving the project.

5) In general, all capital requirements of public enterprises should be provided by the State. But keeping in view the latest trend in some of the European countries some portion of the capital should be issued to the general public and particularly the employees of public enterprises. This will create a sense of belonging and partnership in the employees and will lead to better industrial relations. To make the scheme attractive some minimum return may be guaranteed by the State on such holdings.

6) Foreign collaborations should always be accompanied with Equity participation so that they are also financially involved and give their best.

7) Every public enterprise should be given a suitable capital structure. It should not be burdened with a heavy capital charge in the form of interest, in the initial period of its existence.

8) Enterprises with greater stability of earnings such as public utilities may have a higher debt ratio, while such industries which are heavy capital intensive or with long gestation period or with
unstable earnings or of speculative character should have no loan capital. For ordinary industrial and commercial enterprises, ordinarily, a debt ratio of 25 per cent of the Equity may be considered reasonable. The guiding principle should be, greater the stability of earnings the higher may be the ratio between loan and Equity. Also the capital structure should have a sufficient Equity cushion to absorb the shocks of business cycle.