THE CHANGING STRUCTURE OF INDUSTRIAL FINANCE

Dr. P. S. Lokanathan

1969

THE A. D. SHROFF MEMORIAL TRUST
235, Dr. D. N. Road,
Bombay-1.

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OBJECTIVES

(i) Publication of one or more books in English, Hindi, and regional languages annually on some of the great builders of Indian economy, aimed primarily at educating the younger generation in high standards of building the national economy as practised by those great entrepreneurs and placing the example of their lives for emulation by India's youth.

(ii) Organising one or more memorial lectures annually on subjects which were of interest to the late Mr. A. D. Shroff, namely, banking, insurance, and industrial finance, the subjects to be chosen in rotation, and the lectures to be delivered by persons eminent in these fields.

(iii) Awarding annual scholarship or scholarships to outstanding student or students in the field of management.

(iv) Instituting a prize to be known as The A. D. Shroff Memorial Prize for the student standing first in Banking at the Sydenham College of Commerce, Bombay.

(v) Doing all such acts, matters and things as are incidental or conducive to the attainment of the above aims or objects or any one or more of them; and

(vi) Without prejudice to the above charitable objects or any of them, the TRUSTEES shall have the power to spend, utilise and apply the net income and profits of the TRUST FUND for the TRUST FUND for the charitable object of education or such other objects of general public utility not involving the carrying on of any activity for profit as the Trustees may think proper; it being the intention of the SETTLOR that the income and/or corpus of the Trust Fund shall be utilised for all or any of the aforesaid charitable objects without any distinction as to caste, creed, or religion.

INTRODUCTION

The first public lecture delivered under the auspices of the A. D. Shroff Memorial Trust by Mr. H. V. R. Iengar, I.C.S. (Retd.), former Governor of the Reserve Bank of India, on the "Role of Central Banking Authority & Commercial Banks in a Planned Economy" was published by the Trust and extensively distributed. It is gratifying that the book has been well received.

The second public lecture was delivered by Dr. P. S. Lokanathan, the eminent economist, on "The Changing Structure of Industrial Finance". The Board of Trustees is happy to present the text of the lecture in this book. The late Mr. A. D. Shroff was a pioneer in setting up many financial institutions and running them. Industrial finance was one of his fields of earnest study and endeavour. This publication is, therefore, a meet tribute to the memory of Mr. Shroff.

N. A. PALKHIVALA,

Bombay,
2nd April 1969.

Chairman,
Board of Trustees

A. D. SHROFF

A. D. Shroff's achievements in the field of business, industry and finance were many and varied. A large number of enterprises owe their origin and development to him. As an economist, his predictions have proved right over the years. Through the Forum of Free Enterprise, which he founded in 1956, as a non-political, educative organisation, he sought to educate the public on economic affairs. It was his firm conviction that a well-informed citizenry is the foundation of an enduring democracy.

George Woods, former President of the World Bank, paid the following tributes to A. D. Shroff:

> "In every age and in every society men must express anew their faith in the infinite possibilities of the human indvidual when he has freedom to develop his creative talents. For this is in large part how the message of freedom is passed from generation to generation. A. D. Shroff spoke eloquently in a great tradition, and thanks to him we can be sure that other great men of India will continue to speak this message in the unknown context of our future problems."

Published by M. R. Pai on behalf of The A. D. Shroff Memorial Trust, 235, Dr. Dadabhai Naoroji Road, Bombay 1, and Printed by Michael Andrades at the Bombay Chronicle Press, Horniman Circle, Bombay-1.

THE CHANGING STRUCTURE OF INDUSTRIAL FINANCE*

by

Dr. P. S. Lokanathan

I deeply appreciate the honour done to me by the A. D. Shroff Memorial Trust in inviting me to deliver the Shroff Memorial Lecture this year. The title of my address is "Changing Structure of Industrial Finance" - a subject which would have made a great appeal to him were he alive and of which he was an undoubted authority. My acquaintance with Mr. Shroff goes back to the days of the National Planning Committee set up by the Congress and we worked together in the Committee on Industrial Finance. Later in the preparation of the Bombay Plan, I was invited to join in its deliberations before it was finalised by its eminent authors of whom Mr. Shroff was one. I was then Editor of

* This is the text of a lecture delivered under the auspices of the A. D. Shroff Memorial Trust in Bombay on 24th February 1969. Dr. Lokanathan, an eminent economist, was educated at Madras and in London; was Professor of Economics at University of Madras; Editor of "Eastern Economist", New Delhi; Executive Secretary, ECAFE; actively associated with many public organisations and government committees and he has a number of publications to his credit.

"The Eastern Economist". Later in 1945, when I accompanied the Indian Industrialists' Delegation as Economist and Secretary to U.K. and U.S.A., I came in contact with him. In subsequent years, I had the privilege of knowing him, his methods of work, his deep and intimate knoweldge of finance and industry. But what struck me most was his firm grasp of the essentials of Money, Banking and Finance and the rare courage with which he expressed his views whether they were in accord or not with the current popular thinking. The country will gratefully remember him as one who had the boldness and vision to found the Forum of Free Enterprise at a time when the country had accepted economic planning in an extreme form, with its discriminating controls and inefficient government economic administration. The Forum is a useful and necessary corrective to the uncritical acceptance by the country of a system of planning which with all its merits and achievements led to serious and avoidable distortions of the economy and led to a suppression of initiative and loss of self-reliance. We owe a debt to him.

PART I

Pre & Post-Independence Structure of Industrial Finance

"Industrial Organization in India" was published in 1935. In it, I had devoted three chapters to Industrial Finance. The problems and conditions outlined in them remained more or less the same right up to the end of Second World War and the ushering in of the new Independent India. Thus

1947 may be taken as a sort of watershed in dealing with Industrial Finance. Between 1947 and 1967, in a period of twenty years, something like a revolution has taken place; the structure of industrial finance has changed almost beyond recognition. While some problems still remain, many old and some new problems have been more or less earnestly dealt with. In pre-Independent India, and especially in the earlier phase of industrialization, the bulk of the long-term and a considerable amount of even short-term working capital was provided by the Managing Agents. Many may not be aware of the fact that in the earlier years of industrialization, commercial banking was yet to be firmly established and for several years later, the relationship between industry and commercial banks was far from close. Neither industry nor banks desired to get closer to each other. Later as industrialization got into stride, commercial banks were increasingly resorted to for working capital. But following the British practice, and unlike as in the Continent and to a large extent in U.S.A., banks in India did not think of providing long-term finance to industry. They considered it as not within their purview. Even the working capital and short-term capital needed by the industry was not fully met; a part had to be found by the Managing Agents themselves who were the promoters, financiers and managers of the managed industrial companies. Owing to the lack of issue houses, and investment trusts, there was no way of getting the initial capital for new companies nor for any expansion and the managing agents and promoters had to provide all the initial finance needed by the industry.

There was no wide basis of ownership of industrial shares. No large public issues could be floated and when they were, they were taken mainly by the promoters, their families and friends and some underwriters including a few financial companies which had been established. The lack of a good capital market, the relatively small investing public and the reluctance of the savers to invest in industrial shares and securities led to the predominance of the role of the managing agents who had to provide either directly or indirectly all the finance needed by the industry. The public who had greater faith and confidence in the managing agents than in industry were willing to place their savings in the form of short-term deposits. Underwriting facilities were very poor; no institution existed for providing long-term finance. Further, the establishment and growth of small and medium industry was hampered by the lack of financial facilities. Even the commercial banks which could have provided at least working capital did not care to touch them. Hence, small industry had no other resources except their own personal wealth and the financial help rendered by their families and friends.

But what a change has taken place since 1947! The decline in the financial role of the managing agents since 1947 was more than made up by the establishment of a number of financial institutions, the first of which was the Industrial Fnance Corporation of India set up in 1948. This was followed by the growth of financial corporations and other institutions like The Industrial Credit and Investment Corporation of India and Industrial Development Bank of India set up by the Reserve Bank of India. In addition, there is the newly established Unit Trust of India. These together with the Investment activities of the Life Insurance Corporation of India, have filled many important gaps in industrial finance in the country. The rapid industrialization that has taken place in our country would not have been possible at all in the absence of these new institutions.

The Commercial banks too have changed their policies and attitudes; not only do they play a more vigorous role in providing the short-term needs of the industry but also provide intermediate credit. In this they have been assisted by the Industrial Development Bank of India which has provided refinance facilities. Thus, we find today, first of all, initial capital provided by ICICI, underwriting facilities by many institutions including ICICI, IFC, LIC and some commercial banks. Their investment in industrial shares and securities also help in facilitating the flow of finance to industry.

The credit needs of small industry are being met at least partially. Under the Credit Guarantee Scheme of the Reserve Bank of India, commercial banks, and more especially the State Bank of India, have increased their supply of credit to the small industry. For purchase of machinery and equipment by the small scale industries, National Small Industries Corporation has been established and it provides machinery on hire purchase system.

Under the new Social Control of Banks, the small industry has become a sort of preferred sector along with agriculture.

The capital market has since 1947 also become much wider and better organised; especially in the '50s and '60s, the public interest and capacity to invest in industrial shares have been greatly increased. You will thus see that the structure of industrial finance in India today is very very different from what it was 20 years ago. Not that all problems and difficulties faced by the industry—big or small - have been overcome. There are still some gaps which remain; there are still some inadequacies and difficulties to which I would later revert. But the sheer magnitude of the transformation that has taken place since Independence has often been either missed or given inadequate recognition.

PART II

Role of Managing Agents

Finance is the oxygen of industry. Without adequate finance made available at reasonable terms, it would not be possible for industry to develop. Industry needs three kinds of finance — initial capital, working capital and capital for expansion. The most difficult hurdle to cross is the initial finance required to get the industry off the ground. In smaller businesses this finance has to be generally provided by the promoter with his own funds. But where a business is large, the promoter has to depend largely upon the capital market which includes Investment Houses, the Stock Exchange, the New Issue Market and other financial institutions;

these provide both the initial finance required and also the guarantee for the public floatation of capital issues. In developed countries there are specialised institutions which perform these different functions. The issue houses, for example, undertake the floatation of public issues and play an active role to create public interest in the issues. There are underwriting firms which, for a small commission, are prepared to underwrite the issues. The Stock brokers not only arrange for the absorption of shares by their clients but often act also as underwriters to public issues. An active stock exchange is, of course, a pre-requisite for the working of the new Issue market.

So far as working capital is concerned, generally it is provided by the commercial banks. A part of the working capital, which should be regarded as more or less permanent capital, should also be found by the industry itself out of its public issues. The capital for expansion if it is of modest dimension is generally found from depreciation funds and reserves out of profits. But where the needs are large, industrial units have recourse to right shares (that is, shares allotted to the original shareholders) and to public issues. Thus an efficient banking system, an adequate and efficient net-work of financial institutions, a vigorous capital market and smoothly functioning stock exchanges are basic to financing industrial needs.

In pre-Independent India, although commercial banks were functioning reasonably satisfactorily, there was a big gap in the institutional finance. There were no issue houses, specialist underwriters, or financing institutions for long-term financing of industries. The stock exchanges also functioned only for large and well-known businesses; the medium sized and small industries could not enjoy the services of the stock exchanges.

Most of the early industries that were developed in India—cotton textiles, jute coal mining, shipping, sugar, cement and other industries - had to depend largely upon the capital furnished by the promoters, and the promoters in India were the managing agents. They practically undertook not only the promotion of new companies and expansion of existing companies, but also provided all the initial finance required either through their own resources or by getting the public subscription to the shares issued by them. Since the public had great confidence in the managing groups, generally there was little difficulty for them to raise the necessary initial finance. The percentage of finance actually furnished by the managing agents varied between industry and industry, between different managing agents and also depended partly upon the size of the firms. British managing firms by and large provided more capital out of their own resources compared to Indian managing agents. But whatever be the initial capital provided by the managing agents, gradually, after the companies had started functioning the managing agents generally tried to reduce their share-holdings in the companies which they had floated and used them for floating new companies. Thus the percentage of capital provided by the managing agents became less as the companies became well-established. The proportion of finance provided by the managing agents to larger companies was much less than that provided to medium and smaller companies. A method that was rather unique was adopted by the Ahmedabad textile industry by which the managing agents utilised the deposits which they were able to gather from their friends and other members of the public who had confidence in them. Although these deposits were withdrawable at short notice and could theoretically be utilised only for working capital needs of the industry, in practice the deposits were renewable; there were also term deposits extending for a period of 5 to 7 years. The Ahmedabad textile industry was thus able to develop largely on the basis of public deposits and although this may not be regarded as an ideal method of financing long-term requirement of industry, there is no doubt that the needs of industry were served very well by this method. But at a later date when the industry faced a period of depression there were withdrawals of deposits which caused difficulty to industry. But taking a broad view of the matter, it cannot be denied that the system of public deposits although not without its defects, proved a valuable resource for financing the industry.

The managing agents were able to rely upon the banks for the bulk of their working capital needs. But here again their role was very important because of a practice that had developed by which banks always required guarantees of the managing agents for any loans they were prepared to give to the industry. This system, a wholly unnecessary one, was to some extent historical. The banks had better knowledge of the managing agents than of the companies as such, and were, therefore, prepared to grant loans only on the assurance of the managing agents. Hence indirectly the managing agents were providers of working capital as well. Thus in pre-independent India, managing agents were providers, for all practical purposes, of all financial required by industry—both initial and long-term finance and working capital.

PART III

Institutional Finance

After Independence, when India launched upon a rapid programme of industrial development, financial requirements both for short-term and long-term also increased rapidly. Government took several important steps to provide institutional credit for long-term and medium-term needs. The most important institutions that were established were the Industrial Finance Coporation, the Financial Corporation established by different States and the Industrial Credit and Investment Corporation of India (ICICI).

In addition, in 1964 the Industrial Development Bank of India was established as a subsidiary of the Reserve Bank of India, whose object was to fill in the gap still existing in industrial finance and to serve as a co-ordinating institution in respect of long-term finances. The total assistance sanctioned by these various developmental financing agencies during the Third Plan period amounted to Rs. 479.2 crores. In addition to these institutions, the Unit Trust of India and the LIC subscribe directly to industrial securities and also act as underwriters. Therefore, the wide gap previously existing in the structure of institutional finance has been filled to a large extent by these new institutions.

Two points may however be noted. One is these financial institutions have on the whole met the needs primarily of larger companies. The needs of medium and small companies have not been adequately met by these institutions. Secondly, their assistance has been concentrated in the more developed states; bulk of the loans having gone to Maharashtra, Gujarat, West Bengal, and Madras and the relatively under-developed regions have received much less help.

The role of financial institutions for financing new projects has become most significant in recent years. During the period 1964-68 this was one of the two most important sources of finance for projects of companies which issued capital through prospectuses. While loans from financial institutions accounted for 18 per cent of the total project costs, the loans from promoters, directors and managing agents formed only 0.1 per cent of the total. However, it must be pointed out that promoters, directors, etc. play an important part in the share capital, particularly that of new companies. During the 5 year period from 1963-64 to 1967-68, new public limited companies that issued capital through prospectuses, secured 21 per cent of the capital issues from promoters, directors etc. In the case of old companies, their share was much less at 5 per cent only. The institutions made their subscriptions mostly as underwriters of the capital issues.

The financial institutions have become important underwriters of capital issues, the more prominent being the LIC, Unit Trust of India and ICICI. In 1967-68, these three institutions underwrote 53 per cent of the total of Rs. 40 crores of capital issues underwritten during the year.

The total assistance rendered by the financial institutions constituted 13 per cent of the gross Private Sector investment in the Third Plan period, having increased from 5 per cent during the Second Plan period.

In respect of share capital, a sample study of the Reserve Bank of India on "Survey of Ownership of Shares in Joint Stock Companies" reveals that the holdings of these institutions, excluding the LIC, increased from 1.3 per cent in 1959 to 6.6 per cent in 1965. During the same period, the investment of LIC increased from 5.9 to 9.2 per cent. In 1965, the LIC became the largest single shareholder in the private sector. As regards the size of companies in which these institutions hold shares, their proportionate holdings were much larger in larger companies than in small companies.

As already pointed out, financial assistance of these institutions was concentrated in more advanced states. Maharashtra, Gujarat, Madras, and West Bengal got 52 per cent of the total assistance of the IFC upto June 30, 1968; 69.4 per cent of that of the ICICI upto December 1967, and 70 per cent of that of IDBI during the period July 1964 to June 1968.

An analysis of the Department of Company Affairs reveals that the distribution of financial assistance to business groups was as follows: 21 per cent of the total given by the IFC during the period 1961/62 to 1965/66 went to 24 business groups; 36.4 per cent of that given by ICICI to 18 groups and 36 per cent of that of IDBI to 6 groups of which 20 per cent went to one group only.

In evaluating the performance of these institutions and especially in criticizing the regional imbalances in the granting of advances to industry one has to bear in mind that they cannot be criticised for their shortcomings because, as pointed out by the Chairman of the IFC recently, this assistance of long-term credit is only one of the several factors which goes into the establishment of a new industry in an area. To quote his words, "While the Corporation can assist in meeting a portion of the financial needs of an industrial concern, it cannot create the basic conditions required for the success of an industry. It cannot, for example, arrange for raw materials, create markets or provide the requisite entrepreneurial skills. Even in the financial field, it has to be recognised that the Corporation which is required to function on business principles can only stretch itself to a point and take only limited and calculated risks to foster the establishment of industries in the under-developed States. For a major breakthrough, assistance has to be provided in other ways and possibly through different agencies". (Chairman's speech at the Tenth Annual General Meeting of the IFC held in September 1968).

PART IV

Healthy Stock Exchanges Essential

In view of the contribution to the financing of the Private Sector by the financial institutions by way of long-term finance of loans and in some cases by shares and also in view of the underwriting functions undertaken by these institutions, there has been a general feeling that the Private Sector has ceased to be an independent dynamic sector and that the functioning of an efficient and healthy stock exchange system has become unnecessary. In fact, the view has been expressed in high quarters that in view of these recent developments one can afford not to worry about an active capital market. Such a view is extremely short-sighted. As long as there is a Private Sector which has to function effectively, and efficiently, the need for a healthy and active stock exchange is absolutely urgent.

In the first place, these financial institutions do not provide all the necessary initial finance for new businesses. A large proportion of the equity capital required by companies has to come from the general public, and this will only come under two conditions: (a) that the public have enough savings, and (b) that there is a healthy stock exchange market which will enable the saver to choose his investments, to buy and sell them as and when he desires. There should be a market to enable him to shift his investments from one asset to another and from one company to another. It should ensure the liquidity and marketability of his investments. When he needs funds for consumption, he should be able to sell his investments readily. Without these facilities, the general public would not be interested in industrial securities. A healthy market helps in allocating the savings of the public to alternate uses according to the preferences; it satisfies the different tastes of the savers and the needs of investors through its financial institutions. Unfortunately, on account of various developments in the 60s, the capital market became sluggish and the flow of funds to industry dried up. It is true there were many factors at work. In recent years, partly on account of recent continuous drought leading to a great decline in agricultural production, both the rate of growth of national income and of savings declined. The ratio of savings to national income which had reached about 10 per cent in 1964-65 had diminished to 8 per cent and below. This decline in savings is a very serious factor; but the taxation policy of the government was a further aggravation.

In fact there has been an inherent contradiction between the industrial policy of the government and its fiscal policies. The industrial policy especially in its recent evolution and stress on the importance of the Private Sector in the mixed economy of the country could become effective only if the fiscal policy is in consonance with it. A significant expansion of the Private Sector and its contribution to industrial development can only take place if its financial resources match its obligations. The Private Sector undoubtedly needs a certain amount of foreign exchange for capital equipment and some essential intermediate goods and other raw materials not available in the country. This has been recognised and scarce foreign exchange has been allotted in terms of availability and priority. Through foreign collaboration too a part of the foreign exchange needed for purchase of machinery was secured. But the needs of the Private Sector in terms of rupee capital were not equally recognised. The financial and other institutions which have been set up after independence provide long-term capital and underwrite shares and securities. But industry requires initial capital in the form of equities. Here there is still a gap. The existing institution that is capable of doing so and actually is doing to some extent is the Industrial Credit and Investment Corporation of India (ICICI). But its resources being limited, it has necessarily to adopt a highly selective approach. The LIC has recently taken a positive step and is underwriting industrial equities and also investing in industrial companies. The Unit Trust of India is also similarly investing in equities; but even so, the most important source of finance for the equity capital of industrial companies is the large body of private savers. Their investments in equities have become very marginal due to a number of causes of which the most important is the fiscal policy of the Government. Only the last year's budget gave some welcome recognition to the need for strengthening the captial market. The Government's fiscal policy tended to damage the efficient working of the capital market. The dividend tax, the high corporate tax, the capital gains tax and various other taxes which hit the savers, all tended to both reducing the saving of the public and to weaken the incentive to invest in shares of the industrial companies. Actually the returns from equities to shareholders of the new companies have become negative showing heavy losses to investors. The greater attractiveness of alternative forms of investment has led to a reluctance on the part of the shareholders to invest. The basic tax of 55 per cent on companies and the corporate tax on dividend should be reduced. The income from such investment should be treated as earned income as similar income from government securities is already so treated. Government's mistaken view that investors are rich and can be squeezed should be changed. The shareholders actually are by and large middle income groups who would be willing to channel their modest savings to support the country's industrial ventures provided their savings are intact and a reasonable return is assured to them. Until the government recognise this basic point, the financial needs of the Private Sector cannot be fully met.

The Indian tax system bears more heavily on the Corporate Sector than elsewhere. While the Corporate Sector's tax is 55 per cent in India, it is much less in other countries like the U.S.A. and U.K. It is true that some compensation is found in our fiscal policy by which considerable development rebate is given and a tax holiday is given to new companies. But even taking all these into account, there is no doubt that the heavy corporate tax in an under-developed country like India has contributed to the difficulty of industrial finance.

PART V

Fiscal Measures Needed to Promote Savings

Industrial enterprises in India are dependent on external finance to a larger extent than in western countries. This difference in the pattern of corporate finance should be attributed to the smaller retained earnings in India which have considerably declined over the successive Plan period. The decline has been very substantial in the case of large companies (with paid-up capital of more than rupees one crore), particularly since 1961. The proportion of internal resources to total funds has steeply declined from 66.8 per cent in 1961/62 to 52.3 per cent in 1963/64. The dividend policy of some of the industrial companies has also been partly responsible for the poor performance of retained earnings. Depreciation and other available funds are not as large as in other countries. The greater external reliance does imply that the capital market should function efficiently so as to satisfy the increasing demands of the corporate sector. But this has not been so. The price performances of industrial shares in India has been very poor compared to other countries like the U.K. and U.S.A. etc. The shareholder has suffered great losses during the last few years. The public subscription to shares had become so poor that the proportion of issues of new companies which the underwriters had to carry on their own shoulders had tended to become high amounting in 1964-65 to as much as 83 per cent. Even in the case of established companies the proportion is 40 per cent. As a result of this, there is a decreasing reliance on equity capital for financing new projects - the proportion of equity finance to total finance for such projects declined from 59 per cent in 1962-63 to 36 per cent in 1964-65. The proportion of equity capital from the general public fell from 25 per cent to 3 per cent. It should be a matter of great concern that individuals are no longer taking any interest in the equity shares. The dependence on the financial institutions is growing to an excessive degree. The so called institutionalization of the capital market should not replace the individual who should be the basic source of savings. Even in the United States, U.K. where institutional funds are available in bulk, the individual still holds far greater proportion of the outstanding stocks. Further the capacity of government controlled financial institutions to replace the individual investors is also limited. The only organizations subscribing to industrial securities are the LIC, IBDI, Unit Trust. Even with the addition of ICICI, the combined resources of all of them is too limited to meet the entire demand of the Private Sector - of new equity securities and that except for LIC and Unit Trust all other institutions derive their finance only from government. They do not draw upon the savings of the community. Further the democratic structure of the shareholdings by individuals should be regarded as healthy feature of the corporate enterprise.

Several explanations for the sluggishness of the capital market may be given; but not all of them are valid. The performance of the corporate sector is not bad; indeed it compares well with that in U.K. and U.S.A. The growth of corporate sector's profits has also been faster than the rise in the general level of price and industrial production. What is needed is a sounder fiscal policy which would give encouragement to plough back the profits and bring about a revival of market for equity capital.

It took quite a time for the government to recognise this fact. Recognition came slow but has now come about; particularly in the last budget some of the measures which were adopted had the effect of a good shot in the arm to the stock exchange market. Thus in the field of personal taxation, annuity deposit scheme was discontinued; taxation on dividend income was also liberalised. In regard to the corporate sector, apart from the abolition of tax on excess distribution of equity dividends and the reduction of the rate of surtax the Finance Act provided also for liberal deduction from taxation income of specified categories of expenditure incurred in connection with rising agricultural output and promotion of exports. Another important provision was the abolition of the distinction between earned and unearned income and the exemption of Rs. 500 dividend income from taxation. While these measures are welcome, there should be continuity of the policy and further liberalization possible. The savings rate on which ultimately industrial and other finances depends can also be increased by special techniques of savings promotion. The duty of the government and of the stock exchanges and the Unit Trust of India should be to provide different kinds of incentive schemes to draw funds from different classes of investors with their different psychologies. Much would depend upon the ingenuity of the government in raising resources through meeting the varying needs of the investor. The Unit Trust which has been established is a significant contribution to raising of savings. It would be desirable to have not only more Unit Trusts but Unit Trusts to be organised in the Private Sector. In U.S.A. Mutual Funds which are the counterpart of Unit Trust have made a significant contribution to savings. Similar possibilities exist in India.

Another recent trend has been the distinct shift in favour of fixed income yield securities, preference shares and debentures. The proportion of preference shares and debentures has been increasing and since 1963 almost 90 per cent of them have been offered to public subscription. Thus only companies which were in urgent need of external finance came to the market, issued large amounts of fixed income-yielding securities and offered almost the full amount to the public for subscription. At the same time only a decreasing proportion of equity capital was offered to the public except in 1965. Lastly, market value of shares issued during these years have shown substantial decline.

Capital market which was functioning with reasonable degree of efficiency became very weak in the wake of the Chinese aggression and the fiscal measures that followed it. The stagnation of the capital market also led to distortion in the struction of the corporate sector. The difficulty in getting access to the capital market reduced the number of fresh issues and a heavier recourse to borrowing. Since a good portion of it was short and medium term, the repayment difficulties impaired managerial efficiency. Because with the difficulty in raising equity capital and the institutional investors' preference for preference shares, corporate sector has to fall in line even at the risk of the capital structure becoming lopsided. In recent years, especially after 1965-66, the dividend earning capacity of most companies declined. During 1965-66, 40 per cent of the 1,333 companies each with a paid up capital of Rs. 5 lakhs and over either declared no dividend or a very low one. The Chairman of the IFC has reported that the Corporation's investment in shares of industrial projects at the end of June 1968 amounted to Rs. 10.5 crores yielding as income from dividend of about half per cent against its borrowing of 5.5 per cent to 6 per cent. The problem of disposing of shares devolving on the corporation as a result of underwriting commitments has continued to be a difficult one. The growing disparity has smashed the cult of equity. The corporate sector has sought to finance its long-term investments by resorting to short and medium-term borrowing, and the government has encouraged this process by treating interest paid as an item of expenditure and taxing the dividend twice, once as part of the companies profit and second as part of the shareholders' income. More recently, as has been pointed out earlier, government has granted exemption from tax for the first Rs. 500 of dividend income and for the first Rs. 1,000 of the dividend of Unit Trust and a tax free certificate for 4 years for investment in capital issues subject to certain conditions. One suggestion which I should like to make in order to energise the capital market is to permit industrial companies to pay a minimum rate of interest, say about 4 per cent on all new equities issued to the public leaving the shareholders to receive dividends according to profits earned. The interest of 4 per cent should be treated as expenditure like that of borrowed capital. This may seem a somewhat novel and even revolutionary suggestion. But there is nothing inherently wrong or objectionable in it. If this is done, there will be some incentive to the shareholders to invest in equities because of the guaranteed rate of interest.

To conclude, there has been a revolutionary change in the character of industrial finance since 1951. The rapid industrialization that has taken place in the country with its great diversification has led to large and increasing demands for finance of various kinds. Institutional finance which was wholly absent in pre-Independence India is now playing a very important role. The ability of the managing agents to provide finance has declined. Their contribution to the financing of large companies is very modest. On the other hand, managing agents still play a significant role in the financing of medium and relatively small companies. With the impending abolition of the managing agency system there could be a lacuna in the financial structure relating to medium size companies.

Another basic factor affecting industrial finance is the inadequacy of total savings in the country. Because of the lower rate of growth of national income in recent years combined with other factors the proportion of savings to national income has declined. But there are hopes of recovery; thanks to increases in agricultural income, the rural sector has large incomes which need to be tapped and mobilised. A part of the additional incomes in the rural sector will undoubtedly go to direct investment in agriculture and other activities. But it should be possible to divert a substantial proportion of the increased income to the financial and banking system. If this is done, it would enable industry to get more resources indirectly through banking system, through large mobilization of rural funds. Compared to the situation before 1950, the situation today is certainly much better. There is every reason to hope that finance will not be a serious bottleneck for more rapid industrial development. Mention should be made of the various measures taken by the Reserve Bank of India to extend credit facilities in various ways and for various purposes. The credit guarantee system for the small industry to export, the package credit that is being given to industry for exports and the refinancing facilities afforded by the bank, all are substantial improvements in the financial structure. The decision of the IDBI to directly finance exporters is another welcome trend. Altogether the prospects for better financing of industry are bright.

Until recently the difficulties of the medium and small industries in raising sufficient resources were very serious. As has been pointed out earlier, the supply of credit to medium industries by managing agents was a much larger proportion of their requirements than that to their companies. With the proposed abolition of managing agency system, there is bound to be a gap in the source of finance for medium industries. It is necessary that this gap should be filled by specially requiring one of the existing financial institutions to set aside a larger portion of their assets to medium industries. The difficulties of small industries in securing adequate finance still persist. Until the Small Industries

Board was established which made earnest and continuous efforts to ensure greater flow of credit to smaller industries, they had to depend upon moneylenders, *multanis* and others for their financial requirements. On account of the rigidity of the commercial banking system, they had to resort to borrowings from their relatives and friends as well as from moneylenders. However, since 1958, the conditions have greatly changed. The State Bank of India and other commercial banks have now announced their policy of granting working capital to small industries and during the last year, the total amount of bank credit to small industry was of the order of Rs. 30 crores. The National Credit Council which has been established in pursuance of the policy of Social Control of Banks, has indicated to the banks a target of Rs. 100 crores which is to be provided as working capital to the small industry. If this decision is implemented, there is no need for small industries which are viable and which have promise of profitability to suffer for lack of working capital.

But their needs for relatively long-term capital for purchases of machinery and equipment and for expansion would remain; these have been met only partially by the National Small Industries Corporation. The small industry sector so far has been getting only a small fraction of its credit requirements from institutional sources. From a survey conducted by the organization of Development Commissioner of Small Industries it seems that only about 20 per cent of the credit needs of the small sector are met by the institutions. For the rest, it has to be dependent largely upon internal sources and open loans from friends and relatives. During the Third Plan period, the financial assistance given by different institutions to all industries — large, medium and small — amounted to Rs. 573.3 crores. But only about Rs. 18 to Rs. 20 crores were advanced to small industries by State financial corporations. It has been stated that the additional fixed investment needed by the sector would be about Rs. 250 crores to Rs. 300 crores by the end of the Fourth Plan. At one time a proposal to set up a financial institution specially to serve the small industry sectors was seriously considered. But the proposal was not pressed because it was felt that through the commercial banks and existing financial institutions, it should be possible to meet the essential financial requirements of the small industry sector. Working capital requirement might be of the order of Rs. 600 crores by 1973-74. In view of this it may be hoped that the short-term credit needs of the small industry sector may be fully provided by the State Bank and other commercial banks.

In the Fourth Plan, the investment target for the private industrial sector may be of the order of Rs. 2,500 crores for large and medium industries. The question arises whether the sources available for private industry will provide all the required amounts. If the capital market improves - and this would depend very much upon the fiscal policy of the government — it may be expected that the investing public might show a greater degree of interest in industrial securities. In the Fourth Plan, therefore, it is possible to raise by way of equity a much larger proportion than in the last few years. Provided the economy recovers fast from the recent recession, industry might be expected to work at full capacity and earn reasonable profit. The expectation of profit will undoubtedly stimulate further expansion as well as establishment of new industries. It may be reasonably expected that the proportion of internal resources available will greatly improve. The foreign private capital in partnership with Indian industry or separately might also bring in a reasonable amount of capital. For the balance commercial banks and the financial institutions might be expected to provide no less than 25 per cent of the credit requirements. LIC and Unit Trust might add another 4.65 to 5 per cent; the term credit by commercial banks might add up to another 5 per cent. Thus there should be no insuperable difficulty in finding the necessary finance. In spite of the shift in emphasis and responsibility to agriculture, there should be no difficulty for the commercial banks to provide the needed working capital for industry. The revival of public deposits with industrial companies will also be a help; under suitable safeguards, they can serve as additional resources for working capital.

Whether it is internal or external finance, or whether it be finance for the private sector or the public sector, ultimately the main source is national income. The rate of savings, in terms of national income has gone up from 5 per cent to 10 per cent since 1951; but in 1965-66 and 1966-67, it has gone down. What we need is therefore the raising of the level of savings to 12 per cent to 14 per cent in the next five years of the Fourth Plan. It is not enough if savings increase. It is also a question of diverting savings from unproductive investment to productive investment. Also it should be a policy to ensure that the savings flow through financial institutions which alone can finance essential requirements. From this point of view, the increased income with the agriculturists, however welcome it is, can be effectively utilised only if it can be mobilised by the banking system and for various economic sectors. But taking an overall view, one can reasonably be optimistic about the future.