

CHAPTER III

GROWTH AND ROLE OF CORPORATION IN INDIA (PART II)

In the previous chapter, the discussion on the growth of the corporate sector has thrown some light on the role of the corporate form of business organisation in the economy of the country. Growth of corporations in terms of their number and paid-up capital may be regarded only as one of the indicators of the role of this sector.

The other indicators of the role of corporations are three in number. One of them is the rate of capital formation. Second indicator is the ability of self-financing. The last one is about the share of the corporate sector in the Net Domestic Product of the country. Of these three indicators, the first is an index of companies' contribution to investment. The second indicator is an index of companies' contribution to the saving process. It relates to sources of corporate finance i.e. how capital formation is financed or to what extent internal financing has been achieved. Capital formation and internal financing are two vital processes that may reveal how far the corporate sector has been contributing to its own growth and also the growth of the economy at large. The last indicator explains the position of the corporate sector in the national economy in relation to the non-corporate sectors such as Government sector and the household sector.

As regards the trends in capital formation in the corporate sector of the economy, some useful data are made available by the Taxation Enquiry Commission (1953-54) and the Reserve Bank of India. But, all the detailed and continuous data are available only for the public limited companies and not for the private limited companies. Therefore, in this chapter, only the public limited companies are dealt with. The Taxation Enquiry Commission took a sample of 407 and 448 public companies belonging to manufacturing industries for the period 1946-51. This sample comprised companies having a paid-up capital of Rs.5 lakhs and above and covered 19 major industrial groups. The data are summarised in the following table:-

(Crores of Rupees)

	Assets in 1946		Assets in 1951		Gross assets formation during 1946-51		(3) as percent of (1)	
	1	2	A	B	A	B	A	B
Number of companies	407		407	448	407	448	407	448
Gross fixed assets (of which, plant and machinery)	282 (163)		439 (266)	461 (279)	156 (103)	179 (116)	55 63	63 71
(Depreciation) ..	(153)		(223)	(227)	(70)	(74)	46	48
(Net fixed assets)	(129)		(215)	(234)	(86)	(105)	67	81
Inventory ..	125		232	242	107	117	86	94
Receivables ..	49		87	90	38	41	78	84
Tax advances ..	10		23	24	12	13	130	130
Investments ..	42		30	30	-12	-12	-29	-29
Cash ..	24		41	45	17	21	71	88
Total	533		852	892	320	359	60	67

Source:-Report of the Taxation Enquiry Commission, 1953-54, Vol.I, page 107.

From this table, it can be pointed out that gross capital formation, including that on account of new companies, during the period 1946-51, stood at Rs.359 crores. Of this amount, additions to gross fixed assets accounted for Rs.179 crores and inventory accumulation for Rs.117 crores. Increase in lendings i.e. receivables and tax advances amounted to Rs.54 crores, and increase in investments and cash together to Rs.9 crores. Thus, gross fixed assets accounted for 50 percent of gross capital formation. Inventory accumulation represented one-third of total assets formation. However, from the point of view of the entire public company sector, "the gross capital formation during the five year period 1946-51 in the manufacturing sector for all public limited companies is estimated at Rs.671 crores; the addition of Rs.317 crores of fixed assets (gross) during the period (1) works out to an annual rate of Rs.63 crores".

The above discussion throws light on the performance of public limited companies before the beginning of India's First Five Year Plan. Recently, systematic data relating to company finances are made available by the Reserve Bank of India. The Reserve Bank compiled data for 750 public limited

(1) Report of the Taxation Enquiry Commission, 1953-54, Vol.I, page 114.

companies for the period 1951-55 which is also the period of India's First Plan. Each of these companies had a paid-up capital of Rs.5 lakhs and above. The following table represents data on capital formation during the period, 1951-55:-

(Lakhs of Rupees)

Uses of Funds	1951	1952	1953	1954	1955	Total
(I) <u>Gross Fixed Assets Formation</u>						
(a) Land	186	108	191	205	303	9,93
(b) Buildings	636	835	827	1061	1044	44,03
(c) Plant and Machinery	2183	2842	3380	4629	6024	190,58
(d) Others	252	796	447	451	690	26,36
Total	3257	4581	4845	6346	8061	270,90
(II) Inventory	6041	-1806	-2400	1024	2333	61,92
(III) Lendings	2722	-109	704	1759	1885	69,61
(IV) Investments	245	573	268	480	686	22,52
(V) Increase in Monetary resources	144	-13	516	494	644	17,85
Total	12409	3226	4933	10103	13609	442,80

Based on source:
Table No:8 in Reserve Bank Bulletin, September, 1957, page 853.

The table reveals that the gross fixed assets formation rose from Rs.33 crores in 1951 to Rs.81 crores in 1955. The total uses of funds or what is the same thing as gross capital formation of 750 companies stood at a figure of Rs.124 crores in 1951. It fell to Rs.101 crores in 1954 and rose to Rs.136 crores in 1955. While the gross capital formation has shown rather erratic trends, the gross fixed assets formation has shown a steady rise. Of the gross capital formation of Rs.443 crores during 1951-55, the gross fixed assets formation accounted for about 60 percent. During this period, inventory accumulation revealed wide variations. The value of gross fixed assets at the end of 1955 was about 50 percent higher than at the end of 1950. It can be said that, on the whole, the companies showed a continuous growth from 1953 onwards, after the set back witnessed in 1952 as the aftermath of the Korean boom.

For the first three years of India's Second Plan, the total capital formation in the corporate sector was as under:-

(Amounts in crores of Rupees)

	1956		1957		1958		Total 3 years	
	Public Cos.	175	Public Cos.	226	Public Cos.	188	Public Cos.	589
Gross fixed assets formation	127	167	123	417				
Net fixed assets formation	118	67	4	189				
Inventory accumulation	293	294	192	779				
Total capital formation(gross)	245	234	127	606				
Total capital formation (Net)								

Source: Table No.56 in "The corporate Sector in India", 1960, by R.K.Nigam & N.C.Chaudhari, Dept. of Company Law Administration, Ministry of C.& I., New Delhi, page 80.

From the table, it may be pointed out that as against the total gross capital formation of Rs.293 crores in 1956 and Rs.294 crores in 1957, it stood at a low figure of Rs.192 crores in 1958. The total gross capital formation during 1956-58 stood at Rs.779 crores.

For the year 1959, data for 814 public limited companies are available (vide Reserve Bank Bulletin, February, 1961, pages 198-204). The gross fixed assets formation in these 814 companies amounted to Rs.95.6 crores of which 76 percent was accounted for by plant and machinery. Inventory accumulation amounted to Rs.7.7 crores. Thus, the total gross capital formation i.e. gross fixed assets and Inventories put together amounted to Rs.103.3 crores. In these companies, the rate of total capital formation was 5.7 percent compared to 14.3 percent in 1957 and 8.2 percent in 1958.

For the year 1960, the data for 426 public limited companies (vide Reserve Bank Bulletin, January, 1962, pages 43-48) reveal that the total assets formation in these 426 companies stood at Rs.94.4 crores. The rates of total capital formation for all companies showed a significant improvement and stood at 10.9 percent (gross) and 10.8 percent (net) in 1960 as compared to 4.4 percent (gross) and 2.5 percent (net) in 1959.

From the above discussion, it can be said that the overall trends in capital formation in the corporate sector

could be regarded as satisfactory. In the absence of continuous data for the entire corporate sector (i.e. both for the public and the private limited companies), one can only point out in general that, "if these trends are not interrupted by abnormal factors and situations, the total additional resources that might become available to the corporate sector during the Second Plan as a whole and thereafter during the Third Plan would indeed be substantial".⁽²⁾

The second indicator of the progress of the corporate sector is internal financing. Internal financing when thought in terms of mobilisation and utilisation of resources may be described as an act or process of utilising the retained or undistributed profits to meet the requirements of fixed or working capital. A company's internal funds represent depreciation reserve and free reserves including capitalised reserves.

On the other hand, external financing may imply the use of resources collected outside the business of a company, such as increase in subscribed capital, loan capital, debentures and deposits by the public and payables like tax accruals.

(2) Trends in Company Finances with particular reference to the First and Second Plan periods, 1960, by R.K. Nigam and N.D. Joshi, Dept. of Company Law Administration, Ministry of C.& I., New Delhi, page 47.

Generally, internal financing is governed by the volume of earnings, the policy of dividend distributions and the corporate tax policy of the government. It should be emphasized that the crux of the problem of financing the corporate sector mainly lies in the capacity of the companies to expand with the help of their internal resources. Further, the availability of external resources largely depends on the extent to which companies are able to self-finance. Hence, it is generally the availability or otherwise of internal resources that would set a limit to fixed capital investment.

For the self-sustained growth of the corporate sector, ploughing back of profits is of crucial importance. Of course, a company may plough back the profits for a number of reasons, such as, safeguarding against business cycles, equalising the dividend rates, making good the deficiencies of depreciation, creating or strengthening a sinking fund to meet the debt liabilities and creating a reserve for expansion. Of all these motives, the motive of creating a reserve for further expansion is of the greatest significance in the context of the industrial development of a country. It is mainly due to this reason that while discussing the conditions of a dynamic society, Mrs. Joan Robinson stresses the importance of accumulation

and investment and states that, "for the entrepreneur, the purpose of earning profits is not to indulge in consumption but to preserve and expand his business."⁽³⁾ She further points out that, "the paradoxical seeming pursuit of profits for its own sake has led to the development of an economic system which has proved not only viable but remarkably productive of wealth."⁽⁴⁾

Therefore, in the context of India's Five Year Plans, the Planning Commission too has emphasized the importance of corporate savings. Even before the period of India's Five Year Plans, the corporate savings played an important role in the country. This becomes clear from the following table:-

(3) & (4) The Accumulation of Capital, 1956, by Joan Robinson, pages 39 and 40 respectively.

Sources of Financing Capital Formation during 1946-51
(Crores of Rs.)

	Liabilities	Liabilities		Increase		(3) as per-	
	in 1946	in 1951				cents of	
	(1)	(2)		(3)		(4)	
		A	B	A	B	A	B
Number of Companies	407	407	448	407	448	407	448
Paid-up Capital	159	223	245	64	86	40	54
General reserves	41	62	63	21	22	51	54
Depreciation reserve	153	223	227	70	74	46	48
Taxation reserve	50	49	50	-1	-	-	-
Development and other reserves	45	72	73	27	28	60	62
Borrowings (of which from banks)	77 (23)	162 (67)	172 (71)	85 (44)	95 (48)	110 (191)	123 (209)
Total	533	852	892	320	359	60	67

The totals include "other liabilities" (net)

Source:-Report of Taxation Enquiry Commission, 1953-54,
Vol.I. page 114.

The table shows the sources of funds for financing 448 public companies (407 old and 41 new companies) between 1946 and 1951. During this period, the main sources of finance for these companies were two: additions to paid-up capital by Rs.86 crores and to borrowings by Rs.95 crores. The increase in the bank borrowings was Rs.48 crores, that is, one half of the total increase in borrowings. The increase in internal resources representing general reserve, depreciation reserve and development and other reserves amounted to Rs.124 crores. Whereas the increase in external resources comprising paid-up capital, taxation reserves and borrowing amounted to Rs.181 crores approximately. However, it can be said that the largest increase among the principal means of financing took place in borrowing.

As regards the role of the retained profits during 1946-51 (both years inclusive) in financing the companies, the following table is worked out:-

Totals for 1946-51		
Number of companies	492	438 (including 54 new companies)
(A) Fresh capital (including capitalised reserves)	Rs.53.0 crores	Rs.35.4 crores
(B) Internal finance (total retained profits)	Rs.69.3 crores	Rs.68.6 crores
(C) Retained profits as percentage of total new finance	56.6%	66%

Based on Source: Report of the Taxation Enquiry Commission, 1953-54, Vol.I, page 115.

The table reveals that the retained profits as a percentage of total new finance amounted to 56.6 percent for old and new companies put together; and 66 percent for mostly old companies. In the words of the Taxation Enquiry Commission, "corporate savings provided a larger source than new subscriptions, on the whole, in the financing of industrial expansion during the post war period, including new companies; in respect of the older companies, corporate savings were even more important"⁽⁵⁾.

Against the background of these facts, it would be quite interesting to analyse the broad trends in internal financing of the corporate sector during the period of India's First and Second Five Year Plans.

On the basis of the data made available from the publications mentioned in the footnote⁽⁶⁾ below, the following

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- (5) Report of the Taxation Enquiry Commission, 1953-54, Vol. I, page 115.
 - (6) (1) Reserve Bank Bulletin, September, 1957, Pages 851-854
 - (2) " " " " October, 1958, pages 1133-1172
 - (3) " " " " February, 1959, pages 186-192
 - (4) " " " " August, 1959, pages 955-1007
 - (5) " " " " September, 1960, pages 1243-1310
 - (6) " " " " February, 1961, pages 198-204
 - (7) " " " " September, 1961, pages 1403-1457
 - (8) " " " " January, 1962, pages 39-48
 - (9) " " " " February, 1962, pages 171-178

table has been worked out to indicate the trends in financing the sector of public companies during the period of the two Plans i.e. 1951-60. In preparing the table, first of all, the figures for internal and external sources of finance were collected for every year. They were totalled up for the two separate periods of the two Plans, and then the totals were converted into percentages. The figures have been rounded. Data for the Second Plan period are rough estimates, since all the data for 1960 are not yet available.

Pattern of sources of funds of selected public companies during 1951-60

Pattern of Sources	First Plan period (%) 750 public Cos.	Second Plan period (%) 1001 public Cos.
(A) Internal Sources:		
Total ..	60	40
(a) Depreciation reserve	29	22
(b) Capital reserve	6	1
(c) General & Other reserves	17	15
(d) Taxation reserves	8	2
(B) External Sources:		
Total ..	40	60
(a) Paid-up capital	7	12
(b) Borrowing :Total ..	17	31
(i) From banks	6	15
(ii) Mortgages	5	2
(iii) Debentures	2	-
(iv) I.F. Corporations	Not available	1
(v) Trade dues etc.	16	17
(C) Total funds		
	100.0	100.0

Sources: as mentioned on page 51 , in the footnote.

Despite certain limitations of these data, the table throws adequate light on the pattern of sources of finance for the public companies during the period of one decade of planning. During the First Plan period, a major part of the increase in the resources of the public companies took place under the internal heads. The ratio of additional internal resources to additional external resources during the First Plan period comes to 3:2. Whereas, this ratio during the Second Plan period comes to about 1:2.

This shows a clear shift in favour of the external sources of company finances. From the Reserve Bank's data, it becomes evident that with the beginning of India's First Five Year Plan, a large increase among the main means of financing took place in borrowing, indicating thereby a clear change in the financial structure of companies. This trend seems to have gathered momentum in the Second Plan period due to the phenomenal increase in borrowings from the banks. During the First Plan period when the average annual rate of fixed assets formation was about 9 percent, internal sources could provide as much as 60 percent of the total funds. Of the 40 percent external sources, only 6 percent came from banks. Whereas, during the Second Plan period, eventhough the rate of fixed assets formation doubled (roughly 18 percent), the internal sources provided

only 40 percent of the funds required. Of the 60 percent external sources, the share of the banks was 15 percent as against 6 percent in the First Plan period. Total borrowings including the bank loans amounted to 31 percent as against 17 percent during the First Plan period.

This trend of relying more and more on banks raises some issues of crucial importance. At a time when the Planning Commission has cautiously curtailed the volume of deficit finance to curb inflationary trends during the Third Plan period, if the industries rely more and more on bank money, it is bound to be inflationary. During the Second Plan period, restrictions on bank advances had to be imposed to avoid unnecessary inflationary trends in the economy. Further, if the trend of relying more and more on bank money is allowed to continue, the ratio of borrowed capital to that collected as paid-up capital may become adverse, thereby weakening the equity base of the corporate sector.

Indeed, against the above mentioned point of view, it can be argued that in any case, an ideal proportion of equity to loan capital cannot be laid down, when one speaks of the corporate sector as a whole. In Japan, bank borrowings constitute one of the most important sources of corporate finance and generally contribute even more than internal resources of the companies. In 1957 and 1958, bank credit

formed 41.4 and 38.5 percent respectively of the total funds used by Japanese companies as compared with 30.0 and 33.2 percent from the internal resources and 19.5 and 23.2 percent obtained from new issues. In the U.S.A. and the U.K., bank loans play a relatively less important role; whereas, debentures or bonds provide a substantial part of the funds. Excessive bond financing has often caused much concern in the U.S.A. In India, debentures are relatively less important in the capital structure of the companies. It represented only 10 percent of the paid-up capital at the end of 1957. Of the total capital issues in 1956 and 1957, debentures accounted for only 5.7 percent (Rs.1.4 crores) and 3.5 percent (Rs.1 crore) respectively.

It may also be argued that in a period of rising levels of taxation, companies may find loan financing more attractive than equity financing. Because, for tax purpose, interest on loan capital is deductible; whereas, dividends are not allowed to escape the burden of tax. Thus, loan financing reduces the cost of financing the asset formation of the companies.

But, then it should be remembered that it is a sound principle of company finance that long term investment must always be financed out of the long term source of capital.

Therefore, the general rule is that a company must at least retain sufficient capital to be able to finance its fixed assets investment. In this sense, self-financing happens to be a strategic source of company financing. It is for this important reason that a taxing authority is expected to see that taxation of companies does not harshly cut into the ability of the companies to self-finance. This point will be elaborated in chapter XII to emphasise the need of strengthening and stabilising the internal resources of the Indian Companies through the devices of flexible, liberal depreciation allowances system and tax free investment reserves of the Swedish type.

From the above discussion, it may be said that in view of the obvious dangers of bank loan financing, more reliance on bank loans is by no means a desirable trend. Often the cost of external financing is considered in terms of interest charges alone, but not in terms of non-monetary costs such as: becoming beholden to creditors; diluting the per share earnings of the company; or sharing control with new stockholders. These non-monetary costs of external financing are greater than the companies may be willing to pay. The larger the amount of external financing, the greater will be these non-monetary costs. Added to this

will be the danger of weakening the equity base of companies, unsound financial structure and new inflationary trends.

As regards the future trends in internal financing, an interesting projection to show the future trends in the growth of corporate profits is now available, for the period of the Third Five Year Plan. It has been shown that, "corporate income which stood at Rs.220 crores in 1957-58 should rise to Rs.280 crores in 1960-61 and Rs.480 crores in 1965-66. At the current rate (45 percent), collections should amount to Rs.126 crores in 1960-61 and Rs.216 crores in 1965-66."⁽⁶⁾ Also if the tax receipts from the foreign companies and section 23-A companies are added to the estimated figure of Rs.216 crores, it may roughly come to a minimum of Rs.225 crores. Therefore, profits after tax will stand at Rs.150 crores in 1960-61 and Rs.225 crores in 1965-66. If the companies are able to retain at least between 50 and 60 percent of their profits after tax, then alone they will be able to maintain a high tempo of self-financing. If they fail to achieve this, it may defeat the purpose of creating a self-reliant corporate sector over a period of time.

Then, comes the third indicator, namely, the share of companies in the Net Domestic Product of the country.

(7) Resource Prospects of the Third Five Year Plan, 1960, by I.S.Gulati, page 14.

The following table explains the role of the corporate sector in this regard.

Share of the corporate sector in the Total Net Domestic Product at factor cost

	1948-49	1950-51	1956-57	1957-58
Share of the corporate sector in the total net domestic product at factor cost	7%	8%	11%	12%
Share of the corporate sector (excluding Government companies) in the total net domestic product at factor cost for the non-government sector	8%	10%	12%	13%

Source: The Corporate Sector in India, 1961, by R.K.Nigam and N.C.Chaudhuri, Dept. of Company Law Administration, page 3.

The table shows that the share of the corporate sector in India's domestic net product at factor cost was 7 percent in 1948-49. It rose to 12 percent in 1957-58. If the contribution of the Government companies is excluded, the share of the corporate sector in the total net domestic product for non-Government sector seems to have increased from 8 percent in 1948-49 to 13 percent in 1957-58. These figures indicate that the share of the corporate sector has been slowly increasing during the post-Independence period.

The role of the corporate sector can also be briefly mentioned in terms of employment, tax yield etc. At present, this sector enjoys a very wide control over the industrial sector of the economy. As much as 92 percent of

the total factory output in the 28 major industries of India comes from factories owned by the companies. The output of this sector is estimated to have risen by over 50 percent during the ten year period ending in 1957-58. This sector employs about 18 lakh persons of whom 16 lakhs are workers. The annual wage bill paid by the whole of the corporate sector is placed at Rs.350 crores a year.

From the point of view of tax yield, in the total income tax revenue of the Government, the share of the corporate sector comes to more than 50 percent and, in the overall revenues of the Government from all sources, the income tax paid by the companies come to 12 percent.

The important role of the corporate sector is also recognised in India's Third Five Year Plan ~~xxx~~. Of the total planned investment allocated to the private sector, about 46 percent is to be made in the corporate sector. And in the total investment outlay in both the public and the private sectors, the share of the corporate sector is estimated at around 18 percent.

Thus, the corporate sector plays a significant and decisive role in the economy of the country. It would therefore be no exaggeration to say that the corporate enterprises are really the pulse of the national economy of the country. Their birth, prosperity and demise generally reflect the financial conditions in a country, more so in the developing

economy of India.

This also explains the importance of the study of corporate taxation in its different aspects. In assessing the possibility of tax reforms in the field of company taxation, the role of the companies has got to be kept in view as one of the guiding factors. Because, it not only explains the strength and the weaknesses of the corporate sector but also explains whether or not there is a necessity of widening or narrowing the tax base, raising or lowering the tax rates and inducing or restricting investment through taxation.