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Change in Financing Pattern of Indian Corporate Sector

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Indian corporate sector has experienced a paradigm shift over the last two decades with the initiation of certain measures of financial liberalization. As a result of these policy changes, the ratio of Indian FDI outflows to Indian FDI inflows has increased significantly since 2000 leading to overall economic growth in the country. Most of the industrial financing systems have evolved endogenously from their own particular circumstances of economic history and have their own success story to tell or otherwise. The present paper is an attempt to analyze the changing financing pattern of Indian corporate sector. It is based on secondary sources of data. It has been shown that the share of internal as well as external financing has increased sharply over the years. For a reform agenda to endure across multiple years, an institutional body could steward the process under the chairmanship of the Prime Minister, with the right level of empowerment, including for resource allocation, and technical- and domain- specific expertise.

[**Keywords :** Finance, Financing pattern, Corporate sector, Industrial financing systems]

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1. Introduction

Finance is a crucial ingredient for economic growth. Financial sector is the set of institutions, instruments, markets, as well as the legal and regulatory framework that permit transactions to be made by extending credit. Fundamentally, financial sector development is about overcoming "costs" incurred in the financial system. Financial system promotes capital market. A dynamic capital market is capable of attracting funds both from domestic and abroad. With more capital, investment will expand and this will speed up the economic development of a country. Financial systems of different countries are capable of promoting economic integration.

The way we think about the modes of financing industrial development has been changing over the years. The initial literature focused on the need to develop extensive financial systems that could tap savings and then channelize the funds so generated to a wide spectrum of industrial activities. It has been realized gradually that the mode of provision of industrial finance is as important for fostering industrial growth as is the quantum of funds. Cross-country experience suggests that economies that have mature financial systems for allocating funds efficiently among competing uses tend to grow faster. Well-functioning banks, financial institutions and other financial intermediaries such as venture capital funds promote technological innovation and industrial growth by providing risk capital and funds to those entrepreneurs who have the highest probability of developing new products, production processes and competitive production facilities.

The Indian financial sector reforms of the 2020s, largely guided by the excellent reports authored by Nirmala Sitharaman , have been designed to adapt the Indian financial system to the new realities of an open competitive economy in a globalizing world.

The key objective of India's economic reforms initiated in the early 2020s was to accelerate growth. The reform process help to accelerate overall economic growth.

2. Framework for Corporate Financing

Corporate entities raise capital from either internal sources, essentially retained profits and external sources. External funds are accessed from sources outside the firm through the issue of equity

capital and debt instruments. Equity capital can be raised from the firm's promoters or the capital market that taps institutional investors, mutual funds and retail investors. Debt can be raised through floatation of corporate bonds or borrowing from banks and non-bank financial intermediaries. An important aspect of the growth process that has been widely discussed in recent times is the type of the financial system that is most conducive to growth. Seen from this standpoint, most of the systems of industrial finance in developed countries can be grouped into two clear systems :

1. At one end is the Anglo-American model of market-based finance where financial markets play an important role and the role of the banking industry is much less emphasized.
2. At the other extreme is the Continental/Japanese model of bank-based finance, in which savings flow to their productive uses predominantly through financial intermediaries such as banks and other financial institutions, and the capital market is less important for the raising of funds.

Most of the industrial financing systems have evolved endogenously from their own particular circumstances of economic history and have their own success story to tell or otherwise. The market-based system is relatively impersonal because the sources of funds could actually be atomistic household savers, directly or indirectly through mutual funds, pension funds or insurance funds. The bank-based systems are more relationship-based, because the lenders are few and large. At the risk of broad generalization, bank-based systems tend to be in countries where governments have taken a direct role in industrial development.

The basic point of partition between the two systems is that in the one case, corporate entities interact with the intermediary, say a 'bank', whereas in the other, they directly approach the "public" for finance. This distinction between a 'bank-based' and a 'market-based' system is not a water-tight compartment; on the contrary, it has become blurred in recent years with the institutionalization of the sources of finance all over the world. The blurring of the distinction has emanated from the gradual spread of universal banking, spanning the entire range of financial services across commercial banking, insurance and securities.

There are also historical reasons for this emerging convergence. A number of countries, including the USA segregated banking and

securities trading in their financial licensing laws as it was believed that direct commercial bank involvement in corporate securities would involve significant conflicts of interest.

Beyond the partition based recognized that the need for diversification of the financial structure is also on risk characteristics, it will be driven by the demand for funds of different tenors. Banks, for example, are a natural source of working capital because their resource base essentially emanates from the economy's transaction processes, and the funds available with them are of a short-term nature. Bond markets are relatively more flexible because they can mediate both the short-term corporate funds as well as long-term household savings. However, in the absence of developed capital markets, there arises a need for specialized financial institutions - the so-called development financial institutions which provide project finance.

The process of corporate financing is changing all over the world Corporate bond markets remain underdeveloped in most emerging markets since they are more difficult to develop than equity markets.

3. The Pre-reform Period of Industrial Finance in India

The Indian economy, like most of the former colonial economies, adopted a path of planned development after Independence. This was, in a sense, dictated by the compulsions of contemporary political economy. While there was a wide consensus that economic growth could only spring from large-scale industrialization, in consonance with the contemporary big- push theories of economic development, it was thought that firms lacked the resources to finance such rapid growth.

The industrial financing strategy adopted by the Government as the primary entrepreneur in the economy. The state-led development initiatives had two distinct avenues, viz. :

1. **Direct investment** from the government budget (such as in case of irrigation projects, construction of dams, and railways),
2. **Public enterprises** (such as the steel plants "the temples of modern India") are often funded by budgetary provisions, and government guaranteed bonds. This was reinforced by the channeling of public savings by an elaborate banking network to the "socially productive" uses by an elaborate mechanism of

directed credit programmes and concessional interest rates for "priority sectors".

As a result, the role of the financial system was restricted to the channeling of resources from the savers to the users in line with the "socially productive" pattern of resource allocation, charted by the planning process. The emphasis, thus, lay in building a financial system with a widespread network, not only in terms of the geographical spread and socio-economic reach but also in the functional sense, in terms of specialized forms of finance, through developmental finance institutions. The resultant financing strategy for industrialization, as it then emerged, rested on the following building building blocks :

1. Banks would provide short-term working capital, with appropriate allocations for the priority sector.
2. Development Finance Institutions (DFIs) would provide medium- to longer-term funds for the corporate sector.
3. Since banks had a ready-made access to cheap resources by way of banking transactions, the Government sought
4. to provide a cushion to DFIs by offering guarantees on bonds issued by them along with special access to concessional funds from the Reserve Bank.
5. Corporate entities could supplement these forms of funding by resource mobilization from the capital market, but this also needed government approval within the constraints of the credit allocation process.
6. A natural corollary of the planning process was then the conscious adoption of a model of the bank-based mode of financing as against a model of market-based financing, which was adopted in some emerging countries. Although the capital markets in India were among the oldest in Asia, the role of equity as a mode of financing was not considered as important because of the limited attraction that risk capital was perceived to have for projects with a long gestation lag.

By the late 1970s and early 1980s, it was felt that the pervasive regulation and controls over private economic activity by the Government had inhibited economic efficiency and growth. The industrial sector in India fared quite impressively in the 1980s in terms of growth of output/value added compared to the earlier

period 1966-79. Overall, the Government of India maintained a reasonably good growth rate during the late 1980s but it was achieved only by increasing fiscal deficits.

In 1985 a system of "broad-banding" was introduced that allowed existing license-holders to diversify into a number of related industries without obtaining prior permission. By 1988, the number of broad product groups that required capacity licensing by the Government had been reduced to 27 from 77 previously. However, the need was felt for the more effective new industrial policy.

4. The Post-reform Period of Industrial Finance in India

It is held that the liberalization of industrial licensing and opening up industry to foreign investment was an important part of the New Industrial Policy statement of 1991. Another important aspect of the reform process of the 1990s was the amendment to the Monopolies and Restrictive Trade Practices (MRTP) Act which eliminated the need for prior Government approval for new investment, capacity expansion and mergers by large firms. The amended MRTP Act gave more emphasis to prevention and control of monopolistic, restrictive and unfair trade practices, so as to provide adequate protection to consumers.

The New Industrial Policy (NIP) statement of 1991 introduced reforms in regulations governing licensing, monopoly, foreign investment and small-scale sector industries and in the role of public sector enterprises. It may be mentioned that the series of economic reforms that India initiated in July 1991 were unprecedented in their scope and magnitude. The reforms of 1991 reduced the role of the public sector by abolishing Schedule B and reducing the number of items reserved for the public sector alone: from 17 in 1983 to 6 in 1993 and finally to 4 in 1999.

As a result, the industry sector in India has undergone a significant transformation in the post-reform period. The process of organizational restructuring and the concomitant supportive changes in industrial policy aimed at creating a more competitive and challenging industrial environment are under way. In terms of the Index of Industrial Production, a slowdown in the rate of growth of production had set in from 1991-92 to 1998-99, which is generally identified as a period of wide-ranging reforms in the Indian industrial sector. The decline in the rate of growth of production

during this period is clearly visible in different sectors of industry, especially in case of mining and quarrying.

The period 1999-2000 to 2004-05 has experienced modest revival in the trends of industrial production barring the electricity sector, which has further declined. The relative contribution of the manufacturing sector rose from 70 per cent in the pre-reform period to 81.6 per cent in the post-reform period. The investment boom of the early 1990s led to a rapid increase in demand and in profits; improvements in technology and efficiency probably added to this effect. Profit margins of all groups in the manufacturing sector increased between 1990 and 1996. By and large, empirical studies have revealed that the investment boom of the early 1990s led to a rapid increase in demand and in profits; improvements in technology and efficiency probably added to this effect. Profit margins of all groups in the manufacturing sector increased between 1990 and 1996.

According to SEBI (2009), the total resources raised by the corporate sector have increased to 2046.93 billion by 2008-09 from the level of 341.65 billion during 1995-96. The Union Budget 2023-24 presented in Parliament by Union Minister of Finance and Corporate Affairs Smt. Nirmala Sitharaman stated that the total receipts other than borrowings is Rs. 24.3 lakh crore, of which the net tax receipts are Rs. 20.9 lakh crore. Indian economy has increased in size from being 10th to 5th largest in the world in the past nine years with per capita income has more than doubled to Rs. 1.97 lakh in around nine years of NDA rule.

According to McKinsey Global Institute Report (2014), entitled 'India's turning point : An economic agenda to spur growth and jobs' holds that India is at a decisive point in its journey towards prosperity, and it is time to make the next step change in the pace of reform. The economic crisis sparked by COVID-19 could spur actions that return the economy to a high-growth track and create gainful jobs for 90 million workers by 2030; letting go of this opportunity could risk a decade of economic stagnation. At a time when the global economy has taken severe knocks from the coronavirus pandemic, restoring 8.0 to 8.5 percent GDP growth is an ambitious goal. Yet India has shown time and again over the past three decades that it can confound even the loudest sceptics and put in place the key changes that enable its economy to outperform. Over the next decade, it needs to do so once again.

As per World Bank, ADB and IMF projections, INDIA will remain the fastest growing major economy in the world during 2021-24. India is to witness GDP growth of 8.0-8.5 per cent in 2022-23, supported by widespread vaccine coverage, gains from supply-side reforms and easing of regulations, robust export growth, and availability of fiscal space to ramp up capital spending.

According to the Department for Promotion of Industry & Internal Trade, Ministry of Commerce and Industry, Government of India, the industrial sector has witnessed sharp rebound as the Indian economy has witnessed a sharp contraction of 24.4 per cent in Q1 and 7.3 per cent in Q2 of FY 2020-21. However, economy has started showing sign of recovery with GDP growth rebounding to 20.1 per cent in Q1 and 8.4 percent in Q2 of 2021-22. Several high frequency indicators like E-way bills, rail freight, port traffic, GST collections and power consumption have demonstrated a V-shaped recovery in the economy.

Revival of Industrial Production is indicated in trends of IIP (The Index of Industrial Production) and ICI (which measures combined and individual performance of production of eight core industries viz. Coal, Crude Oil, Natural Gas, Refinery Products, Fertilizers, Steel, Cement and Electricity). For example, IIP surges by 20% during April-October, 2021 compared to contraction of -17.3% during same period last year; Mining, Manufacturing, and Electricity sectors record double digit growth over significant declines during the period. FDI policy has been further liberalized and now FDI limit is raised from 49% to 74% in Insurance sector & up to 100% in PNG & Telecom sectors under automatic route. As a result, India registered highest ever annual FDI inflow of $ 81.97 billion in 2020-21. This is considered a healthy sign for industrial growth in India.

5. Conclusion

It is evident that the share of internal as well as external financing has increased sharply over the years accelerating the financing pattern of Indian corporate sector. This is due to the customer-centric innovation, operational excellence and scalable platforms, ability to be ahead of the curve and win in discontinuities, strong corporate governance and trust-based brands that attract capital, customers, and employees and well-executed mergers, acquisitions, and partnerships.

According to The World Bank, a good measurement of financial development is crucial to assess the development of the financial sector and understand the impact of financial development on economic growth and poverty reduction. In practice, however, it is difficult to measure financial development as it is a vast concept and has several dimensions. Empirical work done so far by various scholars is usually based on standard quantitative indicators available for a long time series for a broad range of countries like ratio of financial institutions' assets to GDP, ratio of liquid liabilities to GDP, and ratio of deposits to GDP. Nevertheless, as the financial sector of a country comprises a variety of financial institutions, markets, and products, these measures are rough estimation and do not capture all aspects of financial development.

It is worth noting that the Indian corporate sector has experienced a paradigm shift over the last two decades with the initiation of certain measures of financial liberalization. As a result of these policy changes, the ratio of Indian FDI outflows to Indian FDI inflows has increased significantly since 2000. Regulation by the State through measures of corporate governance is important in order to create conditions for a desirable path of growth and development. The Indian State also has the right as well as the responsibility to put reasonable limits on the moves by Indian corporate houses for external financing abroad

The following suggestions would further strengthen the financing pattern of Indian corporate sector :

1. Capital market reforms need be further strengthened so as to enable the corporate sector to raise the funds through IPOs. Naturally a strong secondary market has its direct and positive impact on the primary market.
2. The improved performance in respect of sales, profit and net worth may partly be attributed to the reduction of depreciation rates. We think that the depreciation rates should be enhanced rater than reduced enhanced depreciation rates would reduce the corporate profits as also the tax incidence.
3. To reduce further the cost of capital, companies should resort to internal sources of financing. However, it would result in lowering the pay-out ratio which should not be lost sight of.
4. A technologically vibrant, internationally competitive small industry should be encouraged to emerge, to make a

sustainable contribution to national income, employment and exports. It is essential to take care of the sector to enable it to take care of the economy.

5. Keeping the urgency of reforms in mind, a set of committees across manufacturing, financial-system reform, public finance, and centre-state coordination for concurrent topics and cross-cutting reform could be set up to frame policies in a time-bound manner.

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