# Disinvestment and privatisation

Ownership reform in public sector enterprises (PSEs) initiated since 1991 has as yet been quantitatively modest. It is perhaps too early to judge the effects of these initiatives on their financial performance. While the slow pace of the reform can be perceived as an opportunity, there is perhaps merit in carefully reviewing the policy in light of economic theory, and comparative experience. As the bulk of the public investments are in industries with economies of scale and scope (with externalities that in principle invite considerable regulation), this study suggests an alternative institutional arrangement for improving PSEs' financial performance: mutual stock holding among complementary enterprises tied around a public sector bank to minimise problems of soft budget constraint, dysfunctional legislative and bureaucratic interference, and to encourage close interaction between banks and firms to promote long term economic development.

Introduction:

Employing about 19 million persons, public sector currently contributes about a quarter of India's measured domestic output. Administrative departments (including defense) account for about 2/5th of it, the rest comes from a few departmental enterprises (like railways and postal services), and a large number of varied non-departmental enterprises producing a range of goods and services. These include, close to 250 public sector enterprises (PSEs) owned and managed by the central government, mostly in industry and services (excluding the commercial banks and financial institutions). At the state level, production and distribution of electricity, and provision of passenger road transport form the principal activities under public sector, run mostly by autonomous boards and statutory corporations.

Though public investment in irrigation would perhaps rank next only to electricity in most states, it is generally viewed as public service, hence counted as part of public administration. Besides, there are about 1, 100 state level public enterprises (SLPEs) that are relatively small in size. While the contribution of all these varied publicly owned and managed entities to national development is widely acknowledged, their poor financial return has been a matter of enduring concern – especially since the mid-1980s when, for the first time, the central government's revenue account turned negative – an imbalance that has persisted ever since.

In 1991, a small fraction of the equity in selected central PSEs was sold to raise resources to bridge the fiscal deficit. Though quantitatively modest (as will be seen later), the ' disinvestment' signaled a major departure in India's economic policy. While there have been instances of sale of publicly owned enterprises as running concerns on pragmatic considerations, it is only in the last decade that such sales (and sale of limited equity) acquired the status of public policy. Table 1 summarises what successive union finance ministers have said about the policy intent in their budgetary speeches, how they wished to pursue it, and what they planned to use the proceeds for.

Such a shift in policy is in tune with the widespread move away from public ownership since it was initiated in the late 1970s in the UK, and in the early 1980s in Chile – a change that has swept the world since then. Structural adjustment lending that was initiated around the same time by the Bretton Woods institutions' included privatisation as an integral component of the policy based lending for the economies in financial distress. Such an initiative was buttressed by the World Bank's influential official publication,

Bureaucrats in Business (1995), which was a serious indictment of how the extension of the state in provision of private goods and services resulted in serious loss of efficiency, waste and lost growth opportunities for many less developed economies.

In macroeconomics, especially after the Latin American debt and inflationary crisis in the 1980s, privatisation was widely advocated as a quick and sure means of restoring budgetary balance, to revive growth on a sustainable basis (Dornbusch, 1991). At the micro level, the change in ownership is often advocated to increase domestic competition, hence efficiency; and encourage public participation in domestic stock market – all of which is believed to promote ‘ popular’ capitalism that rewards risk taking and private initiative, that is expected to yield superior economic outcomes.

Thus, these changes are part a wider reversal in perception and policy in the recent times. Without attempting a detailed appraisal of the analytics and evidence of privatisation, this report briefly reviews the Indian experience in Part I, and examines the policy options in Part II. The study is largely restricted manufacturing and non-financial enterprises owned and managed by the central government.

Part I

Review of Disinvestment and Privatisation

Disinvestment was initiated by selling undisclosed bundles of equity shares of selected central PSEs to public investment institutions (like the UTI), which were free to dispose off these shares in the booming secondary stock

market. The process however came to an abrupt halt when the market collapsed in the aftermath of Harshad Mehta led scam, as the asking prices plummeted below the reserve prices.[6] Since the stock market remained subdued for much of the 1990s, the disinvestment targets remained largely unmet.

The change of government at the Centre in 1996 led to some rethinking about the policy, but not a reversal. A Disinvestment Commission was constituted to advise the government on whether to disinvest in a particular enterprise, its modalities and the utilization of the proceeds. The commission, among other things, recommended (Disinvestment Commission, 1997):

• Restructuring and reorganization of PSEs before disinvestment, • Strengthening of the well-functioning enterprises, and • To utilize the disinvestment proceeds to create a fund for restructuring of PSEs.

In response to the public debate, and to the commission's recommendations, some large and well-functioning PSEs were declared " jewels" (Navaratnas) in the government's crown, and were granted greater managerial and financial autonomy. However, disinvestment did not pick up as the share prices remained subdued because of the scandals that rocked the financial markets.[7] But, by the turn of the decade, there was some improvement mainly in response to the stock boom engineered by Ketan Parikh. Apparently some PSEs stocks were part of the scandal, which this time also involved the UTI.[8]

The new government that came to power in 1998 preferred to sell large chunks of equity in selected enterprises to “ strategic” partners – a euphemism for transfer of managerial control to private enterprises. A separate ministry was created to speed up the process, as it was widely believed that the operating ministries are often reluctant to part with PSEs for disinvestments as it means loss of power for the concerned ministers and civil servants. The sales were organised through auctions or by inviting bids, bypassing the stock market (which continued to be sluggish), justified on the grounds of better price realisation. Notwithstanding the serious discussion on the utilization of disinvestment proceeds, they continued to be used only to bridge the fiscal deficit.

Strategic sale in many countries have been controversial as it is said to give rise to a lot of corruption, discrediting the policy process. Aware of such pitfalls, efforts were made to be transparent in all the stages of the process: selection of consultants to advice on the sale, invitation of bids, opening of tenders and so on. Between 1999 and 2003, much greater quantum of public assets were sold in this manner, compared to the earlier process, though the realised amounts were consistently less than the targets – except in 2003 (Table 2 and 3).

Nonetheless, there are series of allegations of corruption and malpractice in many of these deals that have been widely discussed in the press and the parliament. Instances of under pricing of assets, favouring preferred buyers, non-compliance of agreement with respect to employment and retrenchment, and many incomplete contracts with respect to sale of land, and assets have been widely reported.[9] Thus, during the last 13 years Rs.

29, 520 crores were realised by sale of equity in selected central government PSEs, (in some cases) relinquishing managerial control as well (Table 4). This formed less than one per cent of central government's cumulative fiscal deficit in this period.

Amid disinvestment and privatisation, some new PSEs are also created. For instance, many departmental activities were being corporatised (setting up of BSNL for instance) with a view to disinvestment. New PSEs are also formed to take up newer activities like road development corporations (promoted by state governments to execute highways and irrigation projects).

Legal issues in the D-P process:

Legality of the disinvestment process has been challenged on a variety of grounds that slowed the sale of public assets. However, there were two significant judicial rulings that broadly set the boundaries of the D-P process. These are:

1. Privatisation is a policy decision, prerogative of the executive branch of the state; courts would not interfere in it. 2. Privatisation of the PSE created by an act of parliament would have to get the parliamentary approval. While the first ruling gave impetus for strategic sale of many enterprises like Hindustan Zinc, Maruti, and VSNL etc. since 2000, the second ruling stalled the privatisation of the petroleum companies, as government was unsure of getting the laws amended in the parliament.

Privatisation at the state level:

A sizable proportion of the state level enterprises are “ welfare corporations” largely intended to meet social welfare objectives, and to secure resources from public sector banks and development financial institutions. However, many SLPEs are also involved in manufacturing and mining activities to utilize local resources and to cater to the regional markets. SLPEs as a whole make sizable financial losses.

Privatisation at the state level began somewhat earlier than at the Centre. Sale of the state government’s equity holding in Allwyn Nissan Limited in Andhra Pradesh in 1989, UP State Cement Corporation to Dalmia Group, and Auto Tractors in 1991 – were precursors to the national level policy changes (Bajaj, 1994)[11]. By 2003, 35 such SLPEs have been privatized. But, interestingly, over five times as many enterprises (180) were shut down during this period (Table 5).

Employment in PSEs:

As Figure 1 shows, employment in the central PSEs has declined from about 2. 2 million in 1991-92 to about 1. 7 million a decade later. A marginal rise in 2001-02 is on account of the shift of employment from department of telecommunication to incorporation of BSNL as a corporate entity. If one traces employment in a set of same enterprises over the 1990s, perhaps the decline would be greater. The fall in employment is clearly the result of voluntary retirement scheme (VRS) initiated using the National Renewal Fund, as part of the structural adjustment programme.

What has happened to employment after privatisation? Perhaps it is too early to get firm evidence since substantial privatisation occurred only

during the last four years. However, popular reports suggest some retrenchments and compulsory retirement of workers. Reportedly some private firms have violated their contract in this regard (Modern Foods, for instance). There are also reports of employment generation at BALCO on account of capacity expansion.

Performance of PSEs after disinvestment and privatisation:

In principle, disinvestment is unlikely to affect economic performance since the state continues to be the dominant shareholder, whose conduct is unlikely to be influenced by share prices movements (or return on equity). Privatisation can be expected to influence economic outcome provided the firm operates in a competitive environment; if not, it would be difficult to attribute changes performance sole or mainly to the change in ownership.

Assessing the principles, premises and performance of the D-P process:

Right from the beginning in the UK, privatisation has been a policy in search of an economic rationale – to borrow the title of Kay and Thompson’s (1986) well-known contribution. Mainstream economics is largely agnostic about the role of ownership, focusing mainly on how market structure affects performance of firms (Vickers and Yarrow, 1991). If privatisation is seen as a means of raising resources for the budget, it can be analytically shown to be cheaper to sell public bonds than public assets (Yarrow, 1986).

Instead of seeking the reasons for privatization, one could instead ask why a certain firm should remain in public sector. Some would contend that with rapid technological change, natural monopoly, as a powerful argument for

public ownership has simply disappeared. Such an argument would surely hold for telecommunications, not but for the rest of public monopolies. Based on studies of privatisation of natural monopolies, Ravi Ramamurthi (1999) contended:

Sectors such as railways, however, are harder to regulate after privatization (see Ramamurthi, 1997). The regulatory task can be especially difficult in sectors such as highways, or water or sewage, where competition is weak or totally absent, investments are lumpier, externalities are much more important, and pay back periods run 8-10 years or more, thereby increasing uncertainty and risk for contracting parties. Renegotiations are likely to be the rule, brought on by unanticipated developments or simply opportunism on the part of investors or governments. History is full of examples in which such arrangements have fallen apart a few years after they were signed (Ramamurthi, 1999: 149).

In fact, it is mainly the property right theorists who have underlined the role of ownership on economic performance (Fama, 1980). But in the twentieth century, with the separation of ownership from control in modern industry, there is a serious agency problem regardless of its ownership. The view that the secondary capital market and the market for managers provide adequate discipline on a firm's performance is at variance with evidence, especially the US experience (more about it later).

What is the evidence on the efficiency effects of privatisation? It is highly mixed, to put it mildly. Florio (2004), perhaps the most recent and definitive quantitative account covering the longest time period of the UK experience,

does not show any measurable efficiency gains on account of the changes in ownership. World Bank's official study (Ghalal et al, 1995), perhaps the most careful exercise at making pair-wise comparisons of comparable firms in many countries, was extremely cautious in suggesting welfare gains. In fact, one of the authors of the study, Pankaj Tandon, in an independent paper was more categorical in rejecting the hypothesis of efficiency gains from privatisation in less developed countries (Tandon 1997). If this selective review of evidence is anything to go by, then one should have a modest expectation from whatever privatisation that has happened in India.[12]

Britain, the cradle of modern capitalism, has witnesses the public policy pendulum swing from nationalisation to privatisation (or denationalization) many times over, in the 20th century. While the US has a model of private ownership, and control with public regulation, continental Europe and Japan have, by and large, stayed steady with greater public ownership in such industries. Although there have been some privatisation in these economies, such attempts have remained relatively modest with limited changes in ownership and control of national assets. Thus, there seems to be no unique ' model' that is universally sound for promoting efficiency of resource use. Perhaps it has a lesson for us: we have to search for a solution suited for our conditions that are broadly consistent with economic reasoning.

Before seeking evidence on the effects of the D-P in India, perhaps it would be useful to ask how valid were the premises of the disinvestment policy to begin with. It is widely believed, as large and growing share of the fiscal deficit was on account of PSEs' financial losses getting rid of them would restore the fisc back to health. How valid was such a diagnosis? Nagaraj

(1993) had shown, using a widely accepted a methodology that PSEs' financial losses were not the principal cause of the growing fiscal deficit in the 1980s, and in fact PSEs' share in the fiscal deficit had steadily declined in the decade. In other words, the government per se was largely responsible for the growing fiscal deficit, not the enterprises owned by it.

Updating these estimates for the 1990s using a more refined method, the estimated deficits of the general government confirmed our previous findings (Figure 2).[13] Government's share (in terms of equity and debt) as a proportion of PSEs' total fixed investment shows a steady decline since the mid-1970s, suggesting a gradual tightening of their budget constraint (Figure 3). The decline in government's contribution is being met increasingly by a rise in internal resources (Figure 4). These long-term trends indicate, contrary to the widely held views, the growing fiscal deficit since the 1980s is not on account of financial losses of the enterprises.

The above evidence suggests that the popularly used indicator of net profit as a proportion of total equity does not adequately reflect PSEs' financial performance. While such a measure may be useful for a private shareholder, it has many shortcomings to gauge the return on public investment. For many reasons, PSEs tend to be over capitalized. First, while these enterprise are expected to develop infrastructure on their own using budgetary resources (adding to their capital costs), state government agencies usually vie with each other to provide larger and better infrastructure for private firms, thus reducing their capital cost. Therefore, depreciation charges for PSEs tend to be much larger. Second, capital structure of PSEs is seldom designed to maximise returns for the shareholder, namely the government.

Usually PSEs are granted large loans in the initial year; when they are unable to service the loans, these are often converted into equity to reduce their debt repayment burden. Thus, many PSEs have high equity, not by design but by default, adversely affecting the net profitability ratio. Moreover, from an economic viewpoint, capital structure of an enterprise is of secondary importance compared to return on capital employed.

It is widely believed that PSEs' respectable profitability ratio (gross profits to capital employed) is mainly on account of the surpluses of the petroleum sector enterprises whose pricing includes an element of taxation. Interestingly, as shown in Figure 5, the profitability ratio has improved since the 1980s even excluding the petroleum sector enterprises – a clear evidence on improvements in PSEs financial performance. But could it be merely due a faster rise in administered prices of PSEs' output (on account of their monopolist position in the domestic market)? This is not so, as evident from the fact that the ratio of deflators of public sector output and GDP has declined since the mid-1980s (Figure 6).

If PSEs' financial performance has improved as shown above, what then accounts for the growing deficits? The problem seems to lay in poor financial returns in electricity boards, road transport corporations and railways, which are probably not adequately reflected in the above measures. For instance, revenue-to-cost ratio in SEBs has remained less than one for much of the 1990s, a decade of much talked about reforms, despite a steady rise in physical efficiency of thermal power plants (as measured by plant load factor) (Figure7).

If the above reasoning and evidence is persuasive, then they suggest that the empirical premises for the ownership reforms were rather thin. While undoubtedly public sector's financial performance needed an improvement, they were not, in the main, on account of the central PSEs that were the targets of the D-P. They mainly lay in (i) the growing expenditure and subsidies of the government, and (ii) poor return on investment in electricity, irrigation and road transport. In all these cases, the real problem is not so much public ownership, but pricing of public utilities and government 's inability to collect user charges, for a variety of political and social reasons.

To sum up, as the sale of equity has been quantitatively a modest, in relation to the size of public sector in India, it is hard to judge the efficacy of the reform effort. Moreover, it is perhaps too early to be definitive about the outcomes. Analytical bases of the policy reform were fragile to begin with, and comparative experience does not give much optimism for measurable efficiency gains from these changes in ownership of industrial assets. Above all, if the evidence reported is anything to go by, the premises of the D-P policy were rather weak.