

Disinvestment and Privatisation in India Assessment and Options¹

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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.⁴ Though quantitatively modest (as will be seen later), the 'disinvestment' signaled a major departure in India's economic policy⁵. 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

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⁴ Besides disinvestment, the reforms also decided refer chronically loss-making PSEs to BIFR (as with the private sector firms), national renewal fund was set up to finance voluntary retirement scheme for public sector employees, introduced memorandum of understanding (MOU) to be signed between PSEs and their operating ministry, as a means of imparting managerial freedom and performance appraisal.

⁵ See Appendix 1 for relevant excerpt from Industrial Policy Statement, 1991

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.⁶

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.⁷

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.⁸ 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.⁹ 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.

⁶ For a symposium of five papers on this study from different perspectives, see World Development, January 1999.

⁷ It is perhaps useful to draw a distinction between privatization and deregulation or liberalization. While the former strictly deals with change in ownership, the latter is concerned broadly with change in rules of entry and exit of firms and on their conduct. In this study we are concerned strictly with privatization, and not with deregulation or liberalization.

⁸ There are many comprehensive reviews of literature on this issue, for instance, Megginson and Netter (2001), Rammohan (2001), Tandon (1997), Cook and Kirkpatrick (2000).

⁹ Though disinvestment was not part of the scandal, the process got some what discredited as some officials associated with the policy reforms were found have had an association with Harshad Mehta.

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.¹⁰ 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.¹¹

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.¹²

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:

¹⁰ It is perhaps worth reminding ourselves that the 1990s witnessed a series of frauds in the financial sector that seriously dented the credibility of the stock market, which is yet to recover in terms of participation of domestic "small" investors. After the Harshad Mehta scam, there was, MS Shoe scam, collapse of NBFCs, vanishing companies scam, teakwood plantation scam, collapse of CRB group of financial companies, collapse of housing bubble in 1996, and finally the Ketan Parikh scam in 2000.

¹¹ A credible and careful account of the reasons of the collapse of UTI (and along with it, public's trust in the stock market) is yet to be written. One could hypothesize that the government's directive to buy PSEs' stocks probably contributed to the beginning of the end of UTI.

¹² As official agencies and courts are investigating many of these issues, we do not consider it prudent on our part to go into them at this stage.

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.¹³

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)¹⁴. 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:

¹³ Apparently, these corporations serve an important political function. Legislators who are denied ministerial positions are usually appointed as their chairpersons of such enterprises.

¹⁴ Allwyn Nissan was a state level joint venture set up in 1985 to produce light commercial vehicles in collaboration with Nissan of Japan.

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. 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.¹⁵

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.

¹⁵ For a different reading of the evidence, with a greater focus on the financial aspects of the reform, see Megginson (2005).

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).¹⁶ 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

¹⁶ For methodological details of the results reported in this section, refer to Appendix 2.

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.

II Policy Options

With over a decade of sustained efforts to redraw the boundaries of the ownership of public industrial assets, there has hardly been any political or professional consensus on the need for, and the modalities of, privatisation. This can be interpreted to mean either of the two possibilities: that there is a great potential for the sale of public equity, or, that there are practical difficulties of doing it. Realistically speaking, if ownership reform is a policy imperative then the options before us seem limited to the following:

1. Rule out large-scale privatization, considering (a) the shallow domestic stock market,¹⁷ (b) relatively small size of the private corporate sector,¹⁸ and (c) the wide spread political opposition to transfer of managerial control to foreign owned firms, and (d) social costs of such transfers.
2. In principle, disinvestment without a change in management is unlikely to make much difference to efficiency. It may help raise limited resources from the capital market, mainly reflecting the government monopoly in the industry. But this is a costly source of finance with high transaction costs. Given excess liquidity currently in the financial system it would be cheaper to sell bonds domestically to raise the required finances.
3. Financially unviable (loss making) PSEs need to be drastically restructured or closed down. However, these enterprises are invariably located on valuable real estate, as most of these industrial enterprises were the locus of urban and regional industrial development. Empowered committees consisting of all the stakeholders could be created to shut down such enterprises, dismantle the plant and machinery, and sell the real estate in a transparent manner; and/or develop the real estate jointly with institutions like the LIC or state housing boards. Workers are unlikely to object to such proposals if they are assured of a fair share of the sale proceeds either in cash or part of the housing to be built using the land.
4. In consumer goods industries like hotels etc, where PSEs may have quality assets in prime locations but lack sound management, long term leases or management contracts could be a viable option. However, efficacy of this option lies in the design of contracts. If they were highly loaded against government it would vitiate the purpose.
5. Need for the institutional mechanism of disinvestment commission with representatives from different stakeholders to deliberate on all the above matters in a transparent manner. Doing it administratively by a ministry would perhaps discredit the D-P policy.

¹⁷ Despite considerable modernisation of institutions and procedures of securities markets in the last decade, they are many shortcomings: one, the market is still very shallow with a few scripts accounting for the bulk of the trade; two, volatility in the Indian market is still one of highest in the world; three, despite NSEs' phenomenal growth, it is small coterie of BSE brokers that call the shots in the entire market. Thus, the India market continues to be what Vijay Joshi and I M D Little appreciatingly called it the "snake pit".

¹⁸ It is perhaps worth reiterating that size of India's private corporate sector is relatively small, estimated to be between 10 to 12 per cent of domestic output. Barring a few, most private sector firms are small compared to PSEs that are targets of privatisation.

If we admit that there are genuine limitations of selling off of PSEs – core of which belong to energy, infrastructure, and industries of strategic interest in national development – then there is perhaps no credible alternative but to improve the functioning of these enterprises.¹⁹ We, then, are back to the old question: how to improve PSEs performance where a change in ownership is unlikely to make much difference.²⁰

There is a large (administrative) literature (including many valuable official reports) addressing such a question; much of it dwells on the autonomy and accountability of enterprises posed mainly in terms of administrative controls of the government as the ultimate “owner”, and procedural accountability of the managers. One of the widely advocated suggestions is to create industry wise holding companies – for instance, Arjun Sengupta Committee’s main suggestion (Government of India, 1984) – as an institutional buffer between an enterprise and the government. But the evidence on this organizational form is perhaps not encouraging, as it often implies creation of another tier of bureaucracy, undermining the autonomy of the firm or factory level managers.²¹

Economic analyses of public sector performance, however, seem to have largely ignored the institutional ‘black box’, by focusing mainly on the macroeconomic effects of public investment and planning for growth. Many studies critical of India’s growth and its distribution have identified political economic reasons for poor performance of PSEs. More recently, in line with the current orthodoxy, some have advocated ownership reform, which we have argued to be of limited value.

Problem of corporate governance:

In the evolution of modern capitalism, with separation of ownership from control as firms grow in size and complexity, agency problem arises: how to ensure that the managers (“promoter” in Indian parlance) work to maximise return on shareholders’ capital. Given the information asymmetry, managers could pursue their private goal disregarding the shareholders’ interests. This is at the heart of the problem of modern literature on corporate governance. Various institutional and contractual mechanisms have evolved in the last century to grapple with this problem.

In the context of efficiency of resource use in a socialist economy, Oskar Lange sought to solve the problem of how to ensure that managers of public firms maximized efficiency consistent with the goals set by the central planners. However, looking at the microeconomics of firms in a socialist economy, Jonas Kornai argued that they were unlikely to be efficient because of the soft budget constraint: that is, firms do not go bankrupt or managers do not lose their jobs for their poor performance. Firms can always renegotiate their contracts with the planners to hide their inefficiency.

In India public sector firms are often faced with multiple objectives, and multiple owners or monitors – central government, state governments, legislators, public auditors and so on. Managers may not necessarily maximise profits as they could always highlight a particular achievement to suit their convenience. Managers may be risk averse as they face constitutionally mandated procedural audit by the CAG if an enterprise is majority government owned. Managers’ efficiency objectives may come in conflict with dysfunctional political interference in operational matters (at the expense of policy issues) to meet narrow political goals. However, at the same

¹⁹ For instance, In 1991, 14 largest PSEs constituted 55 per cent of value added and capital employed. The enterprises included in decending order in terms of gross block are: ONGC, NTPC, SAIL, Rashtriya Ispat Nigam Ltd., NALCO, Indian Oil, Neyveli Lignite, MTNL, Indian Airlines, Shipping corporation, IPCL, Air India, and South Eastern Coal Fields.

²⁰ PSEs need not necessarily have to be large and monolithic organization. There is considerable scope for rationalization of these enterprises.

²¹ It is worth remembering that PSEs like SAIL and Coal India were conceived and functioned initially like a holding company.

time, poor performance by managers does not involve any punishment as they can re-negotiate the output prices, budgetary support, or have access to soft and/or government guaranteed loans; in other words they do not face a hard budget constraint.

Thus, the agency problem is endemic to all economic systems. Moreover, problem of soft budget constraint is not restricted to socialist economies but evident in market economies as well when the firm in question is large and considered of strategic importance for the economy, though perhaps to much lesser extent. Rescue of Chrysler Corporation – the third largest automotive firm in the US – in the late 1970s and United Airlines after “9/11” in the US are clear instances of state support for failing companies. Such support is more common in financial sector, where failure of firms can have significant systemic risk.

Comparative experience:

Experience of the last century shows how different economic systems have sought to solve this problem in a variety of ways with varying degrees of success. The Soviet system was perhaps quite capable of solving the problem in the initial phases of ‘extensive growth’ with a clear objective of maximisation of national output. However the system began to falter, as the economy got more complex, in the phase of ‘intensive growth’ when objective was to increase productivity of resources (Bhaduri, 1998). The command economy was unable to resolve the agency and incentive problems at the micro level because of the soft budget constraint.

As noted earlier, in the Anglo Saxon economies, the secondary stock market acted as the disciplining device on corporate performance, and as market for managers. In principle, stock prices that summarise all publicly available information on the firm performance should provide adequate signals for managers to act optimally. The system also seems capable of providing risk capital to spur rapid technological progress, as witnessed in the role that venture capital funds played in promoting the Internet revolution. However, given the agency problem, there is enormous scope for abuse of the system, adversely affecting the shareholders’ interests and possibly hurting economic efficiency in the aggregate. Hostile takeovers and leveraged buyouts have exposed the inefficiency of such a disciplining mechanism (Dore, 2000). The recent implosion of some of the world’s biggest companies, astronomical rise in managerial remuneration disproportionate to performance of firms, and widespread abuse of stock options by top managements in firms like Enron and Tyco by the turn of the last century have seriously dented the credibility of the stock market based principles of corporate governance (Stiglitz, 2003).

“Follower industrializing” economies of continental Europe and Japan evolved a bank centric mechanism of financing of industrialization and corporate governance to overcome some of the well known shortcomings of the stock market – heeding to Keynes’s advice, and Greschenkron’s (1962) historical insights (Zysman, 1983). In this system, banks not only provide loans but equity as well, hence closely monitor the performance of firms. Japanese system of interlocking equity ownership centered around a main bank, called *Keiretsu*, with mutual stock holding leading to accountability and risk sharing, has been able to overcome some of the widely observed informational deficiencies in the stock market based system, hence improved efficiency and growth over a sustained period (Aoki, 1996).

Admittedly, bank centric systems have had their share of problems. While such a system was perhaps capable of engineering a rapid capital accumulation and technological catch up with the US, it was probably not nimble enough to finance risk taking to extend the technological frontier as evident from the experience of the 1990s. Many blame the close and opaque nexus between firms, banks and the bureaucracy for the Japanese debacle in the 1990s that has persisted for more than a decade now. Similarly, state sponsored industrialism is believed to be responsible for the East Asian crisis in 1997.

Although there is some rethinking on the basis of the above mentioned instances in Japan and continental Europe about their institutional mechanism, it is hard to deny the superiority of the

bank centric systems in promoting the post-war experience (1945-2000). Variants of the Japanese model of financing and governance have contributed in no less measure to the unprecedented success of “late industrialising” economies of East Asia – as represented by the “rise of the rest”, to use Alice Amsden’s phrase (Amsden, 2001). Thus, on balance, history and theory seem to favour a bank centric system – at least in the early phase of industrialisation.

Evolution of the Indian system:

In light of above, how does one characterise India? Over the first three decades of the planned economic development, a bank centric system was broadly put in place with an elaborate network of public sector banks, development finance and investment institutions. Though banks, especially the DFIs had representation on company boards by virtue of their large debt and equity holding (both public and private), there was no attempt to nationalise private corporate firms, or to interfere with managerial control of existing promoters unless the firms were mismanaged. Thus, the system was broadly supportive of development of private enterprise consistent with the national objectives. Moreover, as Indian enterprises are predominantly family-managed, public financial institutions sought modernize corporate governance (like introduction of professional managers in the boards) and financial practices, without questioning the rights of management of the promoters.

But, the role of the financial institutions was largely subordinated to the implementation of quotas and licenses. Financial system, thus, could not adequately develop expertise in screening investment projects, market and technologies, and assessing market risk. They had little role disciplining corporate managers with financial carrots and sticks. In other words, banks and financial institutions were not encouraged to develop their “reputational capital”, that is perhaps central to a sound financial system. A close reading of the early studies by R K Hazari (1986) on licensing, and later Narasimham Committee report on shifting from physical to financial controls (Ministry of Finance, 1985) seem to suggest that they proposed to nudge the institutions towards a bank centric system of financing and corporate governance.

Although development banks increasingly financed PSEs investments, they had limited role in governance of these enterprises, was largely in the hands of the operating ministries and were subjected to parliamentary controls. Parliament constituted Committee on public undertakings (COPU) that looked into the functioning of selected PSEs. Similarly, CAG is constitutionally mandated to audit PSEs in which the central government held more than 50 per cent of equity shares. While such measures of public accountability are in principle desirable in a democracy, in practice, the parliamentary committees had little role in ensuring efficacy of resource use in these publicly owned firms. As measures of enforcing sound corporate governance, these methods were not effective.

However, overlooking the hard task of institutional design to suit the specificities of large, heterogeneous, democratic industrializing economy of India, the reforms initiated in the 1990s have sought to improve PSEs’ financial performance by transferring ownership and control to private sector, and resort to stock market based discipline. As the above discussion clearly demonstrates, regardless of ownership agency problem exists is ubiquitous, and problems of soft budget persist in varying degree when the firms involved are large and strategic. Further, private ownership would not guarantee improvement in efficiency if the market structure remained the same; on the other hand a private monopoly, could be worse than a public one.²²

A suggestion for reform:

On the basis of the above, if we accept that the real problems facing PSEs are, (i) dysfunctional political interference, (ii) constitutionally mandated procedural audit and (iii) soft budget constraint, then following measures can be suggested:

²² In a political democracy, a public monopoly would be more answerable to political representatives than a private monopoly.

- Reduce the government holding in PSEs to less than 50 per cent by transferring share to mutually complementary firms by creating Japanese style *keiretsu*, tied around a public sector bank or financial institution. For instance interlocking of equity holding among steel, coal and electricity firms; or petroleum exploration, refining and petrochemical complexes. Such a measure would eliminate the procedural audit as well as political interference on the day-to-day operational matters.
- However, to ensure public accountability managers may be asked to make presentations to the parliamentary sub-committees on efficiency of resource use. At the same time, managers should have clearly defined security of tenure for say 3 or 5 years to ensure continuity and to show measurable performance.
- Harden the budget constraint for PSEs by a clear sunset clause on budgetary support or government guarantee for loans, except for specific public purpose oriented investments.
- Given that banks provide substantial equity and loans, they would, in principle, have incentive to monitor PSEs performance to retain their reputational capital.
- However, question would still remain who will monitor the banks? There are no easy answers to it. Given the increasing independence of the Reserve Bank, it is conceivable to devise a system to where the central bank and other regulatory authorities are given the responsibility of appointing top managers of banks. Such a scheme of delegated monitoring is in principle is better for efficiency. Such a monitoring could focus on long-term corporate goals such as productivity growth market shares, and R&D outcomes.
- To ensure that PSEs do not abuse their oligopolistic position in the domestic market, reasonably open trade and investment regime could impart the discipline of the world market.

Pranab Bardhan (1991 and 1993) has argued in favour of such a system for India to overcome the problem of soft budget constraint and a way to acquire dynamic comparative advantage. Applying the recent advances in information economics and drawing from the recent experience, Stiglitz and his associates caution developing economies against moving from financial repression to financial liberalization (Hellman, Murdock and Stiglitz, 1996). Such attempts have more often than not, led to many financial crises. Arguing against such polar extremes, these scholars have advocated Japanese style relationship banking system or Korean style hard budget constraint banking as desirable forms of financial system, which they define as “financial restraint”.

Conclusions

While public sector enterprises' contribution to national development is widely acknowledged, their poor financial return has been a matter of deep and enduring concern, especially since the mid-1980s when, for the first time, the central government's current revenues were found inadequate to meet its current expenditure. Though firm and industry level studies of PSEs have often highlighted gross inefficiencies and poor profitability, many of them have also suggested their unquantifiable (or difficult to quantify) non-economic benefits. However, macroeconomic discourse in India has largely focused on the “crowding-in” effects of public investment, and the need for institutional structures to insulate the PSEs from political and bureaucratic interference to improve their financial returns. Deeper analyses have sought to offer political economic explanations for continuation of such a state of affairs.

As a means to restore budgetary balance, after the crisis in 1991, government sold a small fraction of its equity shares in selected public sector enterprises to public investment institutions. Though quantitatively modest, it signaled a major departure in public policy; it was the thin end of the wedge that led to transfer of managerial control in a few PSEs about a decade later. The policy shift was also significant, as it deflected the contours of the discourse on public sector reform from institutional design and corporate governance to a change in ownership in favour of private sector as a means to overcome the inefficiencies. The shift in debate was consistent with the changes in the discussions on economic policies worldwide.

Quantitatively, the disinvestment and privatisation have been modest so far, as proportions of the targets, revenues realised, or as a proportion of the fiscal deficit. Disinvestment did not secure much revenue, as the stock market was subdued during much of the 1990s on account of a series of scandals that repeatedly rocked the financial markets. Sale of substantial chunks of equity with transfer of managements that took place in the last 3-4 years has yielded sizable revenues. But most of these sales have been contentious with a series of legal cases pending in the courts, and enormous adverse commentary on them in press and the parliament.

Should we persist with the policy of ownership reform? Realistically speaking, prospects for the D-P appear limited, as the bulk of the public investments (in terms of capital employed) are in infrastructure and industries of strategic importance, where market failures and national interests seem too significant to be left unattended by public policy. There is little that is credible in economic theory that argues ownership as the principal basis for economic outcomes. Moreover, accumulating evidence on privatisation across the world does not give any prospect of this policy making a genuine difference to firm level performance on a sustainable basis.

If the above assessment is reasonably persuasive, then we are back to the earlier question: how to design an institutional mechanism that limits (if not overcomes) the agency problem that is at the heart of modern capitalism with the separation of ownership and control of large firms, that puts hard budget constraint on firms, and reduces dysfunctional political bureaucratic interference. Solution to this problem seems closely tied to financing of investment, and financial system that provides resources for development and performs the function of a disciplining device on firms. While disinvestment and privatisation necessarily lead towards stock market based discipline, we have argued that history and theory do not seem to support it to be the superior alternative. We are inclined to favour the Japanese and German style interlocking of ownership of complementary PSEs tied together with a bank that enforces greater managerial accountability, and encourages long term outlook of output growth and acquisition of technological capabilities.

Admittedly, there are a numerous enterprises with modest investments that are in the public sector fold that operate in competitive markets or do not serve any strategic purpose. Among these, loss making ones can be disposed off by selling the real estate of these enterprises by creating empowered committees of all stakeholders in these enterprises. Workers are unlikely to oppose such moves if there is a reasonable and transparent sharing of proceeds of such sales. The remaining PSEs operating broadly in "competitive" environment can be granted greater autonomy, or give out to private parties on management contracts or on lease. To undertake these tasks, there is a need for a body like the disinvestments commission with representation from all stakeholders to work out the modalities of undertaking these changes.

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Table 1: What successive Finance Ministers have said about D-P in their budget speeches

Year	Finance Minister	Key phrases used in the Budget speech
<i>Why disinvestment?</i>		
1991-92	Yashwant Sinha Manmohan Singh	For broad-based equity Improve management Raising resources for the PSUs
1997-98	P Chidambaram	Long-term disinvestments policy for enhancing budgetary receipts
1999-2000	Yashwant Sinha	For improving productivity and profitability of enterprises Developing capital markets
2003-04	Jaswant Singh	To unlock production potential of undertakings
<i>Which PSUs to disinvest?</i>		
1991-92	Yashwant Sinha Manmohan Singh	Selected PSUs
1997-98	P Chidambaram	Silent
1999-2000	Yashwant Sinha	Non-strategic PSUs
2000-01	Yashwant Sinha	Non-strategic PSUs
<i>How to Disinvest and to whom?</i>		
1991-92	Yashwant Sinha	Up to 20 per cent equity to MFs/investment institutions in public sector
1991-92	Manmohan Singh	Do
1997-98	Chidambaram	Government to retain majority equity in strategic PSUs
1998-99	Yashwant Sinha	Do
1999-2000	Yashwant Sinha	Though gradual disinvestments or strategic sale
2000-01	Yashwant Sinha	Bring down government equity to 26 per cent or less
2001-02	Yashwant Sinha	Not in small lots
2003-04	Jaswant Singh	Asset management Co. to hold residual shares post disinvestments
<i>How disinvestments proceed be used?</i>		
1992-93	Manmohan Singh	NRF for assistance to workers (specially women) in unorganized sector; Also, for special employment schemes in backward areas After meeting VRS needs, create a Restructuring fund for PSUs.
1999-2000	Yashwant Sinha	To fund social and infrastructure sectors
2001-02	Yashwant Sinha	PSU restructuring For creating workers safety net Public debt reduction Social and infrastructure sector
2003-04	Jaswant Singh	Create Disinvestment Fund to direct proceeds for specific uses.

Source: Sarma (2004): 2195

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Table 1: List of Privatised PSEs

1	Lagan Jute Machinery Company Limited (LJMC)
2	Modern Food Industries Limited (MFIL)
3	Bharat Aluminium Company Limited (BALCO)
4	CMC Ltd. (CMC)
5	HTL Ltd. (HTL)
6	IBP Co. Ltd. (IBP)
7	Videsh Sanchar Nigam Limited (VSNL)
8	Indian Tourism Development Corporation (ITDC)
9	Hotel Corporation of India Limited (HCI)
10	Paradeep Phosphates Limited (PPL)
11	Jessop and Company Limited
12	Hindustan Zinc Limited(HZL)
13	Maruti Udyog Limited (MUL)
14	Indian Petrochemicals Corporation Ltd.(IPCL)

Table 2: Actual Disinvestment from April 1991 onwards and Methodologies Adopted

Year	No. of Companies in which equity sold	Target receipt for the year (Rs. in Crore)	Actual receipts (Rs. in Crore)	Methodology
1991-92	47 (31 in one tranche and 16 in other)	2500	3038	Minority shares sold by auction method in bundles of "very good", "good", and "average" companies.
1992-93	35 (in 3 tranches)	2500	1913	Bundling of shares abandoned. Shares sold separately for each company by auction method.
1993-94	-	3500	0	Equity of 7 companies sold by open auction but proceeds received in 94-95.
1994-95	13	4000	4843	Sale through auction method, in which NRIs and other persons legally permitted to buy, hold or sell equity, allowed to participate.
1995-96	5	7000	361	Equities of 4 companies auctioned and Government piggy backed in the IDBI fixed price offering for the fifth company.

1996-97	1	5000	380	GDR (VSNL) in international market.
1997-98	1	4800	902	GDR (MTNL) in international market.
1998-99	5	5000	5371	GDR (VSNL) / Domestic offerings with the participation of FIs (CONCOR, GAIL). Cross purchase by 3 Oil sector companies i.e. GAIL, ONGC & Indian Oil Corporation
1999-00#	4	10000	1860	GDR—GAIL, VSNL-domestic issue, BALCO restructuring, MFIL's strategic sale and others
2000-01	4	10000	1871	Strategic sale of BALCO, LJMC; Takeover - KRL (CRL), CPCL (MRL), BRPL
2001-02 #	9	12,000	5632	Strategic sale of CMC – 51%, HTL –74%, VSNL – 25%, IBP – 33.58%, PPL-- 74%, and sale by other modes: ITDC & HCI; surplus reserves: STC and MMTC
2002-03	6	12,000	3348	Strategic sale : HZL – 26%, MFIL-26%, IPCL – 25% HCI, ITDC, Maruti: control premium from renunciation of rights issue, ESOP:HZL,CMC.
2003-04	9	13,200	15547	Maruti- IPO(27.5%), Jessop & Co. Ltd. (Strategic sale-72%), HZL (Call Option of SP - 18.92%), Public Offers - IPCL (28.95%), CMC (26%), IBP (26%), DRDG (20%), GAIL (10%), ONGC (10%), ICI (9.2%)
Total #	48*	91500	45066	
* Total number of companies in which disinvestment has taken place so far.				
# Figures (inclusive of control premium, dividend/dividend tax, restructuring and transfer of surplus cash reserves prior to disinvestment etc.)				

Table 3: Disinvestment in Public Sector Enterprises
(Rs. Crore)

Year	Target	Proceeds
1991-91	2,500	3038
1992-93	2,500	1913
1993-94	3,000	-
1994-95	4,000	4843
1995-96	7,000	362
1996-97	5,000	380
1997-98	4,800	902
1998-99	5,000	5371
1999-00	10,000	1860
2000-01	10,000	1871
2001-02	12,000	5632#
2002-03	12,000	3348
2003-04	14,500	15,547

Figures inclusive of amount realized by way of control premium, dividend/dividend tax and transfer of surplus cash reserves prior to disinvestment etc.

Source: *Economic Survey 2003-04*

Table 4: Status of Privatisation of SLPEs (as on March 31, 2003)

State	No. of enterprises	No. privatized	No. Proposed to be privatized	Closed	Working enterprises	
					Profit making	Loss making
Andhra Pradesh	128	30		22	15	25
Tamil Nadu	82		39	11	34	47
Arunachal Pradesh	5			2		
Assam	42			5	3	36
Bihar	54			30	8	
Delhi	15				5	3
Goa	16					
Gujarat	49	3		6	22	24
Haryana	28	1		2	12	16
Himachal Pradesh	21				8	13
Jammu-Kashmir	23			2	3	16
Karnataka	79		5	12	32	38
Kerala	109		15	23	34	59
Lakshwadeep	1					
Madhya Pradesh	34			6		
Maharashtra	66		3		18	44
Manipur	16			2		
Meghalaya	13			1	3	10
Mizoram	6				1	4
Nagaland	6					3
Orissa	67	1		1	14	10
Pondicherry	11				5	5
Punjab	53	1	4	24	10	25
Rajasthan	29	1		1	11	11
Sikkam	11			2		
Tripura	9					
UP	104		24	23	30	68
West Bengal	81		10	5	20	62
Total	1158	35	103	180	288	519

Source: Mishra (2004)

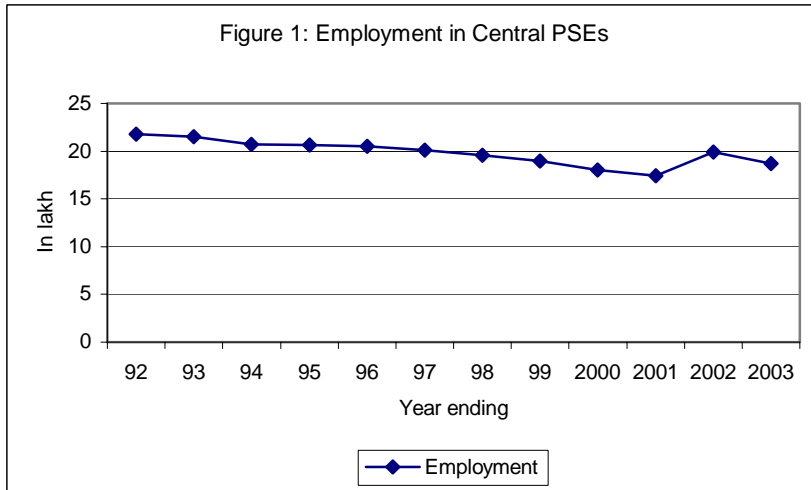


Figure 2: Public sector's share in fiscal deficit of the non-fin. con. gen. gov.

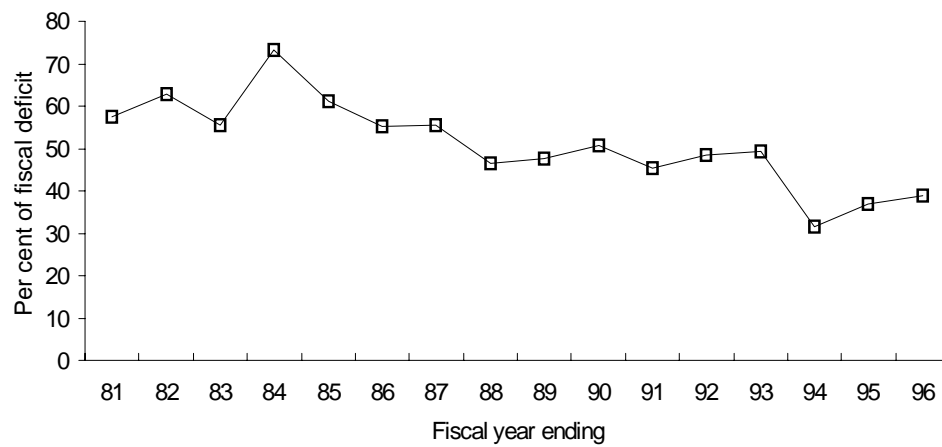


Figure 3: NDNFEs' budget constraint, 1961-96
Govt equity+loans in NDNFEs' investment

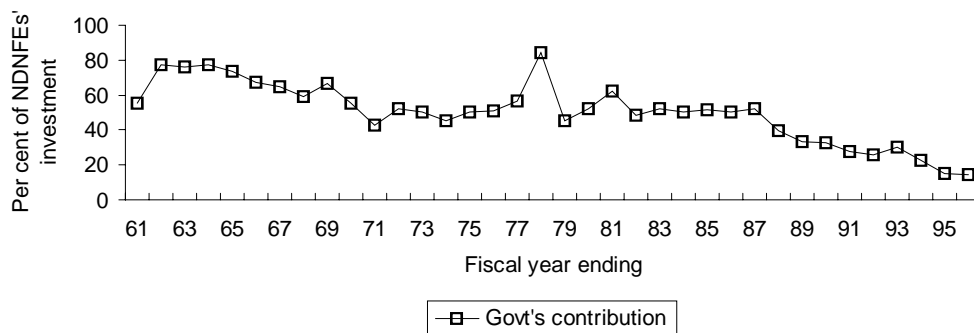


Figure 4: Financing of NDNFEs, 1981-95
as % of gross investment

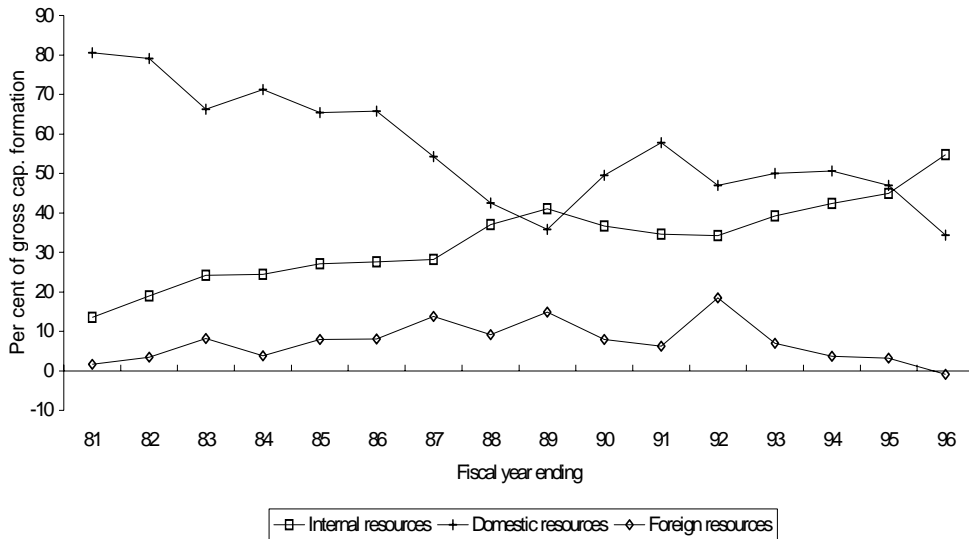


Figure 5: Profitability of CPEs
Gross profit to capital employed

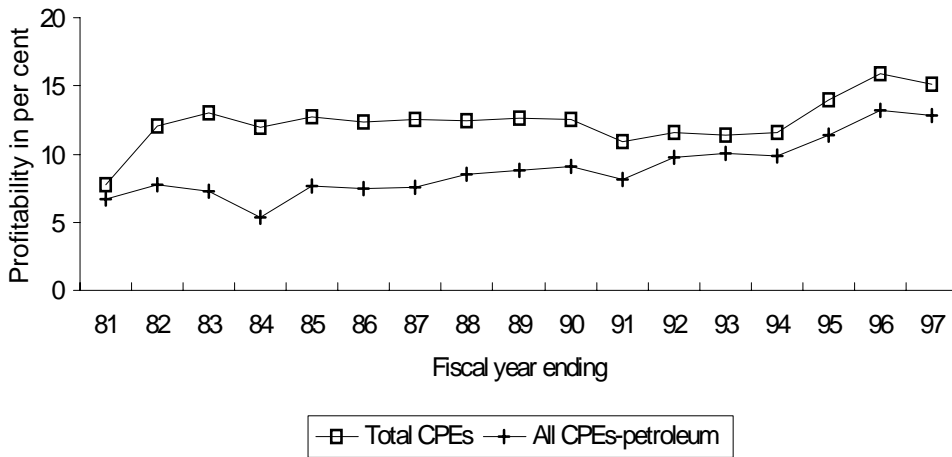


Figure 6: Public sector price deflator relative to GDP deflator, 1982-96.

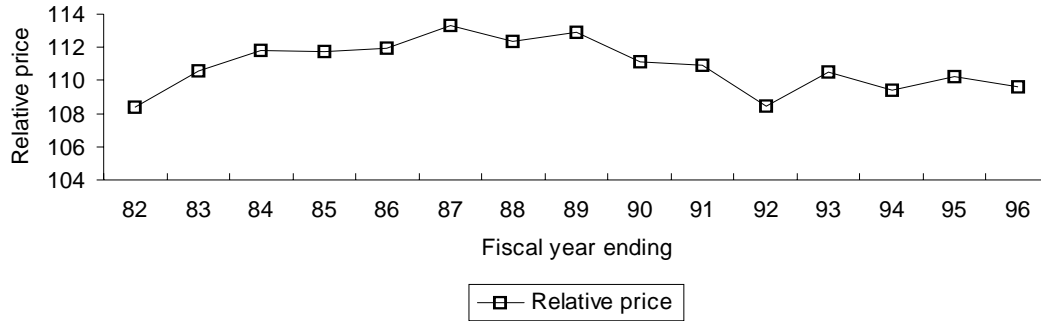
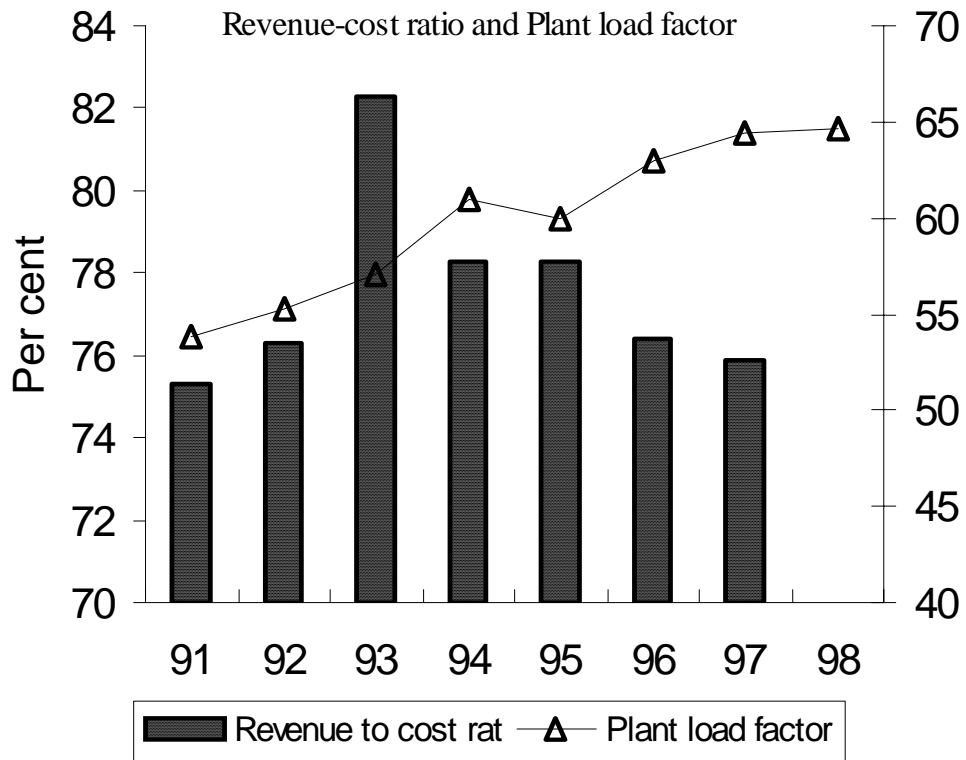


Figure 7: Cost and efficiency of power sector

Revenue-cost ratio and Plant load factor



Appendix 1
Industrial Policy statement in 1991

Public Sector

Portfolio of public sector investment will be reviewed with a view to focus the public sector on strategic, high-tech and essential infrastructure. Whereas some reservation for the public sector is being retained there would be no bar for areas of exclusivity to be opened up to the private sector selectively. Similarly the public sector will also be allowed entry in areas not reserved for it.

Public enterprises which are chronically sick and which are unlikely to be turned around will, for the formulation of revival/rehabilitation schemes, be referred to the Board for Industrial and Financial Reconstruction (BIFR), or other similar high level institutions created for the purpose. A social security mechanism will be created to protect the interests of workers likely to be affected by such rehabilitation packages.

In order to raise resources and encourage wider public participation, a part of the government's shareholding in the public sector would be offered to mutual funds, financial institutions, general public and workers.

Boards of public sector companies would be made more professional and given greater powers.

There will be a greater thrust on performance improvement through the Memoranda of understanding (MOU) systems through which managements would be granted greater autonomy and will be held accountable. Technical expertise on the part of the Government would be upgraded to make the MOU negotiations and implementation more effective.

To facilitate a fuller discussion on performance, the MOU signed between Government and the public enterprise would be placed in Parliament. While focusing on major management issues, this would also help place matters on day-to-day operations of public enterprises in their correct perspective.

Excerpts relating to public sector taken from Press release on July 24, 1991.

To test if PSEs growing deficits is the principal reason for the increasing fiscal imbalance, we need consistent time series information that includes *all* PSEs, at *all* levels of government (in a federal set up), after reconciling transactions among them. Since India's *National Accounts Statistics (NAS)* seem to provide such data set, it perhaps offers an opportunity to test the hypothesis in a limited way. Moreover, as quality of Indian data is accepted to be better than many developing countries, such an exercise appears a useful starting point.

Nature and the limitations of the data set

In *NAS*, public sector consists of (i) administrative departments, (ii) departmental enterprises (DEs) like railways, telecom, postal and irrigation services, and (iii) non-departmental enterprises (NDEs) that include corporate entities like Steel Authority of India, statutory organizations like state electricity boards and road transport corporations. NDEs are further disaggregated into (a) non-departmental financial enterprises and (b) non-departmental non-financial enterprises (NDNFEs). If PSEs are publicly owned organizations that produce goods and services whose selling price is related to costs, then DEs plus NDNFEs would include all PSEs in India.

However, the *NAS* data has some limitations: (i) given the format of the published information, it is not always possible to aggregate DEs and NDNFEs, (ii) since the data are not presented in balance sheet format, widely appreciated financial ratios cannot be computed, and (iii) considerable delay in publication of these tables. Although these categories are comprehensive (compared to the easily available information on central government PSEs), we cannot present all our results for total PSEs; some times they are restricted for NDNFEs only. However, as the information is available for three decades, results based on it could have considerable value. Results reported in Nagaraj (1993) follows the above method. However, this method has some limitations. For instance, it excludes DEs, underestimating the deficits of PSEs. While the overall deficit is estimated using the *NAS*, the fiscal deficit is based on the public finance statistics that does not fully capture the transactions between the government and its enterprises. To overcome these limitations, we use Anand Gupta's (1993) method that consistently uses *NAS*.

To arrive at the true size of India's fiscal deficit, Gupta outlined a method to estimate gross fiscal deficit of the *general government* including its enterprise sector, by reconciling various accounts of the public sector. In other words, his method estimates capital finance accounts for various parts of the public sector, and aggregates them to compute the fiscal deficit (excluding non-departmental financial enterprises).