

PRIVATIZATION AND PUBLIC ENTERPRISE REFORM: A SUGGESTIVE ACTION PLAN*

by

SIMRIT KAUR**

ABSTRACT

Introducing reforms for the State Owned Enterprises (SOEs) has been an integral part of the reform process initiated in India since 1990s. While reforming, the concerns about *ownership*, *competition* and *regulation*, which have a direct bearing on the issue of the relative performance of publicly owned and privately owned firms have been adequately looked into. This paper focuses on the various modalities of reform options, such as *Divestiture* (whereby private ownership is inducted in publicly owned enterprises), *Greenfield Privatization* (whereby private sector is allowed to come and compete in areas hitherto reserved for public sector), and *Cold Privatization* (that is granting greater autonomy to managers of SOEs by making them sign Memorandum of Understanding) adopted by India to improve the performance of its SOEs. Specifically, the paper gives a comprehensive assessment of the disinvestment policies implemented since 1990. The paper provides a suggestive action plan to spur reforms and improve outcomes and concludes by summarizing the main findings from an overall policy perspective in the context of the Indian SOE reform programme.

KEY WORDS: State Owned Enterprises, Public Sector Enterprises, Divestiture, Greenfield Privatization, Cold Privatization, Memorandum of Understanding, Asymmetric Information

Contact Address

D-341 Narmada Apartments, Alaknanda, New Delhi-110019. India

Ph: 91-11-2646 7427, 2622 0898

Fax: +91-11-2622 5799

Mobile: +91 9811137375

simrit@vsnl.net

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** Reader, Faculty of Management Studies, University of Delhi.

PRIVATIZATION AND PUBLIC ENTERPRISE REFORM: A SUGGESTIVE ACTION PLAN

Governments have long used State Owned Enterprises (SOEs) as instruments to achieve their social and economic developmental goals. Until about the 1970s, in most countries it appeared as though they were having some success. In the 1980s, however, there were increasing signs of weaknesses in the SOE sector. Protection from competition, bankruptcy and takeover allowed them to become inefficient. With the world recession of the mid 1980s, they became net drawers on government budgets, rather than net providers. It appeared that the SOEs were undertaking many activities which the private sector could probably do better, since property rights would ensure greater productivity and bankruptcy laws would weed out the unproductive enterprises. The theory of market failure was overtaken by the theory of non market or bureaucratic failure (Stiglitz, 1989). The international community agreed and urged, particularly after the success of early privatization in the United Kingdom that governments shed their public enterprise burden, deregulate sectors formerly monopolized by the public sectors, and provide an enabling environment for the private sector to develop. Privatization thereafter has been widely promoted in the sphere of industries, services and agencies (Kay and Thompson, 1986; Kikery, Nellis and Shirley, 1992; Nellis and Kikery, 1989; Ramamurti, 1992, 1999; Yarrow, 1999; Vickers and Yarrow, 1988).

In developing nations, the market oriented policies such as deregulation, privatization, and liberalization, were adopted or imposed largely under programs known as stabilization and structural adjustments. Privatization proceeds surged significantly in most developing countries during the 1990s, reaping record revenues of USD 66.6 billion in 1997, mainly as result of divestitures in the infrastructure sectors. During the period 1990 to 1998, more than USD 270 billion was collected through privatization proceeds in developing countries. Latin America and the Caribbean, Europe and Central Asia, and East Asia and the Pacific contributed to the largest share of privatization proceeds, accounting for 57 percent, 26 percent and 14 percent of total privatization revenues respectively (Table 1). In South Asia a total of USD 10 billion was collected (over the period 1990-98) as privatization proceeds, out of which more than 70 percent came from privatization in India (World Bank, 2000).

Privatization and Public Enterprise Reform in India

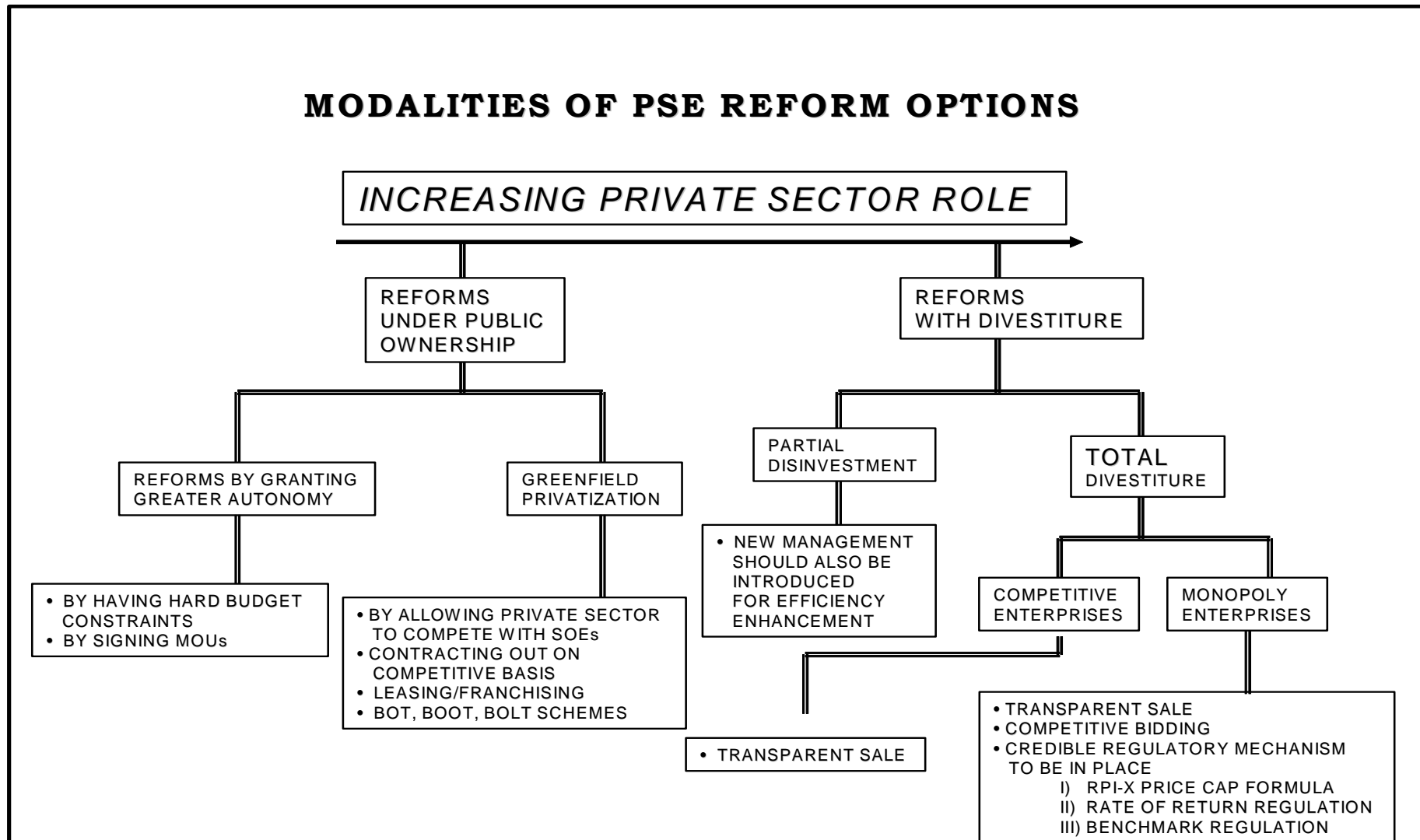
After India's independence in 1947, a socialistic pattern of society was included in the Constitution and Directive Principles of the State policy. The industrial policy resolution of 1948 and 1956 stressed the need for a mixed economy, under which the public sector was to play a significant role. This concept enjoyed almost universal acceptance during the 1950s and 60s. As a result, the public sector became a 'force' to be reckoned with. Starting from only five SOEs accounting for an investment of Rs. 290 million in 1950, the number of operating Central State Owned Enterprises had reached a total of 240 with investments of Rs. 2,525,540 million as on 31st March, 2000. However, over time the Central governments experienced grave financial constraints. Most of the SOEs were incurring losses. The financial compulsion became the main reason for the Centre to embark upon the policy of disinvestment.

In order to reform its State Owned Enterprises, the Government of India considered a wide range of measures. Depending on the suitability and convenience, India chose a few or all of them. The spectrum of options available to reform SOEs is shown in Figure –1 (Kaur 2003). The extreme left corner shows the reforms that could be introduced within the existing ownership pattern. A gradual move to the right increases the role of the private sector. The extreme right corner depicts total divestiture, whereby the public sector enterprise is sold off either to the private sector, employees or the general public. Thus the SOEs could be made more efficient by adopting various modalities of reform options. While on the one hand the policy makers could consider the induction of private ownership in publicly owned enterprises, on the other hand they could also consider introducing competition in product and factor markets as a more important determinant of allocative efficiency, than whether a firm is publicly owned or privately owned. This is because several studies have shown that ownership *per se* - public or private - is not the factor, which determines efficiency. In fact, it is the degree of competition. Thus, provided there is sufficient competition, there is no discrepancy in efficiency between privately and publicly owned enterprises (Williamson, 1969, 1970; Baumol, 1967; Alchian and Kessel 1962, Alchian and Demsetz, 1972; Furubotn and Pejovich 1972). Therefore, in such enterprises (where lack of competition is the major problem), if efficiency is to be improved, a mere change of ownership may not lead to desirable results. In fact, just by enhancing competition (e.g. by allowing private sector to operate in areas reserved for the public sector i.e. Greenfield Privatization), it may be possible to increase the efficiency of SOEs. Further, the policy environment within which public enterprises operate, as well as their management structure, has more to do with their performance, relative to private enterprises, than the ownership of their assets. Therefore, by granting greater autonomy to the managers of public enterprises and thereby also making them more accountable (i.e. by making the SOEs sign a Memorandum of Understanding with the Government , also known as cold privatization), one could enhance the productivity of the public enterprises. This implies that, given the interventionist role of the State, the important question is not the *extent* but the *quality* of such intervention.

This paper has 5 sections. The first three sections discuss the various modalities of reforming SOEs i.e. privatization, greenfield privatization and cold privatization adopted by India since the 1990s. The various modalities adopted by Indian policy makers while addressing the privatization and public enterprise reform process in India, shows that adequate concerns about *ownership*, *competition* and *regulation*, which have a direct bearing on the issue of the relative performance of publicly owned and privately owned firms have been made. In section 4, a suggestive action plan stating how to spur reforms and improve the outcomes is discussed, while the last section concludes the paper with some policy implications.

FIGURE – 1

MODALITIES OF PSE REFORM OPTIONS



Section 1

Privatization through Change of Ownership

The Industrial Policy Statement of 24th July, 1991, envisaged disinvestments of part of Government holdings in the equity share capital, in the case of selected public enterprises , with the following objectives in mind:

- To raise resources
- To encourage wider public participation, and
- To promote greater accountability.

From 1991 to 2000, the emphasis of Indian privatization was on disinvestment - the offloading of government's minority shares to the public or financial institutions. During this period, the government offloaded shares in as many as 39 public enterprises. However, since March 2000 emphasis has increasingly been on strategic sales of identified SOEs .Strategic sale refers to outright transfer of control in SOEs to private management. This normally involves the sale of 26 percent or more of government equity to a private party. Table 1 briefly summarizes the amount realized and the number of SOEs disinvested or privatized till date.

Table 1
Disinvestments from 1991 to 2003
Realization and Methodologies Adopted

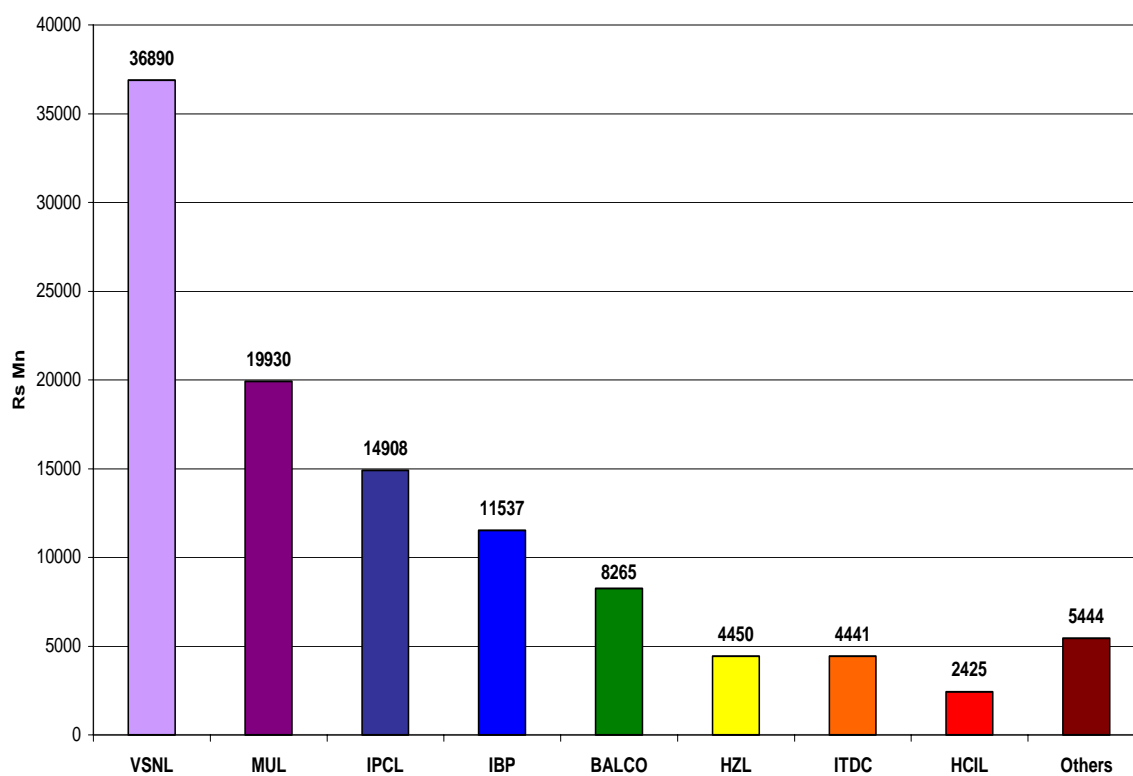
		<i>Sale of Minority Shares 1991-92 to 1999-2000</i>	<i>Strategic sales 1999-2000 till date</i>	<i>Total</i>
1.	Number of SOEs	39*	35*	68
2.	Equity sold(Rs million)	27930	8940	36870
3.	As % of total equity of Central Government (as on Mar 2000)	3%	1.13%	4.13%
4.	Total Receipts (Rs million)	152860	108290	261150
5.	Realization as multiple of equity sold	7	12	

*Seven SOEs are common to both modes.

Modern Foods was the first SOE to be strategically sold. Ever since the sale of Modern Foods, every single disinvestment has followed the strategic sale route. The second strategic sale was of Bharat Aluminium Company (BALCO). Fifty one percent of its shares were sold to Sterlite Industries for Rs 5,515 million. Following this sale, the government was quick to proceed with strategic sales in important firms by divesting 51 percent of the shares in Computer Maintenance Corporation to Tata Sons and 74 percent of the shares in HTL, PPL and Jessop (for Rs 550 mn, Rs.1520 mn, Rs. 180 mn) to Himachal Futuristic Corporations, M/s Zuari Industries & M/s Ruia Cotex Ltd respectively.

Figure 2

Proceeds From Disinvestment(Rs. Million)



So far 35 central SOEs have been strategically sold. Of these, nineteen are hotels of Indian Tourism Development Corporation (ITDC) and three are hotels of Hotel Corporation of India Ltd. (HCIL) Together, these hotels have contributed Rs. 6,866 million towards divestiture proceeds. For all the nineteen hotels, 100 percent of the equity was sold. In terms of individual sales, as shown in Fig 2, maximum proceeds (Rs.37 bn) were collected by selling 25 percent of the equity in VSNL , followed by the contribution made by selling 27.5 percent equity of Maruti Udyog-MUL (Rs19 bn), and by Indian Petrochemicals-IPCL(Rs 15 bn).

Analysis of Privatization Policies

1.1 Mode of Sale

The government of India, initially started the process of privatization by partially disinvesting the shares of its select enterprises. This continued from 1991 till 2000. However, since the sale of Modern Foods in 2000, every sale has been a strategic sale (Kaur 2003 b).

Is the methodology of strategic sale right? It is generally perceived in the Ministry of Disinvestment that strategic sales along with transfer of management control, as opposed to market sale of shares in small lots, best serves the principal objectives of privatization, namely, improvement in firm's efficiency and revenue maximization for the government. In the Indian context this has worked as can be seen from the Price Earnings Ratio of the shares sold by partial divestiture and strategic sale. The realization as a Multiple of Equity Sold increased from 7 during the partial disinvestment stage to 12 during the time of strategic sales (Table 1). However, when sales are being made to private parties (and not to general public),

there is a lack of ‘democratic privatization’. That is, it does not result in widespread ownership of shares. This is in sharp contrast to the privatization in United Kingdom where as a result of ‘democratic privatization’, people of all kinds bought shares, resulting in a widening of the capital market. It is in this sphere that the Indian policy makers have a lot to learn from say their British counterparts in widening the base of the capital market. For instance, when British Telecom (BT) had to be privatized, more than £ 4 billion worth of shares were planned to be sold. This was seven times larger than the world’s then largest equity sale of AT&T in USA equaling \$ 1 billion. Obviously, the target was hard to meet. Nevertheless, not only were the shares of BT sold – they were actually nine times over-subscribed. Since the watershed sale of BT, every UK privatization offering has been over-subscribed.

The important lesson to be learnt is how did the British policy makers managed to do what they did, despite widespread criticism to sell off shares to the ordinary people. The answer lies in several innovations introduced to market the shares of BT to new buyers (Moore 1992). As a result of ‘democratic privatization’, people of all kinds bought shares in the companies privatized in UK, resulting in a widening of the capital market.

1.2 Amount Realized versus Amount Targeted

In the Indian context, it is a matter of concern that the amount realized through disinvestment has fallen far short of the amount targeted. Table 2 shows that the total amount realized through disinvested from 1991 to 2003 was Rs. 261 billion (USD 5.7 billion) against a target of Rs. 923 billion (USD 22 billion) leading to an average under subscription of more than 70 percent. This needs to be contrasted with the revenue proceeds of USD 7.0 billion realized from the sale of a single British company viz. British Telecom. The disinvestment proceeds (Target versus realized) is shown in Fig. 3.

Table 2 Disinvestments during 1991 – 2003

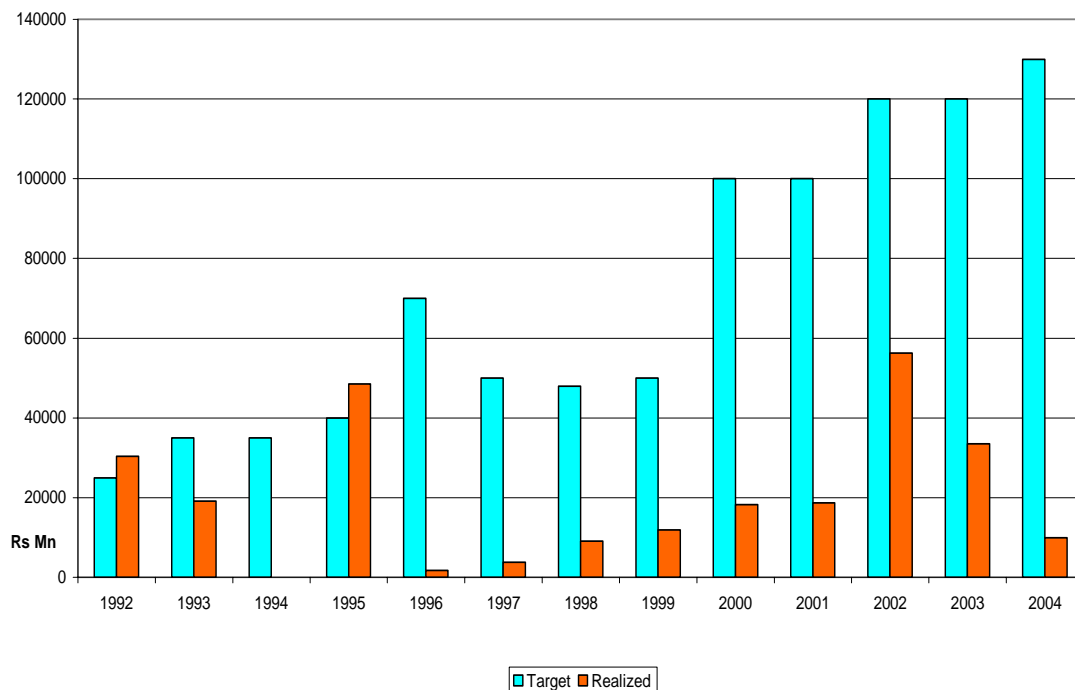
<i>Round</i>	<i>SOEs offered</i>	<i>Target Rs. Million</i>	<i>Realized Rs Million</i>	<i>Realization as % of Target</i>
1991-92	46	25000	30380	121.1
1992-93	29	35000	19130	54.6
1993-94	0	35000	0	0
1994-95	17	40000	48500	121.2
1995-96	4	70000	1680	2.4
1996-97	1	50000	3810	7.6
1997-98	1	48000	9060	18.9
1998-99	3	50000	11870*	23.7
1999-00	4	10,000	18290	18.3
2000-01	4	10,000	18700	18.7
2001-02	9	12,000	56320	46.9
2002-03	5	12,000	33480	27.9
2003-04	3	13,000	9930	7.6
1991-2004	49	923,000	261,150	28.3

*Further a sum of Rs.41840 million was realized by disinvesting equity holding amongst three PSEs inter-se namely ONGC, IOC and GAIL

There is, thus, a large gap between the revenues planned to be raised and the amount actually raised. In fact except for the first year of divestment in 1991-92, in no other year could the government realize revenues greater than the targeted level of disinvestment. The proceeds in 1994-95 are larger than the targeted proceeds, since Rs. 22,900 million was actually from disinvestments done during March 1993-94 - the proceeds of which could only be realized in 1994-95. On an average only 25 percent of the amount targeted could be realized in the 13 year period from 1992 to 2004.

Figure 3

Disinvestment Proceeds(Target versus Realized 1992-2004)



The market for SOE shares seems to have followed the Akerlof's Model. Akerlof (1979) had stated that a market where asymmetry of information exists between the buyers and the sellers, where quality is a major factor in enabling a trade that:

- 1) Either only the very worst cars (read SOE scrips) will be on the roads (read sold);
or
- 2) No trade will take place at all.

Thus, the analogy of market for bad cars, known as 'lemons', could be applied to the SOE equity.

1.3 Disinvestment and the Efficiency Dimension

The two relevant questions in our context are:

- Whether the sale of a part of the equity would force the government of India and the new shareholders to monitor the SOE's managers more effectively?
- How far are the SOEs' shares traded on the stock market so that prices of these shares can be looked upon as an indicator of management's performance?

Answering the first part of the question (i.e., whether the partial sale of equity improves shareholders monitoring), the following observation needs to be made. For many of the SOEs, less than 2 percent of the equity has been disinvested, since the inception of the disinvestment policy in 1991-92. In fact for 17 out of the 39 enterprises less than 10 percent of the shares have been disinvested. Only in six SOEs (namely HOC, HPCL, IPCL, MTNL, MFIL and VSNL) did the extent of divestiture exceed 40 percent of government equity. If it is assumed that at least 51 percent of the shares have to be divested to the private sector for effective efficiency implications, then it is clear that this would not happen. However, with the governments' recent decisions to strategically sell SOEs one could expect efficiency enhancement in the concerned SOEs.

We now try to answer the next question (i.e. how far the SOEs shares are actively traded on the stock market, so that the prices of these shares can be looked upon as an indicator of the managements performance). As of January 20, 2000, shares of SOEs comprised a weight of 14 percent in the Bombay Stock Exchange (BSE) Index. Stocks like IPCL, HPCL, ONGC, VSNL and BPCL, which came out with public issue and invoked tremendous responses from the retail investor are very liquid because of wider holding. On the other hand shares like CONCOR and HOCL are thinly traded. Moreover, the main activity is between the financial institutions. Participation by the retail investor is almost negligible. Further, it is estimated that nearly 80 percent of SOE shares acquired by financial institutions and mutual funds during Jan. 1992 to March 1993 and later, still await being offloaded in the secondary market. Since SOE shares are not traded actively, their prices do not reflect management's performance. It is undoubtedly clear that the efficiency of privatization exercise will critically depend on the ability of private participants to take full part in the exercise. It is in this sphere that the Indian policy makers have a lot to learn from say their British counterparts in widening the base of the capital market.

1.4 Disinvestment and the Fiscal Dimension

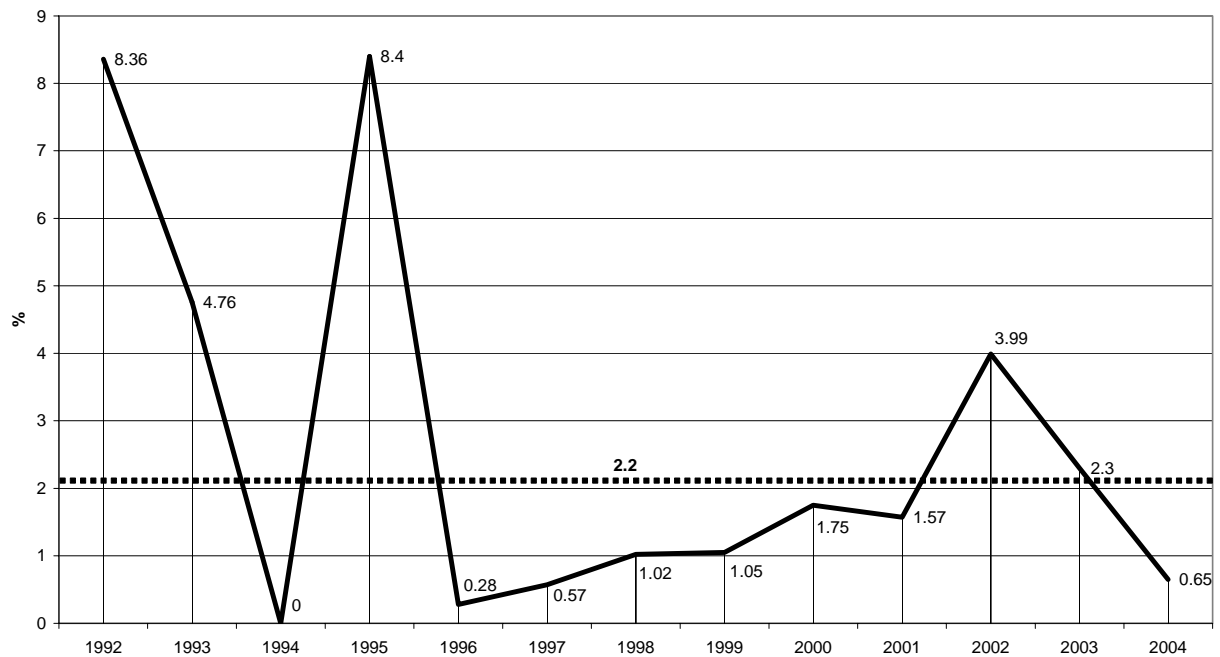
At the time of launching of the disinvestment policy in July 1991, a three fold objective - namely, to raise resources; to encourage wider public participation; and to promote greater accountability was envisaged. However, it is often stated that the prime objective of disinvestment is mainly to mobilize non-inflationary resources for the budget. This being the case, it is necessary to have a close look at the disinvestment proceeds and its relation to fiscal deficit. This is shown in Table 3 and Figure 4. Table 3 reveals that the amount of earnings realized through SOE disinvestment is Rs. 261 billion, while the total fiscal deficit since 1991-92 has been to the tune of Rs. 11873 billion This means that on an average only 2.2 percent of the fiscal deficit has been financed through the sale of SOE equity (shown by the dotted line in Fig 4), being as low as 0.28 percent in 1995-96 and 0 percent in 1993-94 (Figure 4). Therefore, one can conclude that the current levels of disinvestment are of limited consequence for closing the fiscal deficit. However, this is not to say that disinvestment proceeds *per se* have been insignificant.

Table 3
Deficit and Disinvestment (In Rs. Million)

YEAR	CENTER'S GROSS FISCAL DEFICIT	DISINVESTMENT PROCEEDS	DISINVESTMENT AS % OF FISCAL DEFICIT
1991-92	363250	30380	8.36
1992-93	401730	19130	4.76
1993-94	602570	NIL	0
1994-95	577030	48500	8.4
1995-96	602430	1680	0.28
1996-97	667330	3810	0.57
1997-98	889370	9060	1.02
1998-99	1133480	11870	1.05
1999-00	1047170	18290	1.75
2000-01	1188160	18700	1.57
2001-02	1409550	56320	3.99
2002-03	1454660	33480	2.3
2003-04	1536370	9930	0.65
1991-92 to 2003-04	11873100	261150	2.20

Figure 4

Disinvestment as Percentage of Fiscal Deficit



1.5 The Employment Implication of Divestiture

The impact of liberalization on employment primarily depends on the components of measures one takes into account, viz. *stabilization* or *structural adjustment*. It is generally hypothesized that stabilization measures are likely to have an adverse effect on employment growth whereas the impact of structural adjustment on employment depends on several factors. While some factors may work towards creating a positive impact on employment (by improving efficiency and productivity- Joshi and Little, 1996) others may work towards worsening of the employment situation (by making the pattern of growth more capital intensive or as an outcome of a more liberal exit policy and privatization – Ghosh, 1995; Datt, 1997; Kundu, 1993).

Largely, through the practical documentation provided by the trade unions, it is widely accepted that privatization usually results in a decline in the number of employees, as well as changes in organization, pay and other working conditions. Therefore, with divestiture, as far as the workers are concerned, initial apprehensions regarding employment are justified. The change of ownership from public to private usually means losing a status resembling that of a civil servant to becoming a private sector employee with no guaranteed job security. Moreover, positive human resource policies and a closer eye on society concerns are generally associated with public ownership, largely because of the narrower economic objectives characteristic of privatized or private enterprises. Therefore, the trade unions' general stance towards divestiture is largely defensive and uncompromising. Nevertheless, it is also interesting to note that there have also been instances whereby employment has been protected through guarantees given by governments, or by agreements signed between trade unions and governments and/or the new employing body (ILO – SAAT, 1997; and Oestmann, 1994).

In India the policy of disinvestment has been looked upon with skepticism. The strategic sale of BALCO in 2000, to a private party was met with a lot of resistance from the workers. They went on an indefinite strike, which lasted for over 60 days. They allowed Sterlite Industries (the new employers) entry into the premises only when the latter agreed not to retrench a single worker. Given this, the focus of this sub-section is specifically to examine the impact of disinvestment on employment levels in the Indian SOEs.

The public sector in India until the late 1980s played a fundamental role in the development of the economy. It accounted for almost 70 percent of the total employment in the 'organized sector'. Despite the process of liberalization in early 1990's, the public sector continued to account for a large percent of total employment in the organized sector. However, its share marginally declined from 71.2 percent in 1990 to 69 percent in 1999 (Public Enterprise Survey, Various Issues; Kaur, 002).

We now show the break up of the level of employment in the 240 SOEs in terms of employment in the disinvested and non disinvested SOEs for the period 1981 to 2000 (Table 4). The rates of growth of employment in the SOEs, divested SOEs and non divested SOEs were 15.15 percent, 19.16 and 11.3 percent respectively for the period 1981 to 1991. The corresponding figures for the post reform period (1991 to 2000) were minus 17.5 percent, minus 17.8 percent and minus 17.4 percent respectively. This implies that the decline in employment in the post reform era was almost the same for

the three categories. Moreover, the share of employment in disinvested SOEs to total SOE employment remained at 27 percent in the 10-year period. This indicates that even though the absolute number of people employed in disinvested SOEs decreased from 0.6 million in 1990-91 to 0.51 million in 1999-00, it may have nothing to do with the policy of disinvestment *per se*.

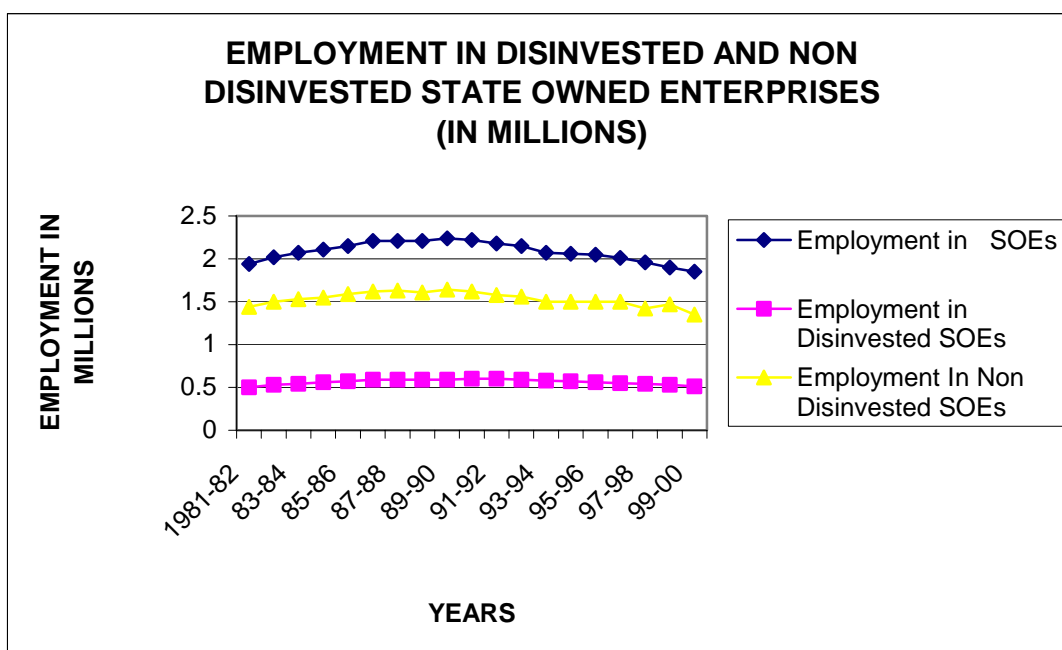
Table -4
Employment in Disinvested and Non Disinvested SOEs
(in millions) 1981-2000

<i>Year</i>	<i>Employment in SOEs</i>	<i>Employment in Disinvested SOEs</i>	<i>Employment In Non Disinvested SOEs</i>	<i>Employment in Disinvested SOEs as percent of total SOE employment</i>
1981-82	1.94	0.50	1.44	25.80
82-83	2.02	0.53	1.50	25.98
83-84	2.07	0.54	1.53	26.11
84-85	2.11	0.56	1.55	26.38
85-86	2.15	0.57	1.59	26.36
86-87	2.21	0.59	1.62	26.50
87-88	2.21	0.59	1.63	26.55
88-89	2.21	0.59	1.61	26.88
89-90	2.24	0.59	1.64	26.81
90-91	2.22	0.60	1.62	27.00
91-92	2.18	0.60	1.58	27.35
92-93	2.15	0.59	1.56	27.60
93-94	2.07	0.58	1.50	28.04
94-95	2.06	0.57	1.50	27.60
95-96	2.05	0.56	1.50	27.29
96-97	2.01	0.55	1.50	27.30
97-98	1.96	0.54	1.42	27.50
98-99	1.90	0.53	1.47	27.80
99-00	1.85	0.51	1.35	27.39

Source- Public Enterprise Survey-Various issues

In figure 5 we can clearly see that the employment in the post reform era has declined in both the divested and non divested SOEs. Interestingly, the decline in employment in the post reform period has been greater for the non-disinvested SOEs than for the disinvested SOEs.

Figure 5



Section 2

Greenfield Privatization

Privatization as a process that aims at reducing the involvement of the State or the public sector in the nation's economic activities, by shifting the divide between public sector and private sector in favour of the latter (Greenfield Privatization) has made considerable progress since the introduction of the new economic policy (NEP) in 1991. The process of re-divide has been mainly through:

- Delicensing of major industries
- Decline in number of areas reserved for public sectors, and
- Encouraging direct foreign investments

Thus, the role of the public sector which was sought to be enlarged in the Industrial Policy Resolution (IPR) of 1956 is henceforth to be limited to essential infrastructure and defense and more and more areas are now being opened to the private sector. Encouraging private sector participation has been the main thrust of reforms in SOEs most of which are in the infrastructure sector. A wide spectrum of services such as transportation (railways, roads, civil aviation, ports and shipping), power generation, transmission and distribution and telecommunication services have now been opened to the private sector. In these areas, new schemes of Build Operate Lease Transfer (BOLT), Build Operate Transfer (BOT) and Build Own Operate Transfer (BOOT) have been introduced (Kaur 1999). Under the BOLT scheme the private entrepreneurs are invited to build the asset and then lease the constructed assets to the public sector. The public sector pays the private entrepreneur the lease charges for the asset. On the expiry of the lease period, the asset is transferred to the public sector for the remaining period of the economic life of the asset. Under the BOT scheme, the private operator builds the project at hand, operates it till it has broken even and then transfers it to the government, who takes care of the asset from then on. Similarly, BOOT is functionally

the same as above, except for the fact that the ownership of the project/asset resides with the private operator. The main differences between these modes of private sponsor participation are indicated in Table 5.

Table 5
Differences between Modes of Private Sector Participation

Arrangement	Ownership of Assets	Operator of the Facility during the concession Period	Transfer of Assets after Concession Period
BOO	Private	Private	No
BOT	Government	Private	To Government
BOLT	Private	Private/Government	Yes

In the transport sector, schemes such as own your wagon, own your tourist train, maintenance of a railway station, privatization of catering have also been initiated. Roads are also now open to the private sector. In fact, the Thane-Bhiwadi bypass in Maharashtra and the Udaipur bypass in Rajasthan have gone to private investors on BOT basis. In the case of ports, leasing out of existing assets of the port to the private sector has been introduced. In air transport the Indian skies have opened up to the private sector to include two scheduled private airlines which provide regular domestic air services along with Indian Airlines. In addition there are 41 non scheduled operators providing air taxi/non scheduled air transport services. In the telecommunication sector, in both the basic and the value added services, private entry is now permitted. Various value added services such as cellular mobiles, radio paging, electronic mail and video conferencing are now provided by the private sector. In the power sector private participation is now allowed in both generation and transmission.

Section 3

Cold Privatization: Memorandum of Understanding

The concept of Memorandum of Understanding (MOU), also referred to as Cold Privatization is a very simple one. It is supposed to be a “freely” negotiated performance agreement between a public enterprise and the Government acting as an owner of the public enterprise, in which both parties clearly specify their commitments and responsibilities. The need for this device arose because no one, including the public enterprises knew what was expected of them. Different agencies of the Government - Planning Commission, Finance Ministry, Auditor General, Administrative Ministry and Parliament - had different and often conflicting expectations from these enterprises. Most frequently it is described as a problem resulting from the fact that public enterprises very often have “multiple principals” with “multiple goals” that are often conflicting. MOU was recommended by the Arjun Sengupta Committee as an instrument to reconcile these multiple objectives in a single document and send a consistent signal to public enterprises. Further, once the tasks of public enterprises have been specified in the MOU, these enterprises are to be evaluated only against them and given total operational freedom to achieve their goals. The idea is to simultaneously increase accountability and autonomy by moving towards management by objectives instead of exercising control through procedures.

The MOUs have progressively covered an increasing number of SOEs. From just 4 SOEs that signed an MOU in 1987-88, the number of SOEs that signed MOU in 2002 is 109. At the beginning of the period when the MOU is signed, not only is a weight assigned to each criterion but also a set of five criterion values, varying from 1 to 5, indicating excellent, very good, good, fair and poor performance is listed. At the end of the period, the actual performance is compared to the criterion value. Then, through the process of interpolation, a raw score is evaluated for each criterion. This raw score when multiplied by its weight gives the weighted raw score (WRS). Summation of all WRS gives a “composite score” (Kaur 1998). The Bureau of Public Enterprise has given the MOU ratings as follows:

Composite Score Between	Rating
1.00 - 1.50	Excellent
1.51 - 2.50	Very Good
2.51 - 3.50	Good
3.51 - 4.50	Average
4.51 - 5.00	Poor

Based on the above scores, the percentage of SOEs getting a rating of either *excellent* or *very good* has always been higher than 70, being as high as 96 percent in 1990-91. However, the performance of SOE based on MOU rating should be analyzed with caution, since despite a good ranking the SOE may not be performing well. This is because the possibility of fudging targets cannot be ruled out.

Since the composite score of each SOE depends upon its actual performance vis-à-vis the target assigned to each criterion, it would be in the interest of the managers to set soft targets that can be achieved easily. Setting soft targets, no doubt will make a mockery of the evaluation system. In order to check this, the Adhoc Task Force (which consists of eminent management experts, chartered accountants and professors) assists the High Power Committee (consisting of those Secretaries to the Government of India who do not sign a MOU themselves) to monitor the targets set by the managers and their performance. The Planning Commission and Finance Ministry also examines these targets before they come to the ATF. However, despite all this, target setting has often been soft in the past. Target setting could be soft if any of the following happens:

- When *actual value* far exceeds not only the *targeted value* but also the criterion value of *excellent*, and/or
- When *target values* for next year are set lower than *actual* achievements of the previous year.

For instance, for the enterprise Bharat Petroleum Corporation Limited (BPCL), almost every year the actual performance related to the financial indicator Profit before Depreciation, Interest and Tax (PBDIT), exceeded not only its targeted value but also the criterion value of *excellent*. For instance, as given in Table 6, in 1991-92 the enterprise’s target was to make a ‘PBDIT’ to the tune of Rs. 2700 million. Yet, it exceeded its target by Rs. 1330 million to ultimately attain Rs. 4030 million. This was Rs. 1280 million more than the criterion value of *excellent*. Similarly, for the year 1994-95, its target was to attain a ‘Gross Margin’ of Rs. 4360 million. The criterion value to attain an *excellent* score was to get Rs. 58 million more

than the 'very good criterion' value of Rs. 4360 million, i.e. in order to get an excellent rating it needed to have a gross margin of Rs. 4418 million. Yet, in the year 1994-95, its actual performance on this criterion was Rs. 6090 million i.e. almost Rs. 1670 million higher than its *excellent* score. Same holds for the year 1995-96, in which its actual Gross Margin exceeded the criterion value of *excellent* by Rs. 380 million.

Table 6
Instances when Actual Value Exceeded the Criterion Value of Excellent

ENTERPRISE	Year	EXCELLENT	TARGET	ACTUAL
BPCL				
I) PBDIT (Rs. Million)	1990-91	2900	2820	3490
	1991-92	2750	2700	4030
	1992-93	3290	3270	4735
	1993-94	3654.5	3600.9	4069.1
II) GROSS MARGIN (Rs. Million)	1994-95	4418	4359	6090
	1995-96	5774	5695.6	6154.5

Similarly, instances can also be cited for various indicators, such as 'PBDIT', 'Net Profit as a Percent of Capital Employed', 'Refinery Crude Throughput', 'Market Share' and 'Fuel and Loss', where very often the targets fixed for next year were set lower than the actual achievements of previous year. For instance, for the indicator 'PBDIT', the target for 1991-92 was fixed at Rs. 2700 million even though it had made Rs. 3490 million in the previous year. Similarly, the same target was fixed at Rs. 3270 million for 1992-93, which was lower than Rs. 4030 million made in the previous year. In fact, the target of Rs. 3270 million for 1992-93 was not only lower than the actual achievement of 1991-92 (Rs. 4020 million), but even lower than the achievement of Rs. 3490 million in 1990-91 (Details given in Table 7). A justification for lower targets could be an adverse market condition or rise in input prices. However, no such condition prevailed since the enterprise actually made a profit of Rs. 4735 million i.e. Rs. 1465 million more than its targeted value of Rs. 3270 million.

To cite another example, consider the indicator 'Fuel and Loss'. With respect to this indicator, it is interesting to note that every year since 1990-91 the target fixed for next year is lower than the actual achievement of the previous year. As a result, each year's performance exceeded the target (as well as the criterion value under excellent) set for the same year. Because of this the enterprise continued to get a raw score of 'one' even though its performance was deteriorating over the period. For instance, its efficiency in 'Fuel and Loss' decreased from 5.83 percent in 1990-91 to 6.22 percent in 1994-95. Yet, this decline could not be captured by the performance of the enterprise based on MOU rating.

Table 7
Cases when Targets for Next Year Were set Lower than Actual Achievement of Previous Year

Enterprise	1992-93	1993-94	1994-95	1995-96
BPCL				
I) PBDIT (Rs. Million)				
Target	3270	Criterion did not exist	Criterion did not exist	Criterion did not exist
Actual	4730			
Excellent	3290			
II) Net Profit After Tax as % of Capital Employed				
Target	Criterion did not exist	11.15	11.81	12.68
Actual		12.85	15.21	13.44
Excellent		11.44	12.13	12.95
III) Refinery Crude Throughput (Mn Tonnes)				
Target	7.20	7.05	7.00	7.05
Actual	7.23	7.21	7.41	7.35
Excellent	7.25	7.25	7.20	7.20
IV) Market Share (%)				
Target	18.61	18.61	18.61	18.69
Actual	19.22	19.88	20.10	20.35
Excellent	18.64	18.64	18.64	19.75
V) Fuel and Loss (%)				
Target	6.80	6.85	6.60	6.70
Actual	6.18	6.19	6.22	6.40
Excellent	6.70	6.70	6.45	6.50

Section 4

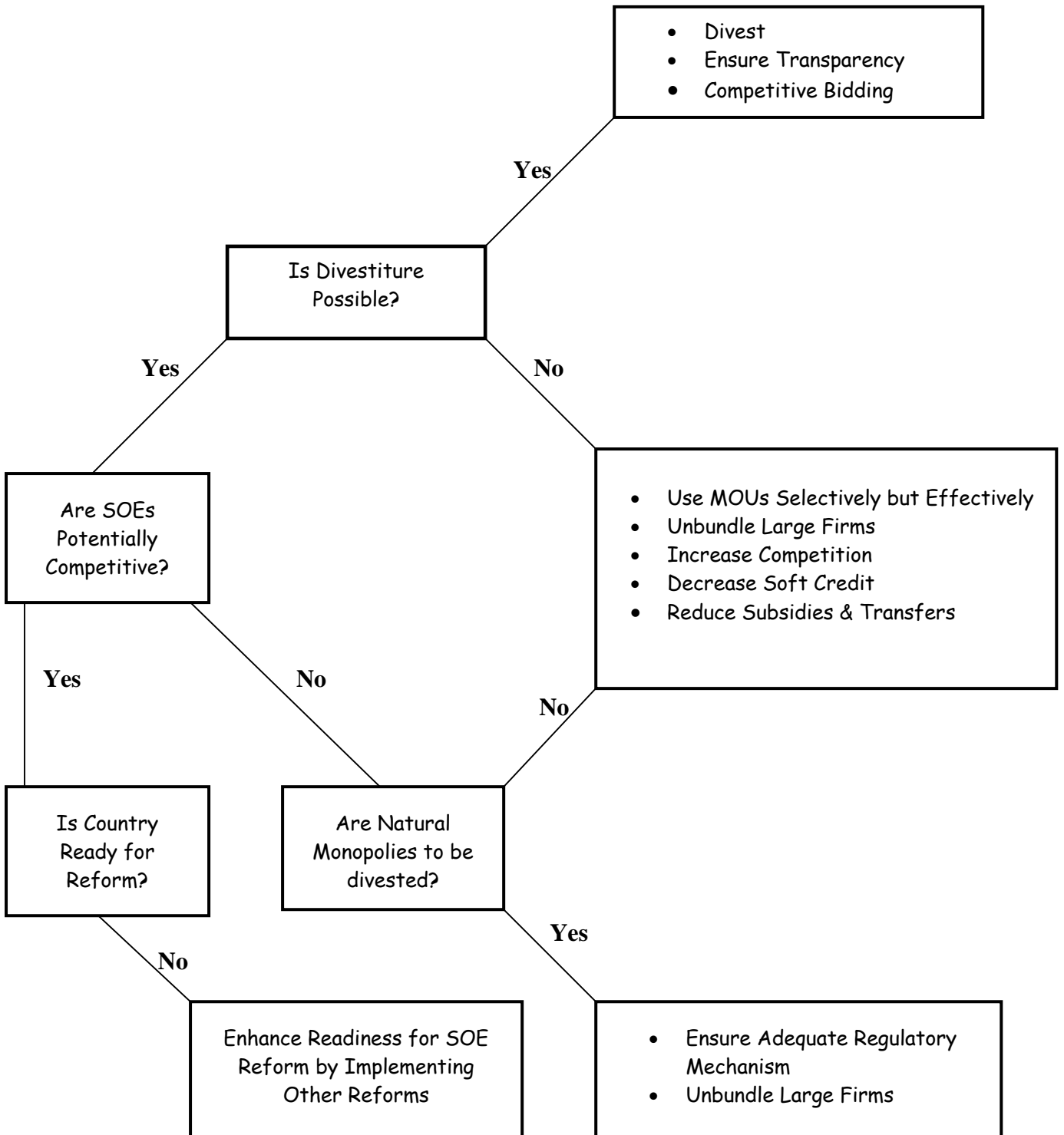
Implementation of Reform

There are no blueprints that guarantee the success of reforms. However, there are some ground rules, derived from research and practical experience that could increase the probability of success. Such reform options are shown in Figure 6. For instance, the figure shows that reforms should be initiated only when the country is ready to accept and absorb them. Countries that are not ready for SOE reforms should first introduce measures (such as reduce fiscal deficits and introduce trade, industrial and financial sector reforms) to create conditions for such reforms to be successful.

For countries that are ready for SOE reforms, the foremost task is to decide whether SOEs need to be divested or is a suitable mechanism to be introduced to enhance efficiency without divesting them. Enterprises that are to be divested could be operating in either competitive or potentially competitive markets (most manufacturing activities) or natural monopoly markets (some utilities and most infrastructures). Selling off competitive SOEs is not much of a problem. Nevertheless, efforts should be made to make the sale as transparent as possible. For divesting enterprises operating in monopoly market environment two considerations should be kept in mind:

- Firstly, one must try to unbundle large firms by, say, breaking a national monopoly into regional monopolies or by separating one activity from the other. For instance, electricity generation could be separated from electricity production.

Figure 6

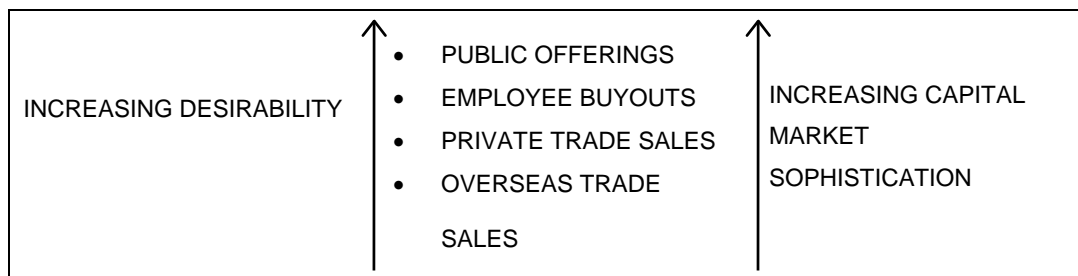


- Secondly, by ensuring that a credible regulatory authority is in place so as to overlook the functioning of newly privatized firm. Research has shown that regulatory contracts are more successful when either the price cap¹ or benchmark regulations² are adopted instead of rate of return regulation³. This is because rate of return regulation does not induce the firm to lower costs (World Bank, 1995).

Another important area that needs to be addressed relates to the question ‘whom to sell’. In other words, who are to be the potential buyers of SOEs equity? Because of the desire to spread ownership widely, public offerings of shares are the preferred choice. Failing this, employee buyouts are an alternative provided that the funds are available and the company's cash flow can support the necessary leverage. The most difficult sales are to corporate purchasers particularly if overseas buyers are involved. The politics of privatization are such that the domestic investors normally have to be given preference although minority sales overseas can be an important factor in bringing an otherwise domestic sale to a successful conclusion.

In practice, therefore, a hierarchy of political desirability can be established, which coincides fortuitously with the level of capital market sophistication, that is necessary to bring the sales to a conclusion. This hierarchy is demonstrated in Figure 7.

Figure 7
Hierarchy of Political Desirability in Privatization Options



The public offering represents the high point of privatization. For countries with undeveloped capital markets, overseas trade sales may be the only option, even if undesirable politically.

Unfortunately, the capital market in India is not well developed. The size of investor population is very small and is less than 1 percent. The ownership pattern of securities is heavily biased in favor of 5 centers viz.; Mumbai, Delhi, Kolkata, Ahmedabad and Chennai. Semi urban towns with population of less than one lakh have insignificant security holdings. Farmers as shareholders are negligible. They have less than 3 percent of the paid up value of the shareholdings. There is thus a need to tap the large untapped rural and semi urban deposits while going ahead with privatization.

¹ The price cap regulation is also known as the (RPI - X) regulation. Under this regulatory mechanism, the private monopolist cannot charge a price higher than the increase in Retail Price Index (RPI) of all commodities minus a politically chosen number, say X. The higher the value of X, the greater the benefits passed on to consumers.

² In benchmark regulation (or yardstick regulation), tariffs are set to allow the firm a fair rate of return with reference to some yardstick, rather than its actual costs.

³ Under the rate of return regulation, prices are set in such a manner that the firm can cover costs and make a fair rate of return.

Irrespective of the government's decision to privatize SOEs, some public enterprises in competitive and non — competitive markets will remain in the domain of public sector for several reasons. Such as: the government's inability to divest in a competitive and transparent manner, lack of administrative capacity to regulate private monopolies, underdeveloped capital markets, or for political reasons.

In such a situation policy makers have two options:

- i) One, to go in for management contracts - those between the government and private managers managing SOE.
- ii) Two, to go in for reforms under the existing ownership and existing management.

A World Bank Study (1995) shows that management contracts with private managers do a better job of improving company performance than contracts with public managers. However, management contracts are suitable only in specific sectors (where technology does not change rapidly or where the final product is highly visible, easily compared product - such as hotel services). Since management contracts are useful for only a small group of industries, there still remain potentially competitive and non-competitive enterprises with the government. For such enterprises, the governments have no choice but to attempt improvements within the existing ownership and management arrangements. For such enterprises, the options are: to increase competition by dereserving goods to be produced by the public sector only; by delicensing; and by reducing trade barriers; by creating a level playing field for the public enterprises; by cutting subsidies and transfers and by using performance contracts with public managers selectively but effectively. Performance contracts provide greater autonomy to and induce greater accountability among public enterprise managers attained. However, due care should be taken to ensure that soft targeting does not exist. One reason managers use their information advantage to act opportunistically is that the rewards and penalties in the contract do not motivate them to try to improve performance. Therefore, monetary incentives should be introduced. However, they should be given when the SOE meets not only its contracted target but also improves upon its efficiency (Kaur, 2003).

Thus in order to reform the SOEs, various options are available, ranging from complete divestiture to reforms that can be introduced within the existing ownership pattern.

Section 5

Conclusion and Policy Implications

Fiscal compulsions forced the government of India to sell the equity of their enterprises in the 1990's and later. So far 39 SOEs have been partially disinvested while 35 SOEs have been strategically sold. A total of approximately Rs.300 billion has been raised through disinvestments. However, unlike many other developing economies where an aggressive policy of privatization (i.e. a transfer of ownership from the public sector to the private sector) has been adopted as part of liberalization, this has not been the case in India. In India, the new economic policies of liberalization are more in the nature of *Greenfield Privatization*. Such policies have prompted private industrialists to venture into areas earlier reserved for the public sector, such as, power, aviation, telecommunications, roads and railways. These policies are expected to have a major thrust on enhancing efficiency in the industry. This is

because removal of entry barriers opens the floodgates of competition. *Cold Privatization* has also been adopted with limited success.

The process of privatization raises a few set of questions. In the first set are questions such as – what are the economic consequences of selling public sector enterprises? Is the government doing the right thing by disinvesting? Will privatization deliver? These ownership (public versus private) related issues have not gone uncontested. Within an orthodox microeconomics framework, it is perfectly possible to argue that in many contexts (of which existence of externalities and natural monopoly are the more obvious examples), public ownership will do better in terms of economic efficiency than private ownership. However, in cases where state failures dominate (of which internalities and unequal distribution of power, as against wealth, are the most significant factors), privatization in fact may be a better option. That is to say that ownership does matter. The allocation of property rights matters because it determines the objectives of the owners of the firm (public or private) and the systems of monitoring managerial performance. Since public and private ownership differ in both respects, changes in property rights will materially affect the incentive structures, the behavior of managements and hence the efficiency of the organization. Thus the economic consequences of selling public sector enterprises will get reflected in enhanced efficiency of the privatized unit. However, in the Indian scenario, changes in performance of SOEs have not materialized due to the nature of disinvestment modality adopted till recent years.

Another set of questions that arise are: whether it was right to sell the companies that have been privatized and whether it is desirable to press on with the privatization program? Though the questions cannot be answered independently of the mechanisms of competition and regulation for the industries concerned, but broadly it can be stated that: privatization is appropriate where market failures are less serious than state failures. Therefore, the privatization of firms by the central government in reasonably competitive industries, such as 19 hotels of ITDC, Modern Foods- a bakery, BALCO- an aluminum company, Maruti- a car manufacturing company, is fine.

Regarding the future of privatization process, while the public sector should continue to operate in strategic and defense related sectors, for consideration of national security, the rest of the enterprises could be privatized. This re-divide in favour of the private sector should not be for the reason that efficiency in public sector is at a discount but rather for the fact that:

- Once private sector is allowed in areas hitherto reserved for the public sector, competition will enhance, which in turn will increase efficiency of the erstwhile monopoly SOEs.
- Privatization will reduce government's commitment and involvement in enterprise decision making and thereby it will be in a better position to provide infrastructure and welfare goods to the public, which at present it is unable to do adequately on account of its pre-occupation with production activities.

Given these considerations, the policy of privatization in the era of globalization, seems to be in the right direction. However regarding the strategy adopted, questions such as – why strategic sales and why not widening of employee ownership by selling shares to the employees or the public will, no doubt, continue to be raised.

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