Note on Privatisation

By Ajay Chhibber

India is saddled with a socialist legacy of some 235 State-Owned Enterprises (called Central Public Sector Enterprises –CPSE's) at the center and over 1000 smaller State-Owned Enterprises in the states (SLPE's), built up largely from the mid 1950's to the mid 1980's. They were called Ratnas (crown jewels) of India's economy, but instead became "bleeding ulcers". Since the 1991 liberalization their importance in the economy has declined, but still remains significant.

Their record is mixed and while their combined balance –sheet with assets worth over $500 billion - shows profits, they contain large loss makers eating up vital public resources which could be used to finance badly needed health care, education and roads, ports and rail infrastructure. Over 1000 state level PE's also remain in trouble. Congress led UPA governments have tried to improve CPSE performance through greater commercialization, opening up sectors to private enterprise, restructuring and performance contracts called Memorandum of Understanding (MOU's). A BJP led NDA government tried to privatize a few of these companies with some success, despite huge opposition from vested interests. The current NDA government has once again announced that it will embark on privatization and closure of CPSE's including that of the marquee "Air India."

Both UPA and NDA governments have resorted to partial privatization (share sales), mainly to raise resources to finance budget deficits. But this is like "selling the family silver to pay the grocer's bill". Almost 10% of the total share value of CPSE's has been sold off after listing. 35% of the CPSE's are now listed. Ironically, even though the main reason for share sales was revenue for the budget, divestment has led to improvements in CPSE performance, much more so than have MOUs (performance contracts). The discipline of market listing and having more private input into management of the companies has improved the financial and economic performance of many divested PSE's although there are exceptions. Full privatization also improves firm performance based on the experience of the few firms privatized in the period 1999-2004.

Very little has been done to improve the over 1000 state level PE's. There is no consolidated picture on their finances. Almost a quarter of them are non-functional but have not been closed down. Many of them are loss makers – especially in transport, water and energy. Very few of the profitable ones even declare a dividend.

Instead of more aggressive privatization and using the freed up resources to build public infrastructure, India embarked on huge program of public –private partnerships (PPP's) - probably one of the biggest in the developing world. The record of these PPP's has also been poor. Managing this program will require

transferring these PPP's into a professional central agency to assess and apportion risks and tailor the PPP's to sectoral requirements.

India needs to prepare a ten year plan to privatize and improve the performance of its PSE's, instead of piece-meal asset sales and privatization. The plan could have two 5 year phases with Phase 1 focused on PSE's that need closure or where outright sale in PSE's in manufacturing, mining and services will not disrupt provision of goods and services to citizens because the share of these companies in total sales in their respective industry is relatively small. Phase 2 could be reserved for PSE's where alternate service provision options are needed with reforms in those sectors.

For now, the 10 year plan could leave the Maharatnas in state hands—whose total assets are around Rs 10 trillion ($133 billion), about one-third of total PSE assets of about Rs 30 trillion ($500 billion). In any case, the Maharatnas—BHEL, Coal India, GAIL, Indian Oil, NTPC, ONGC and SAIL—are collectively doing better than private companies of similar size. Their return on capital and return on assets have been higher than those of comparable private firms by 4% and 2%, respectively. However, even in this category the situation has seen a reversal of trends in the last three years; the private sector has shown a surprising improvement in return on capital and return on assets while the Maharatnas are showing a continuous decline in performance. Therefore, among the Maharatnas, SAIL, BHEL and Indian Oil need serious restructuring and better leadership to make them world-class companies.

The remaining two-thirds of state assets are in the 17 Navratnas, 73 Miniratnas and 120 odd companies that are not given a Ratna status. The performance of the 17 Navratnas is consistently worse than that of comparable private companies, with return on capital roughly 2% lower compared to equivalent private firms. Many of the companies in this group could be privatized in Phase 1—especially Bharat Electronics, MTNL, NMDC and Oil India.

The category of Miniratna is formed by 73 companies, and these are the ones that are most ripe for strategic disinvestment in Phase 1. A plan to sell most of these companies should be developed, with those in manufacturing and the services sector high on the list for immediate sale as these are the worst performers. There will be many arguments made against selling these companies to the private sector, but there seems to be no reason to run these as public companies except to provide employment to a small number of people and to be able to provide managerial positions to party members once any new government comes into power. A far more serious issue is that of tainted contracts and procurement, where lucrative deals are handed out to cronies.

It is often argued that PSE's should be prepared for privatization through restructuring prior to the sale. But it is not evident that such restructurings are helpful or get higher valuations. The buyer may or may not value any of these restructurings and may have very different ideas of how to improve the company. So operational restructuring is often not advisable. On the other hand financial

restructuring may be needed for many PSE's as they often have a web of complicated financial relationships or like Air India are saddled with large debt. Cleaning up these financial issues will be needed to prepare them for sale. In the case of partial privatization preparing a company for listing on the stock market can help create value as the listing requirements will inevitably improve transparency and move the company to adopt common financial and governance standards in order to be listed.

The largest group are those that do not have Ratna status. The loss makers in this group which serve no social or security objective should be prepared for sale or closure in Phase 1. But even for those that do we need a long term plan to look for alternative ways to serve national and consumer interest. For example, it will be argued that the Food Corporation of India (FCI) is needed for India's food policy objectives. But if India reforms its food policy and allows private traders to play a much bigger role in the purchase, storage and sale of food (along the lines of the Shanta Committee Report, 2016) the FCI could be run as a small non-profit agency. Poor consumers could be provided cash transfers instead of the elaborate system of fair price shops. Mexico provides a good example of how it got rid of a costly state-owned enterprise CONASUPO over a ten year period and replaced it with a well-run cash transfer system called PROCAMPO. But of course such changes in the entire food marketing chain will take time and cannot be done overnight. But without a clear plan on where India needs to be 10 years from now it is hard to make any change at all.

The same logic applies to India's numerous fertilizer PSE's. Farmers (especially small farmers) should be paid a cash subsidy to help them purchase fertilizers and other inputs. But the private sector should gradually take over the production and distribution of fertilizers and get the numerous fertilizer PSE's out of the system altogether. Again Mexico (through its PROGRESSA program) and later Turkey were able to make this transformation with huge savings to the budget. But these changes will take time and should be included in a ten year plan. India does not need food and fertilizer PSE's to meet its food policy objectives: it needs a different system altogether. These types of PSE's could be reserved for closure or sale in Phase 2.[1]

There is a case to keep some of the power and oil companies in public hands at least in the first phase. For example, the Power Grid Corporation could remain in government hands until complete unbundling has occurred in the power sector after which it too could go into private hands. Some of the oil companies could also for now remain in government control until fuel prices are liberalized and brought under the GST.

There was a case earlier for defense-related PSE's on security grounds- such as Hindustan Aeronautics Limited (HAL). That case may yet exist but with the government opening up the defense sector to private investment and consciously

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[1] India was developing a futures market in food grains in the 1950's but once the government entered the food grain market in a big way in the 1960's it killed the development of futures.

encouraging the private sector to enter this excluded area the case for defense sector PSE's becomes weaker. It may in any case help bring in foreign partners into these companies to upgrade their technology and make them more cost-conscious. But even if the security area the case for PSE's is now much weaker and even these could be under plans for privatization in Phase 2.

How and to whom these companies are sold does matter. Russian-style or Latin America style privatization—where most of state assets were sold to "oligarchs"—must be avoided. Transparent processes, competitive bidding and ensuring that some of the funds are set aside for worker compensation are vital for strategic disinvestment to succeed. Strategic sales are considered the optimal way to get the best returns from the privatization but this need not be so. In democratic countries with reasonably well developed capital markets, open market sales (share sales) could be designed to widen ownership and create a greater public stake for the sales. India now has many large well-functioning private companies with professional management and are not family owned. Employees could also be provided shares – employee stock option plans (ESOPs) in the privately managed companies so that they are not so resistant to the sale and also share in the upside post-privatization. For companies that are already listed the concern that such large block sales will lower their share price can be countered by call-auctions and pre-announced share sales in smaller chunks over a period of time. FII's could be allowed to purchase shares so that there would be no need to list these companies in international stock exchanges. They could be listed in the National Stock Exchange or the Mumbai Stock Exchange – which are now experienced enough to handle such sales- but with FII access the market for these shares would be wider. [2]

The opposition to such an approach will come from trade unions, vested interests and even consumers afraid of higher prices. But considering the long-term benefits to the economy and, eventually, better services and products to the consumer, this approach is worth exploring. Without such a bold approach we will perhaps see some temporary improvements in some PSU's but the underlying incentives for better performance will not have changed and future politicians will again have the opportunity to misuse them.

The PPP program needs a major overhaul along the lines of the Kelkar committee recommendations. Banks are not the best place to seek long term finance for PPP projects and efforts must be made to develop non-bank financial sources: the bond market, insurance and pension funds going directly to finance such projects

At the state level more than half the SLPEs should be shut down. In fact over 300 of the registered companies are "non-working" and should be wound down immediately. There is no particular reason to keep them open; other than the state does not know what to do with employees who are part of the payroll of these companies. But despite repeated admonitions by the CAG these have not been

[2] See Kelkar (2010) for more elaboration on these issues.

closed down. But even among the "functioning PSE's" there are many loss making companies that have outlived their usefulness and are candidates for closure.

A centralized account should be created to know the full financial picture of all remaining SLPE's just as has been done for the CPSE's. A dividend policy should be enforced so that profit making SLPE's provide a return to the taxpayer. Privatization should be pushed for those in the mining and manufacturing sector and much greater commercialization for the service PSE's in water, electricity distribution and in transport.

In order to avoid the charge that the government is selling the family silver to so to speak pay the grocer's bill – the proceeds from the privatization and sales of assets of closed firms should not go back into the budget but instead should be put into the National Infrastructure Investment Fund and used to pay worker compensation so that the people can visibly identify how the proceeds are being utilized. Such an approach also follows the best practices of the IMF's fiscal rules which have inexplicably been eroded in India and even the IMF has acquiesced in this relaxation of the fiscal rules for India.

Privatisation of some of India's state owned banks is also badly needed. That India was able to avoid the Asian financial crisis and the global economic crisis is often cited as a sign that our financial system is solid. But the slow spreading malaise of non-performing loans (NPL) and scams if not dealt with could prove damaging to India's ambitions to be a global economic power.

So far, we have dealt with our banking crisis with palliatives: the weak Indradhanush scheme, a non-functional Banks Board Bureau, a promising but complicated to implement Insolvency and Bankruptcy Code, and a missed reform opportunity with the bank recapitalisation scheme. The irony is that the hit on the taxpayer is massive even without a full-blown crisis. When the $30-billion recapitalisation plan was announced, it was clear that it was insufficient to address the NPL problem that exceeded $150 billion. But it was hoped that if the bulk of the funds would be used to recapitalise the better performing banks first, and these banks could also raise private financing, the credit cycle could be quickly revived.

Instead, the money was dribbled out to all the PSU banks with a greater share going to the weaker banks. Now, with the revelation of scams, even more capital will be needed, and the ability to raise funds from the equity markets is dwindling as PSU banks shares take a hit.

The recapitalisation plan should have led to a reduction in the number of PSU banks — either through privatisation or through merger. But unfortunately this did not happen. The clamour for privatisation has increased after the latest scam in Punjab National Bank and at Bank of Baroda. The argument made is that India should not privatise PSU banks because they provide a social function: lend to rural sector and provide banking in remote areas. It is also argued that banking crises occur even in countries that do not have state-owned banks. But when a crisis is

systemic, and the financial system freezes, the bailout hits the taxpayer whether the problem is caused by public or private banks.

But these are still not good arguments for keeping 21 PSU banks — which are hard to regulate, lack adequate managerial competency and are gamed by cronyism. It may be better to have at best two PSU banks for meeting 'so-called' social functions and free up the rest to do professional commercial banking. In any case, the bulk of the NPL problem is due to cronyism towards well-connected 'wilful defaulters'.

India underwent a phase of liberalization after the 1991 reforms but some 25 years later the socialistic legacy of the public sector and government control still remains large at the central and state level. Controls have shifted from licensing to regulatory bodies and a large public banking system remains allowing the business-politician nexus enormous power, patronage and opportunity to shift down side risks to the taxpayer and derive huge profits on the upside.

India is ready for a second set of reforms to unshackle India from state control, reduce the footprint of the state so that the government's slogan of "maximum governance; minimal government" can be realized. India has a public sector balance sheet with a large portfolio of public sector companies. It must over the next ten years convert this balance sheet of capital in PSE's into a balance sheet of public infrastructure which can deliver services and crowd-in private investment for sustained long term growth and poverty eradication. It must also reduce the number of public sector banks (PSB's).