

A Review on Privatization of public sector enterprises in India

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Abstract

The words didn't quite translate into privatisation. Indeed, for the 34 entities identified by the Niti Aayog, the phrase used was strategic disinvestment. The number of operating CPSEs has gone up from 236 in 2014 to 249 in 2015 — and since 2015 the only big tag disinvestment of a public sector unit has been that of HPCL to the government-owned ONGC. There seem to be broadly three positions with respect to the privatisation of public sector undertakings (PSUs). The left position is "PSU is family silver and should not be sold irrespective of its performance". The divergent stand is that "business is not the business of government", which found resonance in the United Kingdom, and, of late, in India. There is also the third position: Why privatise profit-making PSUs? Why do you sell the family silver? Bharat Petroleum Corporation Limited (BPCL) which is making handsome profits, comes under this category.

Key words: *privatization, public enterprises, asset, fiscal target*

Introduction

PSUs certainly merit privatisation — but no one would buy them with their huge debt and employee liabilities. The government may even have to pay the buyer, as it happened in the case of the Delhi Discom privatisation. Even then it may be worth it, since privatisation will stop fiscal flows to these PSUs. Alternatively, there is the exit route through the new Insolvency and Bankruptcy Code.

Some of the major loss-making PSUs, Bharat Sanchar Nigam Limited, Mahanagar Telephone Nigam Limited and Air India should go under the block as their losses are greater than their revenue. *The Economist* has a term for such entities — value subtracting enterprises. Restructuring them and even ensuring an additional infusion of funds and other resources have not produced results. Their chairmen cum managing directors are bureaucrats who may not have domain knowledge or technical service people bereft of business acumen. Justifying their existence — in the case of BSNL/MTNL which ran telecom at one time as a government monopoly, with a teledensity of 0.01% — by citing national security is strange. At one time the argument was that BSNL alone maintains the military telecom network. It was for the same reason that the private sector was not allowed to operate in the defence sector; we have paid a heavy price for only entrusting it to the public sector in this area. The present government has by and large done well in opening up defence to the private sector.

Privatisation is not a default option; rather, it is resorted to only out of extreme necessity. As World Bank consultants said on the Delhi Discom privatisation: "Privatization is resorted not just when the firm makes losses, but only when the physical performance is so bad that the PSU becomes a political embarrassment to the Government." This may explain the hesitation to privatise some of the largest loss-making PSUs — Air India, the BSNL and MTNL — as the embarrassment threshold

may not have been reached as yet. To realize the ambition of raising over ₹2.5 trillion from the monetization and sale of state-owned businesses and assets, the Modi government will have to get two crucial things right.

The first is well known: Process. After Niti Aayog recommends what to do with each of the 300-odd public enterprises, it will be examined by a committee of secretaries, then by a committee of ministers, before the Department of Investment and Public Asset Management (DIPAM) puts it to the Cabinet Committee on Economic Affairs (CCEA) for ‘in-principle’ approval. Instead of this long route, either Niti Aayog or DIPAM should directly take it to the CCEA.

The Union government currently does not have an administrative setup and sufficient talent with the professional skills needed to carry out what is at its core a corporate mergers and acquisitions role. What is more, good civil servants will hesitate from taking up the job for fear of a career- or retirement-ruining scandal. Outsourcing the job to private investment banks could bring greater efficiency to the process if done right, but opens up a host of conflict-of-interest issues that would be difficult to manage in the Indian context. The ideal setup is a special purpose department that has political sponsorship, administrative clout, professional talent, incentives for transparency, rewards for performance, and insulation from scandal. So it will have to be a new hybrid species of the genus *Governmenta*, incorporating many genes, functions and adaptations from the genus *Privata*. For if we continue with the current administrative machinery and processes, the gap between the country’s disinvestment targets and actual proceeds will yawn even more widely.

The second issue is perhaps more important but gets a lot less attention: Equity. Not equity as in shares, but equity as in fairness. The Prime Minister mentioned stakeholder mapping in the context of transparency and competition in implementation. For privatization to be successful, widely accepted and in the public interest, stakeholder mapping should be vastly expanded to cover all sections of society that will be affected by the reforms.

Objective:

This paper intends to explore and analyze **privatization of PSUs** ; defined as a transfer of ownership and control of the enterprises from the **public to the private sector**, with particular reference to asset sales.

Challenges of globalization and its effects on Indian society

So as the Americans would say ‘what gives’, what accounts for the shift in language and strategy, the re-convening of the idea? The answer to why now is illustrated by the politics of economics. Economic policy under Modi is not anchored in any particular ideology but is rather entrepreneurial — it rests on the linear coefficient of possibilities and political dividends.

After the setback in Bihar and Delhi polls, following the jibe of suit-boot ki sarkar, Modi expanded welfare economics and wrapped it in Hindutva politics. In 2015, the BJP is better placed in the Rajya Sabha and the opposition is emasculated. The conversion of the 2014 popular mandate into popular authorisation allows political entrepreneurship.

The shift is driven by economic realities. Why privatisation matters now is embedded in the detailing of Budget 2015 documents. The gap between the government’s income and expenditure shot up from Rs 7.96 lakh crore to Rs 18.48 lakh crore and is expected to be capped at Rs 15.06 lakh crore. To bridge the deficit, the government will borrow Rs 12 lakh crore this year — that is, around Rs 3,287 crore a day or `136 crore an hour every day.

Worsening the picture is the skew in the revenue model — one item, taxes on petro products, which has caused justifiable outrage, is the single biggest source of revenue accounting for collections of over `5 lakh crore. The inflationary consequences were spelt out by RBI Governor Shaktikanta Das.

And although the economy is ostensibly on a path of recovery — assuming there are no socio-economic disasters ahead — the level of borrowings and deficit will hurt cost competitiveness and economic growth. To pave a path towards a low-cost high-growth economy, the government must cut its borrowings and shrink debt and deficit levels. And the moolah mantra is obviously privatisation. It affords the monetisation of assets, caps erosion of public wealth, frees resources for human and physical infrastructure and promises the upside of enhanced growth as enterprise productivity improves.

It is instructive to know how China migrated from abject poverty to prosperity. It sequenced its reforms for growth — it first modernised its agriculture, opened FDI into real sector and captured global trade. When India attained Independence, it liberated political rights but shackled economic liberties. Post 1991, it opened up the financial sector but constrained FDI in manufacturing. It joined GATT and then WTO without acquiring the bandwidth to meet competition. And till recently, it kept farming, its largest private sector, under fetters. The consequences are manifest in the data on income and inequality.

Context is critical for policy — particularly, the interplay of global finance and geopolitics. Global interest rates are hovering between zero and one per cent. Money is chasing returns — evident from portfolio flows to emerging economies. A McKinsey study estimates a fifth of \$ 4 trillion of goods exports is expected to shift supply base in five years. It is, therefore, critical to view the paradigm shift in policy — whether it is farm laws, productivity-linked schemes, opening up of FDI, new code for labour laws and privatisation — through the prism of India's necessities and global opportunities.

The confluence of policy reforms represents systemic risk. It calls for shepherding of politics past competing compulsions and contradictions. My book 'Accidental India' proved India's transformation from penury to potential of prosperity was propelled by crises. As it comes out of the health and economic crisis, the world will find itself in the cusp of mega disruptions. The emerging challenge is also an opportunity and affords India a shot at shifting orbits.

Raghuram Rajan and Viral Acharya, former governor and former deputy governor of the Reserve Bank of India, get a lot of play in the Indian media. Recently, they published a research paper — 'Indian Banks: A Time to Reform?' on September 21 which has been widely reported. Both the authors have had enough exposure and access to information about the harsh events that have taken place in the world of finance and banking.

So, when they write a paper, one would expect these experiences provoke a thoughtful reflection. It amounts to a shocking failure of academic rigour and integrity that the prescriptions given in the paper, euphemistically called reforms, become unidimensional, looking at one aspect of banking and completely ignoring the needs of the most important stakeholder.

Rajan and Acharya say that due to the pandemic, India cannot afford to fund its banks. The dimension they focus on is credit growth and management of loans — the assets side of the banks' balance sheet. Therefore, one of their prescriptions is the oft-repeated agenda of Big Capital, which is the privatisation of Indian banks and handing over the banking system to investors. The authors identify these investors on page 24 of their paper: "It might be especially valuable if these investors have financial sophistication (a *foreign financial firm* or a domestic private bank) and technology sophistication (a fintech firm or a technology-focused *private equity investor*)" (emphasis mine).

Rajan and Acharya's paper includes many recommendations under different heads such as 'Dealing With Bad Loans', 'Improving Performance', 'Alternatives For Ownership Structure of Banks', 'Strengthening Risk Management' etc.

Let's, for now, look at the proposal to privatise public sector banks.

The question of ownership has to be seen first from the perspective of the most important stakeholder in banks — the depositor. This is the liabilities side of the banks' balance sheet, the side ignored by Rajan and Acharya. There are around 2.5 billion current and savings accounts in Indian banks. This is the source of money for the banks to lend. The loans extended by banks would be less than 10 per cent of this number, including credit card loans.

Meeting fiscal targets

But why privatise a profit-making PSU. What comes into play here is not the lofty "business is not the business of government" argument, but a more mundane fiscal imperative. The Finance Minister's disinvestment target of a little over a lakh of crores for the current fiscal has to be met. It is this fiscal requirement that now drives privatisation. Let us revisit the question: Should profit-making PSUs be privatised? It is good to remember what former Prime Minister Manmohan Singh once said on the issue. He made the assurance that the government would not "privatise profit making PSUs working in competitive environments". That is, if the output price is a competitive price and you still make a profit, then you are efficient and the need to privatise does not arise.

But if the output price is set in a monopoly background — the case now being the monopoly cartel of the oil majors, BPCL, Indian Oil Corporation Limited and Hindustan Petroleum Corporation Limited — with the autonomy given being used for monopoly pricing, then your profit is no longer an index of your efficiency. In that case, privatisation will still bring in benefits of the efficient operation of private sector through reduced costs. Examples of PSUs that made monopoly profits and still inefficient were Coal India and Indian Airlines (IA). For IA, there was poor punctuality, high staff-to-plane ratio, high operating costs and overall customer indifference.

The BPCL is not inefficient but its privatisation still offers scope for improvement. When a company such as this has never faced any serious competition, it is impossible to even discuss the issue of efficiency or inefficiency. There is no comparable firm in the private sector to benchmark it with.

However if one looks at just about any public sector company in India, it is impossible to argue that the BPCL can be an exception. Over the years, the financial performance of oil marketing companies has undergone a bureaucratic process called "administrative price mechanism". All one can say is that the oil PSUs have been allowed to make profit; if one can use *The Economist's* phrase again, they can be called "allotted millionaires". On the non-financial performance side, it would be difficult for the BPCL to show what innovations it has implemented over the years either in marketing or refinery operations.

Accompanied by competition

There is no point in converting a public monopoly to a private monopoly; it will only result in inefficiency being replaced by private profits. Privatisation must be accompanied by competition in the post-privatised scenario.

However, the government will face a dilemma. If you want a high price, you must allow a monopoly situation post-privatisation, and if you want competition and low price for consumers, you must be content with a modest sale price, as

the post-privatisation valuation of the firm critically depends on the market structure post-privatisation. If that is to be competitive, other PSU national oil companies such as the IOC and HPCL should also be privatised. There is also no issue of national security for downstream oil firms. Oil marketing companies, even if they are not in the public sector, can be made to own strategic petroleum reserves as in most of Europe and by the government itself as in the U.S. Thus privatising the BPCL does not compromise India's national security.

Similarly, LPG and kerosene subsidies can be handled by direct benefit transfer, which is already in vogue in the case of LPG.

Finally, there is an argument advanced in the case of the BPCL: that the government paid about ₹622 crore in today's money to acquire it, while it now has a market value of around ₹85,000-1,15,000 crore. How did ₹622 crore balloon into this amount even after the time value of money adjustment? Is it a bargain one cannot refuse? Not quite. After all, in the interim period of many years, the firm would have invested, out of retained profits, and also generated further monopoly profits for dividends which explains its increased value. This is not by its virtue of being a PSU. The BPCL is not a golden goose. It may be an ATM.

Privatisation of banks

Privatisation of banks is a terrible idea from the depositors' point of view for reasons given below:

1) Private players in the financial sector are prone to failure: The world felt the shock waves as the financial markets collapsed in 2008, caused by over-reaching private players. In what has been documented copiously as the subprime mortgage crisis, this resulted in the biggest economic downturn since the great depression of the 1930s hurting millions of people.

A deeper crisis was averted only with the US Federal government, and other governments, providing the bailout. What is remarkable about this crisis is this — not one banker or executive of a financial organisation went to jail for this extraordinary level of fraud imposed on the world. Rajan and Acharya are advocating that Indian banks should be handed over to investors and private players with a similar DNA.

2) Private banks fail all the time: The website of the US Federal Deposit Insurance Corporation (FDIC) — an independent body created by the US Congress to maintain stability and public confidence in financial system — carries this information prominently. In the 20 years from 2001 to 2015, as many as 559 private banks with assets of \$721 billion failed in the US (see chart). What happened to the depositors? It was the problem of the FDIC to bail them out.

The principle followed by private banks is this. When they make profits, it goes to shareholders. When they make losses, it gets socialised and falls in the lap of the government to make good the deposits either through insurance or taxpayer bailout. This has happened again and again. This is what Rajan and Acharya are prescribing as reforms.

3) Big private banks can fail any time: There is a myth that if a bank gets large enough, it will not fail. Wrong. While one can agree that the larger the bank, the greater its ability to absorb losses, this does not mean it cannot fail. The axiom “Higher you go, harder the fall” applies best to private banks. This year we were all witness to the failure and subsequent reorganisation of YES Bank.

Let’s take some bigger examples.

Citibank: Founded in 1812, this is an outstanding example of how large banks fail and get rescued by taxpayers. In 1998, Citicorp merged with Travelers to form Citigroup to be hailed as the first modern American “universal bank” that could offer comprehensive banking, securities and insurance services to its customers.

Within a decade, Citi’s strategy proved to be disastrous. The bank recorded more than \$130 billion of write-downs on its loans and investments from the second half of 2007 through the end of 2009.

To prevent Citigroup’s failure, the US government injected \$45 billion of new capital into the bank and provided it with \$500 billion of additional help in the form of asset and debt guarantees, and liquidity assistance. Citibank survives today thanks to its bailout with public money.

Washington Mutual Bank: Washington Mutual is the largest bank failure in US history. The bank was wound up after 119 years; private bank failure can happen at any time no matter how large. In 2004, WaMu was the sixth-largest bank in the US and a leading mortgage lender with \$300 billion in assets, \$188 billion in deposits, 2,300 branches in 15 states, and over 43,000 employees. By 2006, following a high growth strategy, WaMu’s loans began incurring record rates of default, and its securitisations saw ratings downgrades and losses.

In 2007, the bank went into the red. Its shareholders lost confidence and depositors began withdrawing funds, causing a liquidity crisis. In September 2008, WaMu was seized by its regulator and sold to JP Morgan Chase for \$1.9 billion. Had the sale not gone through, WaMu’s failure might have exhausted the \$45 billion Deposit Insurance Fund.

Conclusion

For privatization to be successful, widely accepted and in the public interest, stakeholder mapping should be vastly expanded to cover all sections of society that will be affected by the reforms. Prime Minister Narendra Modi’s statement that “the government has no business to remain in business” is the clearest articulation of the reason why India must privatize the hundreds of public-sector enterprises that its Union and state governments run.

There are countless examples of failures of private banks all over the world. Rajan and Acharya advocate privatisation because they say India cannot fund its banks due to the pandemic. Pandemic or not, hundreds of millions of Indians are not worried stiff if their bank deposits are safe, thanks to the sovereign ownership. In doing so, he departs from earlier prime ministers, who preferred incremental dilution of government shareholding, or a cautious one-by-one approach in the sale of public enterprises. The invention of the term ‘disinvestment’, which for two decades has been used to describe the privatization of public sector enterprises in India, showed both a lack of clarity of purpose on the part of previous governments and also their need to apologetically cloak the policy against criticism from ideologues across the political spectrum. It is to Modi’s credit that he has decided to use his political capital to declare that [privatization](#) of public sector

enterprises is in the national interest and thus ought to be carried out whole-heartedly. This is a welcome break from the past.

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