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**Privatization in India:  
The Imperatives and Consequences of Gradualism**

by

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**PRIVATIZATION IN INDIA  
THE IMPERATIVES AND CONSEQUENCES OF GRADUALISM**

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## INTRODUCTION

For nearly a decade since the onset of economic liberalization in India, a key component - privatization – remained dormant. The usual explanation has been that weak governments could not overcome the many vested interests, from rent seeking bureaucrats and ministers to public sector trade unions. In addition ideational resistance in India’s elites has also been attributed to the virtual absence of privatization in India’s economic reforms.

However, when the Indian President in his opening address to Parliament in the 2002 budget session, stated, "It is evident that disinvestment in public sector enterprises is no longer a matter of choice but an imperative ... The prolonged fiscal hemorrhage from the majority of these enterprises cannot be sustained any longer,"<sup>1</sup> Indian privatization finally came out of the shadows. How then does one explain the recent acceleration of privatization in India and what does it reveal both about state capabilities and the strength of societal actors? This paper argues that it was not just “vested interests” alone, but institutional structures, in particular those embedded in the judiciary, parliament and India’s financial institutions, that played an important role in the long lag between the onset of economic liberalization and privatization. The time variable however, has been important in two additional ways. For one, just as the external debt crisis forced the initial round of economic reforms, the growing internal debt problem and the fiscal crisis of the Indian state has increased the opportunity cost of state owned enterprises. Second, the passage of time has also resulted in significant ideational changes in India, both with regard to the relative effectiveness of the state and markets in commercial activities, as well as assumptions of the Indian state being a “guardian of the public interest”.

The privatization of state owned enterprises severely underestimates the degree to which privatization – *de jure* and especially *de facto* -- has been occurring in India, ranging from the privatization of public space to education, to privatization-like processes

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<sup>1</sup> Feb. 25 opening the budget session of parliament

in the bureaucracy itself. We examine this issue briefly and some of its implications. Finally we offer some thoughts on the road ahead.

## **WHY GRADUALISM?**

One dimension on which countries' privatization programs can be compared is the speed with which they are implemented. Some countries, like Argentina or the Czech Republic, implemented privatization programs rapidly, with large chunks divested within 3-5 years of launching the effort (Alexander & Corti, 1993). But the vast majority of countries, including India, have implemented privatization much more gradually, in fits and starts. Although many observers have complained about India's slow privatization, in fact gradual privatization is the international norm and rapid privatization is the exception (Ramamurti, 1999).

To begin with, India was not a likely candidate for rapid privatization, because it did not satisfy two necessary conditions for rapid privatization: severe macroeconomic crisis, including high inflation, and a strong executive that could ram policies through. Many developing countries satisfied one of these criteria, e.g. Brazil and Turkey experienced several bouts of macroeconomic instability, yet these countries did not privatize rapidly. Even countries that satisfied both criteria, e.g. in sub-Saharan Africa, privatized gradually or not at all (Dia, 1992). Only a handful of countries in Latin America and the transitional economies met both criteria and also privatized deeply and quickly (e.g. Argentina, Chile, Peru, Czech Republic, Estonia, etc.).

To be sure, in 1991, when serious economic reform began in India, the country was in the midst of a balance of payments crisis and sought IMF assistance. But that crisis quickly gave way to a decade of good economic performance by Indian standards. From 1992-93 to 2000-2001, India's GDP grew at an average rate of 6.1 percent, inflation averaged 7.1 percent, and although imports exceeded exports every year, remittances and service exports grew to limit the current account deficit to average 1.1 percent of GDP (Acharya, 2002). Rising capital inflows saw the country's foreign exchange reserves climb to \$55 billion by 2002. While these results were not spectacular compared to the high-growth Asian economies in their heyday, they were certainly better

than India's previous record as well as the record of most other LDCs in the 1990s. Given that reality, politicians had little incentive to push through structural reforms like privatization that would run into fierce resistance from powerful interest groups.

Countries that privatized rapidly either did so under such severe macroeconomic conditions that included hyperinflation, shrinking GDP, and a severe balance of payments crisis or a sharp political discontinuity leading to a regime change (such as the ouster of a military dictatorship or the fall of communism). Under these circumstances, hard economic medicine was acceptable. As part of that package of policies, privatization was a way to rein in inflation by reducing the fiscal deficit (thereby limiting the monetization of the deficit), and a convenient way to both raise foreign exchange, e.g. by selling state enterprises to foreign investors and increase FDI. The severe macroeconomic conditions were also the culmination of a long period of poor economic performance. In Argentina, for instance, the state was thoroughly discredited by the time President Menem came into office and pursued economic reforms, including deep privatization. In countries like the Czech Republic, central planning and state ownership were so discredited that sweeping privatization was politically very popular. The Indian economy, on the other hand, experienced mediocre economic performance for decades but never experienced very high inflation or prolonged periods of economic stagnation.

At the same time, in India, the executive branch was weak throughout the 1990s. Molano (1997) has shown that privatization was more likely if the party in power also controlled the legislature, although his analysis essentially applies to presidential systems. Through the 1990s, governments either had bare majorities or were coalition governments in which the leading party never had a majority on its own. In Argentina, Menem had much greater powers to push policies through, including relying on presidential decrees for some of the most important steps. In the Czech Republic too, President Havel and Prime Minister Klaus had a very broad mandate. Equally importantly they were ideologically committed to privatization. On the other hand, in India's democratic setting with multiple institutional constraints, progress was understandably slow. Moreover, the liberalization agenda was only grudgingly accepted across a wide swathe of the Indian political spectrum. The Congress Government headed by Narasimha Rao which initiated the radical changes, continued its ritualistic

genuflection to the Nehruvian legacy of planning and SOEs. The Swadeshi Jagaran Manch and other elements of the BJP from the right and the CPM from the left had more in common with regard to economic policies on openness than differences. The caste-based parties—the BSP, SP and RJD—concerned that economic liberalization would mean the unwinding of the hard won gains of reservations for their supporters in particular, were less than happy.

Consequently, despite the many changes in policies and regulation, and a less adversarial relationship between business and government, there was a reluctance to overtly criticize earlier policies or explain with conviction and clarity why changes were needed. Reforms were too often undertaken by stealth (Jenkins, 1999). A lack of conviction translated into a lack of “marketing” reforms to the voter. Individual bureaucrats and ministers might have done so, but no Prime Minister has been willing to go to the people say this is what we are going to do and these are the reasons why we need to do this. Thus, India’s privatization was of the gradual type.

## **ESCALATING COMMITMENT**

Nonetheless, there is no question that India’s commitment to privatization escalated steadily through the 1990s, despite changes in the party in power. We will illustrate that escalation along four dimensions.

First, the program of deregulation steadily increased the ambit of the private sector in the economy. Starting with manufacturing, and then services and infrastructure, and now even the social sector, the state’s role as a direct producer of goods and services has declined, partly by design and partly a result of the fiscal stress on the state. It would perhaps not be an undue exaggeration to say that the public, and especially elite, perception of the private sector is as favorable today as it was towards the public sector four decades ago, and vice versa. This change in public opinion has made it easier to contemplate privatization, in a way that would not have been possible even a decade ago.

Second, and most importantly, the government’s privatization program began as a divestment program, whose aim seemed to be merely to reduce the government’s holdings by up to 20 percent, principally to raise resources to plug the budget deficit.

Accordingly, the program was labeled “disinvestment” and the term “privatization” assiduously avoided. The next stage of escalation was raising the amount that would be divested to 49 percent. Since this would still leave the government with majority ownership, the fundamental character of the enterprise would be unchanged, while on the other hand even more resources could be mobilized to plug the budget deficit, which at the onset of the reforms exceeded 9 percent of GDP. In the next stage, the government decided that it would sell up to 74 percent of the equity, since that would leave it with 26 percent—a level high enough to give it a strong voice in the enterprise, though not a controlling voice. Finally, outright divestment became acceptable, initially for loss making enterprises and later even for profitable enterprises. Thus, the government escalated its commitment from merely privatizing *ownership* to privatizing *control*. And during the 2000-01 budget debate, Finance Minister Yashwant Sinha actually used the term “privatization” to describe the government’s program for reforming SOEs.

A third dimension along which the government’s commitment to privatization expanded was in the sectors in which firms could be sold. The term “strategic” was frequently used to describe those state-owned enterprises (SOEs) that the government intended to retain control over the long term. But the definition of “strategic” became progressively tighter, so that the number of SOEs that could be divested expanded. Initially, for instance, the Ministry of Petroleum argued that oil companies were strategic, but by 2000 the cabinet committee on disinvestment had classified it as non-strategic. Eventually, only nuclear power, defense and railroads were left in the strategic category, and everything else was eligible for privatization. And even in the last two, greater deregulation and outsourcing of activities is increasing the role of the private sector. To be sure, the debates on which sectors were strategic were contentious, but they ended with progressively narrower definitions, even though the party in power changed thrice. Although there has been a noticeable increase in the commitment to privatization after the BJP-led governments came to power, there has been more continuity than discontinuity in the privatization program.

Finally, the restrictions on the buyers also progressively declined. Initially the auction of shares was restricted to public financial institutions that over time were expected to offload them to private investors. By 1996 equity was being offered to

foreign institutional investors. This followed three concomitant trends—the willingness of the government to sell SOEs to “strategic investors,” that is, to private investors who would own a large block of shares (not necessarily 51 percent) and would enjoy management control, the liberalization of rules governing foreign direct investment, and the opportunity to list Indian firms on foreign stock exchanges through ADRs and GDRs. Thus, potential buyers of Air India included Singapore Airlines in partnership with the Tatas, and Air France in partnership with a local Indian group, while foreigners owned portions of VSNL and MTNL through ADRs traded on the New York Stock Exchange.

The criteria for prioritizing PSUs for divestment had been clarified by 2000. Priority in sequencing privatization would be given to firms where sales led to large revenues to the government; where the sale could be implemented with minimum impediments in a short span of time; and where mounting losses and concomitant drain on the budget could be curtailed swiftly. In contrast, in sectors where the presence of the PSU was necessary to prevent a monopoly from emerging and where a regulatory framework was necessary before the government withdrew from the sector, the priority would be lower. In addition, given rapidly changing markets the Divestment Commission kept in mind the prospects for performance of PSUs in reaching its conclusions.

Taken together, the extent of escalation in commitment to privatization over the decade is quite remarkable, if one recalls the political climate at the beginning of the period. From “disinvesting” 5-20 percent of shares to dispersed domestic investors, it had become acceptable to privatize control of even large, important firms, including selling them to foreign investors. Compared to the Latin American experience, one threshold that the Indian government hadn’t crossed was that of selling control of a large, important firm to multinational firms – and with the sale of Maruti to Suzuki in May 2002, that threshold too had been crossed. One lesson from international experience relevant to India is that the ownership profile seen immediately after privatization is seldom permanent. As soon as restrictions on ownership transfer imposed by the government at the time of privatization lapse—or when sectoral restrictions on foreign ownership are independently relaxed—the ownership profile of SOEs is liable to change (Ramamurti, 2000). In sectors like oil, petrochemicals, or airlines, foreign multinationals are likely to emerge as the eventual owners of privatized firms. It is very likely that one of the two

major PSU oil companies whose privatization is likely to occur in the current financial year (HPL and BPL) will be bought by an MNC.

## **IMPLICATIONS OF GRADUALISM**

It is thus unmistakable that India's gradual approach to privatization did in fact lead to deeper commitment to privatization. We will turn later to the question of how gradual privatization can be accelerated, but first we will consider the implications of the gradual approach. International agencies like the World Bank tend to focus on its disadvantages, which are real and important (see, for example, World Bank 1995). But they overlook the potential advantages of gradual privatization.

### Disadvantages

One disadvantage of slow privatization is that it gives opponents of the program time to organize their resistance, which can slow the program even further. Opponents usually include employees, labor unions, civil servants, ministers, and members of opposition parties. As we discuss later, while there is certainly evidence in the Indian case of such opposition slowing down the privatization program, institutional factors also played an important role. Such resistance could ultimately derail the whole program, so that gradualism turns into inaction. Any misstep on the government's part provides a particularly good opportunity for opponents to derail the program, as happened in 1992, after the first block of shares in SOEs were sold to government-owned mutual funds and became embroiled in a major financial scandal (the "Harshad Mehta scam"), and again in the mid-1990s after the fiasco with auctioning the telephone licenses. Each such misstep was followed by a lull in privatization (see Table 1). Since 1991-92, there have been only three financial years when divestment proceeds exceeded the budgetary target (in 1991-92, 1994-95 and 1998-99). However, it must be emphasized that simply meeting targets is not that important since that could be achieved through distress sales and poor selection processes, with negative long-term consequences.

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Table 1 here  
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Delays have high opportunity costs both for the economy in general and government finances in particular. Measured by profitability ratios, the private sector is more efficient than the public sector in India (Table 2). And given the negative rates of return in many PSUs, postponing privatization exacerbates the stress on government finances.

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Table 2 here  
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Another potential cost of gradualism is that the performance of SOEs deteriorates in the run-up to privatization. In countries like the United Kingdom, the performance of SOEs improved significantly in the run-up to privatization, because the newly-appointed heads of these companies used the several years between the announcement of a privatization program and the actual divestment of firms to improve labor productivity, shut down unprofitable plants, streamline the product mix, and so on. Indeed, the productivity of British SOEs improved as much or more in the run-up to privatization as it did after privatization (Yarrow 1992).

However, the Indian experience appears to have been different, because the period leading to privatization was marked by considerable policy uncertainty. Unlike Prime Minister Thatcher, who announced unambiguously her intention to privatize state enterprises outright, Indian prime ministers pursued privatization in small doses and almost by stealth, as discussed earlier. Therefore, neither the government, nor supervising ministers, nor the chief executives of SOEs had a clear mandate on what was to be accomplished in the run-up to privatization. Since the government was officially only looking to divest minority equity in these companies or to retain a loud if not controlling voice after disinvestment, managers of the firms also behaved as if the changes expected of them were incremental and marginal. The most important reform that gathered steam

was initiatives to downsize the workforce through generous voluntary retirement schemes.

The CEOs appointed to SOEs were also not much different from those appointed in earlier decades, that is, they were either technocrats promoted from within the firm or civil servants deputed to the firm, often with only a few years left before they reached the mandatory retirement age. Partial privatization of SOEs, through listing on the stock exchange, did not reduce materially the meddling of ministries in their operational affairs or strengthen managerial autonomy. In the first half of the 1990s, when outright privatization was not being discussed openly, there was much discussion about giving the largest SOEs—the “navaratna” firms—greater managerial autonomy, but this never came to pass. On the other hand, deregulation and de-licensing often pitted the SOEs against new entrants who were more efficient, be it in steel, airlines, or telecommunications. Unable to respond effectively to increasing competition and price erosion, the SOEs’ financial performance deteriorated, and employee morale sagged.

A third disadvantage of gradualism is that it punctures investor confidence in purchasing SOEs or their shares. A critical issue facing investors is how to value the shares of SOEs. If investors believe that the government is likely to privatize control over the firms, they value them higher—usually using norms applicable to private firms. But if they fear that the government is looking to retain control or a strong voice over SOEs, they fear that the interests of minority private shareholders will be ignored (Boardman & Vining, 1989). Gradual privatization signals a government's apparent unwillingness to give up control of SOEs, and this depresses their stock price in secondary trading. In the Indian case, the government's credibility with private investors was considerably weakened when in 1998-99 large blocks of government equity in state-owned oil companies were sold to other oil companies. While this allowed the government to claim that it had disinvested its holdings in three SOEs and raised more than a \$1 billion for the treasury, the stock market interpreted this pseudo-privatization as a clear signal of the government's intention to retain control of SOEs in the long run. The shares of the three oil companies, as well as other SOEs, fell on the news. By 2000, investors were valuing SOEs at half to one-third the values of comparable private firms (Government of India, Department of Disinvestment, 2000). Credibility once lost is hard to regain. Only by

early 2002, after successfully privatizing control of VSNL, Maruti, and IPCL did the government regain that lost credibility.

The change in strategy also yielded better returns to state coffers. This is apparent in comparing the price-earnings ratio (P/E) of partial divestment through share sales in the open market in the early 1990s with those earned subsequently in strategic sales (although since the firms are quite different, the comparison has limits). In the former case, despite the near-absolute monopoly in sectors like telecom and oil, P/E ratios varied from 4.4 to 6.0. The P/E ratio of the oil companies IOC, BPCL and HPCL was 4.9, 4.4 and 6.0 respectively. In comparison, the strategic sales this time round fetched a P/E of 19 for Balco, 12 for CMC, 37 for HTL, 63 for IBP and 11 for VSNL. The earlier strategy of selling only a minority of shares in the open market was helpful in two respects: one, it established an objective baseline of how markets valued the “family silver”. Second, gradualism diffused the political opposition that would have occurred if there had been a one-off transfer. But the financial cost was high. Since these minority sales did not result in a change in management, markets discounted the values of the firms resulting in substantially lower revenues.

It follows from the above that gradual privatization risks lowering the proceeds to the government from privatization, both because SOEs’ performance may deteriorate in the run-up to privatization and because investors may apply a “government-control discount” in valuing SOEs. Privatizing too swiftly, as in Argentina, can also lower the government’s proceeds, because assets are sold under “fire sale” conditions. But so too can privatizing very slowly. From the perspective of maximizing proceeds to the treasury, the optimal length of a privatization program may be five years after the launch of the program. India’s privatization program gathered momentum fully ten years after the program was launched.

### Advantages

Gradualism has its advantages. It increases the likelihood that other efficiency-enhancing reforms, such as competition and deregulation, will be implemented before or alongside ownership changes. It gives policy makers time to build support for and

consensus on privatization. And it provides the opportunity for policy makers to incorporate lessons from earlier rounds of privatization in later rounds. To be sure, none of these advantages of gradualism are automatic, in the sense that merely delaying privatization does not guarantee their realization. In the Indian case, the benefits were realized, despite changes in governments, because of two structural factors.

The first structural factor was the government's high budget deficit, running through the decade at 5-7 percent of GDP, which put constant pressure to raise additional resources. Therein lay privatization's universal appeal to finance ministers—it held the prospect of turning money-sucking SOEs into money contributors. Thus, every finance minister projected some revenues from privatization each year. The other structural factor promoting privatization was globalization. India had committed to opening up the economy, especially after the Uruguay Round, and steps had to be taken to modernize SOEs and promote private investment in the economy. Once again, privatization was seen as part of the answer. For these two structural reasons, every government in the 1990s, regardless of ideology, took incremental measures to privatize SOEs. Thus, Narasimha Rao's Congress government issued the initial policy statement on disinvestment, the Janata Dal government constituted the Disinvestment Commission, the NDA replaced the Commission with a Department of Disinvestment and a Cabinet Committee on Disinvestment, and so on.

The most important advantage of gradual privatization was that it afforded time to implement policy reforms that complemented privatization—reforms that countries privatizing in a rush generally did not implement or implemented poorly. The experiences in Eastern European countries and the former Soviet Union where many western advisers encouraged these countries to privatize firms quickly under the assumption that market institutions would develop once firms were privately owned, proved painfully erroneous. The consensus now is in favor of establishing an institutional framework conducive to promoting competition before privatizing firms. In a recent study focused on the telecommunications sector Wallsten (2002) found that countries that established separate regulatory authorities prior to privatization saw increased telecommunications investment, fixed telephone penetration, and cellular penetration compared with countries that did not. He also found that investors were willing to pay

more for telecommunications firms in countries that established a regulatory authority before privatization. This increased willingness to pay is consistent with the hypothesis that investors require a risk premium to invest where regulatory rules remain unclear.

We will illustrate the point about the importance of reforms that complement privatization with three examples: reforms that deregulated sectors in which Indian SOEs operate, reforms that phased out subsidies in industries dominated by SOEs (e.g. oil), and reforms that downsized the workforce in SOEs. In theory, all of these reforms can and should be done simultaneously with privatization, but countries that privatized quickly usually struggled to implement these complementary policy reforms for several years after privatization. We would argue that implementing such reforms after privatization can be very difficult, because the new private owners of SOEs will view such reforms as changing the “rules of the game” after the fact. In several Latin American countries, SOEs were privatized first and deregulation of their sectors was postponed to a future time, because SOEs could be sold more quickly—and for a higher price—if they were sold as monopolies (for examples from telecommunications and transport, see Ramamurti 1996). Experience has shown that private owners will fight deregulation later on, making it harder to create effective competition in the long run. This carries a substantial social cost, because competition spurs productivity gains more effectively than ownership changes *per se* (Yarrow 1992). Gradualism increases the likelihood that competition-enhancing policies will be implemented prior to privatization.

Countries that privatize gradually—that is, countries whose macroeconomic and political circumstances are such that rapid privatization is unlikely—are nevertheless able to implement deregulation and other competition-enhancing reforms, which face fewer political obstacles than privatization. Even though deregulation is also a threat to SOE employees, apparently labor unions and SOE employees do not recognize fully its long term, negative consequences for themselves, or perhaps they are not powerful enough to prevent it. In India, airlines, telecommunications, power, and all manufacturing sectors (e.g. oil, petrochemicals, steel), were deregulated in some measure long before SOEs in the sector were privatized. Indeed, in 2002, several years after deregulation, SOEs were still dominant in many of these sectors. China has followed a similar strategy of

economic liberalization and greater private participation in the economy, sans privatization.

The increased competition resulting from industry deregulation—and, in the case of tradable goods, import competition—puts pressure on SOEs to lower costs, which, in turn, reinforces moves to downsize the SOE workforce. In India, labor union support for the downsizing seems to have been obtained by making the schemes voluntary, and applicable only to employees close to retirement. No workers would be fired, and compensation package for early retirees was generous, as in other countries adopting this policy. Employees opting for the scheme received up to three years salary, based on length of service. Voluntary retirement schemes (VRS) began with \_\_ and gradually spread to SOEs in other sectors. By 2002, a total of \_\_ employees had opted for the scheme in \_\_ companies, representing \_\_ percent of the workforce of these companies [numbers to be added].

This is not to say that gradualism is a prerequisite for labor downsizing. Argentina, which privatized rapidly, sharply downsized the SOE workforce in railroads, for instance, prior to privatization, but it did not do so in the case of telecommunications, its first major privatization. But without the macroeconomic crisis that he was purportedly fighting, President Menem would probably not have been able to take on the unions. Likewise, President Salinas of crisis-ridden Mexico confronted unions early on to pave the way for labor downsizing and privatization. In the absence of an economic crisis, and with prime ministers who were much less powerful than presidents of countries like Argentina or Mexico, labor could not have been downsized rapidly in Indian SOEs. Had privatization somehow been implemented rapidly in the Indian case, almost surely it would have resembled the Malaysian approach, wherein SOEs were sold with the condition that workers would not be fired for five or more years (Jomo, 1995). The result then is ownership change with limited improvement in labor productivity.

Gradual privatization also gives governments time to make policy reforms in areas such as price controls and subsidies, because raising prices or ending cross-subsidization are easier done over time than implemented at once. In the Indian case, this point is illustrated by the petroleum sector, where it took the better part of a decade to unwind a system of administered prices under which some products were under-priced

(kerosene, diesel) and others were overpriced (gasoline, aviation turbine fuel). Countries that privatized very rapidly were sometimes able to push through such price adjustments in one sweep at the time of privatization (e.g. Mexican telecommunications), but in other instances SOEs were privatized without price reforms or with ambiguous pricing policies. Again, without proper price signals, privatization is unlikely to yield the anticipated improvements in efficiency and resource allocation.

The creation of regulatory agencies is another example of reform that is more likely under gradualism. The Indian experience with regulatory institutions is relatively new and checkered (Bhattacharya and Patel, 2001). The new regulatory institutions include TRAI (telecom), SEBI (capital markets), TAMP (ports), CERC (power) and a newly constituted petroleum regulatory board.

In most cases privatization had to await substantial changes in the policy regime and new regulatory regimes and institutions. In turn this meant that new laws had to be drafted and enacted by Parliament, a time consuming process. Thus SOEs in fertilizers, oil, telecom and power had to await these changes; else, the markets would either simply discount their value or the result would be a private monopoly. Markets will similarly discount the value of NTPC given that a large fraction of its customer base is bankrupt SEBs. NTPC's privatization must await the privatization of at least a few SEBs or at least power distribution is privatized to some degree.

A second major benefit of gradual privatization is that it gives policy makers time to build support for privatization. We alluded earlier to the fact that gradualism can make it easier for opponents of reform to mobilize, but the sequence of reforms seen in India also works in the opposite direction, that is, to blunt opposition to privatization and build new constituencies of support. In other words, gradualism has political appeal, because it spreads or postpones the political costs of reform, while allowing the benefits of reform to be realized early on. One important example of this dynamic in the Indian context is the fact that allowing greater competition in sectors that were dominated by state monopolies demonstrated to the public the advantages of better service and/or lower prices, e.g. in airlines or telecommunications. Having experienced greater choice and competition, the average consumer becomes a more passionate supporter of further reforms, including privatization. Public support for labor unions and SOE employees can

also erode as new private companies provide competing products and services that are superior or cheaper. This, in turn, weakens the bargaining power of workers and unions.

For instance, prior to deregulation, a strike by Indian Airlines workers would have crippled passenger air transportation, but after deregulation the same strike would only have bolstered rivals like Jet Airways or Sahara. Unfortunately, the delay in the sale of Indian Airlines (allegedly sabotaged in part by the concerned Minister and in part by a private sector rival), proved costly. By the time in 2001 when the GOI offered to sell a 26 per cent stake in Indian Airlines to a strategic partner, buyers were uninterested in part because of the amount a new partner would need to invest to turn the airline around (given the airlines ageing fleet) and in part, the decline in market share (by March 2002 Indian Airlines' market share sank to 39.9 while privately owned Jet Airways' market dominance grew to 48.9 per cent).<sup>2</sup>

At the same time, if competition worsens the financial performance of SOEs, it forces internal reforms in these enterprises (thereby yielding some of the benefits of privatization) or strengthens the government's case that the firms should be privatized.

The third major advantage of gradualism is that it allows the government to apply lessons learned in one stage of reforms in subsequent stages. These lessons encompass both *substantive policy issues*, such as what policy reforms should accompany privatization or what sale strategy to use for any given enterprise, as well as *process issues*, such as how to manage the divestment process. In India, one can see a vast improvement in how disinvestment was handled in 1992, when the SOE reform program began, and in how it was being handled in 2002, when the program seemed finally at a take-off stage. By 2002, the government was building on the recommendations made by the Disinvestment Commission, and was using investment bankers to prepare sale documents, value enterprises, and to invite and evaluate bids. At the same time, a clear political decision-making process was in place, involving the Disinvestment ministry and the cabinet committee on disinvestment.

Over the last year, three privatizations stand out in their precedent setting nature with important effects on the program. Foremost was the case of BALCO, which we

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<sup>2</sup> Figures compiled by the Director General of Civil Aviation. Cited in:  
<http://www.rediff.com/money/2002/may/16ia.htm>

discuss in detail later. What is important is that the privatization was fiercely resisted both by the Chief Minister of the state where the firm was located (Ajit Jogi), as well as labor. Less than a year later the story was completely different. In a exceptional gesture to compensate for a 67-day strike last year opposing privatization, workers volunteered to work overtime for free till the plant records 100 per cent operational output. The Chief Minister also had a completely different attitude. Post-strike, workers returned with a court-brokered agreement that protected their jobs and paid them full salary for the strike period. Jogi now trumpets that "Sterlite is scripting a success story and Chhattisgarh is proud of it." As Jogi himself works on reforming state PSUs, closing as many as 30 of them, he blithely states, "Who says we protested against disinvestment? We only protested against the company's valuation. We are disinvesting all over the state."<sup>3</sup> And as for labor, Bramha Singh, general secretary of the Balco Mazdoor Union, who led the strike rues: "It (the strike) was a terrible mistake. There is virtually no pressure. Even idle employees are being paid and the company pay package is the best in the last three decades." The post privatization success of both Balco and Modern Foods, was particularly important in that it demonstrated that labor was not necessarily a casualty of privatization.

The privatization of Paradeep Phosphates for Rs. 151.70 crores, below the reserve price of Rs 176 crores was another important landmark.<sup>4</sup> This was the first time in the government's disinvestment drive that the government agreed to a bid price which was below the reserve price. With the firm incurring a loss of Rs 10-12 crores every month, re-bidding would have resulted in a delay where the losses would have exceeded the difference between the bid and reserve prices (as of 31 March 2001, Paradeep Phosphate's accumulated losses stood at Rs. 431.50 crores). The sale of a government asset below the reserve price would normally have attracted instantaneous howls of protest and allegations of malfeasance. Indeed, in 1994, a CAG report had claimed that the government had sold shares below the reserve price. The ensuing criticisms coming as it did at a time when the stock market had fallen, led to a sharp decline in sales for fear

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<sup>3</sup> *Outlook*, March 2002

<sup>4</sup> The government sold a 74 per cent equity stake in Paradeep Phosphates Ltd to Zuari Maroc Phosphates Private Ltd — a 51:49 joint venture between the K.K. Birla-promoted Zuari Industries and Maroc Phosphore of Morocco.

of charges of undervaluation (Ahluwalia, 2002).<sup>5</sup> In a country where the polity is swarming with scams, scandals and corruption, and where distrust of state functionaries is acute, an extreme risk averseness has become the norm be it public sector bank lending (Banerjee, 2001) or defense procurement. Bureaucrats in senior positions privately admit to postponing decisions to avoid controversies, especially following the investigation of Mascarenhas (MD of Air India) for charges of which he was later cleared. Fearing that any major financial decision is bound to be probed later, bureaucrats find it simpler to let a file go back and forth.

The third landmark sale was that of IPCL (the 2<sup>nd</sup> largest petrochemicals producer) to Reliance Industries (the largest), giving the latter a singular dominance in many segments of petrochemical markets. This sale resolved fundamental policy issues that had delayed sell-offs, such as barring companies from bidding because of monopoly concerns. The government adopted a policy that it would not bar companies acquiring PSUs even if it resulted in a monopoly, provided the assets divested were in the manufacturing sector. However, in the services sector – airlines, banking, oil retailing -- the government will not allow the divested assets to go to a company if it results in it acquiring a monopoly status. The logic being that in tradeables, given India's WTO commitments, international markets would provide the necessary discipline on the domestic monopolistic manufacturer. In non-tradeables, however, where local monopolies could form (such as oil distribution) the government imposed a condition that the acquirer of IBP would be banned from bidding for HPCL and BPCL when they come up for disinvestment and the acquirer of HPCL would be similarly forbidden from bidding for BPCL and vice versa.

The post-privatization performance of three former SOEs that were the first to be privatized were the best testimony to the fruits of privatization – higher sales, margins, investments and productivity. Hindustan Lever, gave Modern Food workers a raise and offered a VRS that reduced the workforce from 2000 to 1,330. Critically it pushed Modern's bread through its own vast distribution network. Today 90,000 outlets across India stock Modern bread, against 32,000 before the privatization. In the case of CMC

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<sup>5</sup> Although it was true that the sales value was lower than the original reserve price, the latter had been lowered because it has been based on wildly optimistic earnings projections.

the company's share price has risen 167 per cent since October 2001 when it was bought by Tata Consultancy Services, India's top software exporter.

Currently the privatization program is on a roll with even large firms like VSNL, IPCL, and Maruti being sold to strategic investors, including foreign firms like Suzuki, without controversy, without charges of corruption, and without legal challenges. To be sure, the improvement was partly the result of having a person like Arun Shourie as disinvestment minister, but mistakes made in prior transactions, precedents set in prior sales (e.g. the sale of BALCO to Sterlite), and analysis done by prior committees were also important.

## **ACTORS AND INTERESTS**

Most analysis of the political economy of privatization puts the onus on the nexus of self-interested rent-seeking politicians, bureaucrats and labor unions. The politician-bureaucrat nexus has long been viewed as a critical actor that seeks to block reforms that undermine its rent-seeking capacity. There is little doubt ministers, who would stand to lose the many benefits of departmental enterprises, have repeatedly tried to scuttle disinvestment of PSUs under their administrative charge and this has also been the case with the current government. Sharad Yadav, as Civil Aviation Minister scuttled the sale of Indian Airlines and in the case of IPCL and Hindustan Zinc Ltd (HZL) the two concerned ministers (Ram Naik and Ram Vilas Paswan) allegedly tried till the very end to put a spanner in the works. In IPCL's case, ONGC which was legally bound to supply the firm with gas until 2006 irrespective of ownership, suddenly changed its position when the IPCL sell-off process began. This despite the fact that the same ministry supervised both ONGC and IPCL and 14 months earlier the cabinet secretary had met the petroleum secretary and they had decided that ONGC would abide by the contract. But when the sale deadline neared the government did not have a formal assurance and Naik cited the possible non-availability of gas to IPCL to try and postpone the sell-off. Paswan insisted until the last minute that that HZL should not be sold off until a 'control premium' was added to the overall price. Minister for heavy industry, Manohar Joshi, (now Speaker) had been unwilling to let go the control of some of the companies under

his ministry, including Maruti Udyog Ltd. He raised objections claiming that Maruti would seek recourse to component imports at the expense of domestic automobile component manufacturers. And Joshi like virtually all Ministers who want to delay sales, justified his opposition on the grounds that a delay would result in better valuation and they were simply trying to safeguard workers' interests. On two occasions the Minister stalled critical meetings claiming the file on Maruti's divestment had been "misplaced".

Although all political parties had opposed privatization they had begun to have more varied stands by the end of the decade. Today while both the BJP and Congress back privatization, they are still cautious in their support. The Congress for instance at its most recent conclave supported privatization but was opposed to "mindless" privatization. The Shiv Sena has publicly opposed disinvestment in the ministries manned by its ministers. The left political parties have obviously been opposed, although even here their opposition seems less vociferous. Along with the right ("Swadeshi Jagaran Manch") its opposition to privatization also stems from their antipathy to foreign capital and fears that it might win the privatization stakes. The parties that have a Dalit/OBC constituency, oppose privatization on grounds that this will result in a reduction of hard won jobs for members of their constituencies. Although these groups have a considerable stake in employment in PSUs (see Table 3), the sales agreements specifically try to guard their interests. In general this group appears to be more geared to opposing government downsizing in the administrative departments than in SOEs.

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Table 3 here

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Despite the calumnies heaped on labor, it has not yet been a critical factor opposed to privatization (in part because sales of the large SOE employers – banks, coal mines, SEBs and MTNL – are not yet on the cards). BALCO was the big battle and labor regretted its decision to oppose privatization. By and large the use of the VRS has helped reduce labor redundancies both before and after privatization. Other incentives such as granting a fraction of shares to employees at a price which was one third of the market price in preceding months of privatization, have also helped. However, as the unhappy experience of CES in GRIDCO (the privatized Orissa power distribution company)

demonstrates, the interests of organized labor are more heterogeneous than is often realized. The sheer magnitude of rents in State Electricity Boards (SEBs) means that a discounted present value of overall earnings inclusive of rents would far exceed a financially viable VRS. By and large there are no such extraneous rents in the case of manufacturing companies.

Even supposedly pro-reform chief ministers like Chandrababu Naidu have a NIMBY (Not In My Backyard) approach to privatization – yes to privatization conceptually, but not to enterprises in their states (Rashtriya Ispat Nigam, which suffers from large losses, is a case in point). The divestment of four India Tourism Development Corporation hotels has been stalled because the Ministry of Disinvestment needs concurrence of the state governments since the properties are in the joint sector, with the land provided by the state governments on a long-term lease. And the state governments have not given their concurrence.

Ironically, one of the most important obstacles to privatization has been Indian business. This is not surprising in lieu of the thick nexus between business and politicians nurtured in the long decades of the control raj. In one of his many exit interviews SEBI Chairman D.R. Mehta expressed grave disquiet over the fact that ‘corporations have become very powerful... ‘They are powerful in terms of their sheer size. The moment you start taking some action, they jump on you.’. The influence of corporate houses is apparent in the investigations of the multi-party JPC which while aggressive with regulators, bankers and brokers, refused to examine industrialists despite three SEBI reports on the involvement of at least a dozen corporate houses in price manipulation with Ketan Parekh. Arun Shourie has been categorical that, “ The “core competence” of many of our industrialists is their skill in manipulating the State apparatus — a skill that they deploy with single-minded perseverance to keep their rivals down, to keep competition at bay. In my current charge, I get to see every other day the doggedness with which some of our industrialists strain to keep others down, and the skill they deploy in inventing “grounds” why the other fellow should be disqualified. I also get to see how deep and extensive is the reach of these persons within the State apparatus. This obsession with keeping the other fellow down, in particular by using the State apparatus

has been as much of an impediment to faster privatization as any other, indeed to reform in general.”<sup>6</sup>

## INSTITUTIONAL CONSTRAINTS

Political compulsions, fiscal and market realities are necessary but not sufficient conditions for economic policy change to occur. While the gradualism that underlay India’s economic reforms also characterized privatization, a combination of leadership and institutional factors accelerated the process. In Arun Shourie the government had a privatization minister who was not just unabashed about the case for privatization, but a strong champion. The combination of self-confidence and pecuniary integrity led to perhaps the most transparent procedures of a major government program being put into place. From the selection of advisors to the final selection of the strategic partner, open competitive bidding has been the norm. Once transactions are completed, all files are handed over to the Comptroller and Auditor General’s office. This procedural transparency was critical in the strength of the Supreme Court’s BALCO judgement, which in turn significantly legitimized the program.

Although the interests of key actors undoubtedly plays a critical role in shaping public policy, they are not the sole determinant. Institutions can play a significant impact, and India’s privatization program, highlights the role of two institutions – the Supreme Court and Parliament -- whose role in India’s economic reforms has been considerable. Over the past two decades in India, the institutional *teen-murti* of the legislative, executive and judicial arms of government have witnessed a shift in power towards the last. In part this has been because of an erosion in the other two institutions, and in part due to macro-political changes that have led to increasing political instability.

However, the mere fact that the Indian courts are more influential does not imply that this is necessarily for the better. A peculiar generosity of the India court system, a Trojan Horse that has had broad political, social and economic consequences has been the penchant for stay orders. The disjunction between the speed of judicial decision making

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<sup>6</sup> Arun Shourie, *Based on the author’s address at a plenary session of the Confederation of Indian Industries’ annual meeting held recently in New Delhi* Indian Express, May 7, 2002

and the rapidity with which market forces operate today has meant that the opportunity costs of delay are particularly severe on economic issues.

It should not, therefore, be surprising that the privatization process had also become hostage to innumerable challenges in the courts. In an atmosphere of general distrust of the state's capacity to conduct financial transactions without impropriety, it is trivial to muddy the waters with allegations. This was the case with Bharat Aluminum Company (BALCO), India's 3<sup>rd</sup> largest aluminum company located in Korba in the newly created state of Chattisgarh.<sup>7</sup> When the central government announced the sale of 51 per cent of its share to the highest bidder, Sterlite Industries for Rs 5.515 billion, the Chief Minister of Chattisgarh, Ajit Jogi (a former member of the IAS) strongly opposed it, charging that the BALCO sale was malafide as it had been influenced by payments to an officer of his state government, an officer of the Prime Minister's Office and one from the Department of Disinvestment. The sale was challenged by the BALCO Employees Union and a PIL against the sale was also filed in different High Courts. At the request of the Union government these cases were consolidated and taken up by the Supreme Court. At the same time, Chief Minister Jogi instigated labor in the plant to strike, claiming that their future would be jeopardized if the sale went through. The plant was brought to a halt (for 67 days), inflicting crippling losses, given that alumina production is continuous processing industry.

The challenge was both legal and political in that a state government was frontally taking on the federal government on matters that concerned central PSUs. Ironically, the challenge was the best thing the opponents of privatization could have done for accelerating the program. In December 2002 a three-judge Bench of the Supreme Court not only upheld the sale, but in a landmark decision unequivocally silenced the critics. More importantly, in laying down far-reaching principles that will influence the tenor of jurisprudence on economic affairs, the significance of the judgement far transcended the specifics of the BALCO transaction.

First, in the specific case of the alleged malfeasance in the case of BALCO, the Court categorically stated that "the facts herein show that fair, just and equitable

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<sup>7</sup> The discussion and quotations in the next few pages draws heavily from Balco Employees Union v. Union of India and others, Supreme Court of India, Indlaw Sc 181, December 10, 2002.

procedure has been followed in carrying out this disinvestment. The allegations of lack of transparency or that the decision was taken in a hurry, or that there has been an arbitrary exercise of power are without any basis. It is a matter of regret that on behalf of the State of Chattisgarh such allegations against the Union of India have been made without any basis. We strongly deprecate such unfounded averments which have been made by an officer of the said State.” The judgement was not simply a strong rebuke to the credibility of Jogi, it served to forestall further challenges by state governments on the federal government’s prerogatives on privatization.

Second, and critically for economic reforms, the Court circumscribed the extent to which matters of economic policy — and disinvestment, it emphasizes is a matter of policy — shall be scrutinized by courts. In this it build upon other recent judgements, signaling a retreat from the judicial expansion over the previous two decades. In a judgement in 1998 (*Zippers' Karamchari Union vs Union of India September 1998*), the Court had argued that “In tax and economic regulation cases, there are good reasons for judicial restraint, if not judicial deference, to the judgment of the executive. … In matters of trade and commerce, or economic policy, the wisdom of the government must be respected and courts cannot lightly interfere with the same unless such policy is contrary to the provisions of the Constitution or any law, or such policy itself is wholly arbitrary.” In the BALCO case the Court went further declaring that “it is neither within the domain of the Courts nor the scope of judicial review to embark upon an enquiry as to whether a particular policy is wise or whether a better public policy can be evolved. Nor are our Courts inclined to strike down a particular policy at the behest of a petitioner merely because it has been urged that a different policy would have been fairer or wiser or more scientific or more logical. … Parliament is the proper forum for questioning such policy.” The Court further stressed that it will refrain from interfering in economic decisions “unless the economic decision… is demonstrated to be… violative of constitutional or legal limits on power or … abhorrent to reason…In the case of a policy decision on economic matters, the Courts should be very circumspect in conducting any enquiry or investigation and must be most reluctant to impugn the judgement of the experts who may have arrived at the conclusion unless the Court is satisfied that there is illegality in the decision itself.”

Third, cognizant of the economic costs of the plant closure as a result of the judicial intervention, the Court for the first time declared that, “No ex parte relief by way of injunction or stay especially with respect to public projects and schemes or economic policies or schemes should be granted. It is only when the Court is satisfied for good and valid reasons that there will be irreparable and irretrievable damage can an injunction be issued after hearing all the parties.” It even added that “the Petitioner should be put on appropriate terms such as providing an indemnity or an adequate undertaking to make good the loss or damage in the event the PIL is dismissed.” While recognizing the important role of PILs, the Court cautioned against the dangers from an excessive use of the instrument. “Every matter of public interest or curiosity cannot be the subject matter of PIL. Courts are not intended to and nor should they conduct the administration of the country. Courts will interfere only if there is a clear violation of Constitutional or statutory provisions or non-compliance by the State with its Constitutional or statutory duties.” In regard to disinvestment specifically, it says, “The decision to disinvest and the implementation thereof is purely an administrative decision relating to the economic policy of the State and challenge to the same at the instance of a busy-body cannot fall within the parameters of Public Interest Litigation.”

Finally, the Court specified the contours of the rights of labor when policy changes are affected, for instance when the Government disinvests its equity in an enterprise. Virtually every privatization has been challenged on the grounds that the employees have not been consulted, or that their views have not been taken into account. In the case of the BALCO disinvestment, the Court founds that the Government had exerted itself to protect the interests of employees of the company.<sup>8</sup> More generally it emphasized that while it is prudent for Government — like any other employer — to take workers along, to keep them informed about prospective changes and to allay their apprehensions, labor cannot claim a right — either on the basis of natural justice or any other foundation — to be consulted, or the right to receive prior notice, or to be consulted at every stage of the process. Much less can it claim or exercise a veto over the new

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<sup>8</sup> After privatization, BALCO offered an early retirement package. Despite strong opposition from the union, more than a quarter of the employees opted for early retirement, but only half of those could be given the package. Under the VRS package, a workers were paid an average of Rs 400,000 (\$8,489) while executives received double this amount.

policies or changes. “Even a government servant, having the protection of not only Articles 14 and 16 of the Constitution but also of Article 311, has no absolute right to remain in service,” the court points out.

Another institution that has shaped privatization is Parliament. As discussed earlier, for a variety of reasons at the rhetorical level at least political parties have by and large not backed privatization enthusiastically, although in private the leadership acknowledges that some of this has to occur. Parliamentary standing committees have invariably criticized privatization decisions. Thus with regard to the government’s decision to privatize Shipping Corporation of India, the Parliamentary Standing Committee on Shipping said "The committee fails to understand as to why the decision for divestment of SCI has taken place when SCI is able to manage its activities through its own resources". Other Parliamentary Committees have severely criticized the government on the issue of land valuation in divestment of stake in public sector units, saying asset valuation guidelines were "inadequate and vague" and that land should be valued separately and should be factored into total asset value. Land valuation is frequently cited by parliamentary committees and other critics as a reason why they believe that companies were being sold at “throwaway” prices. The reality is that the value of an asset matters only in so far as it is giving income to a company. A sick firm like the National Textile Corporation sits on land potentially worth hundreds of crores but it is an encumbered asset since state governments would not give permission to sell that land.

But where Parliament has played a more important – and negative – role, is in its inability to pass the necessary enabling legislation that would undo and modify prior law as well as make for new regulatory institutions. Parliament’s legislative output has dropped by a third in the 1990s relative to previous decades, even as the need for new legislation to address the new economic policies have increased (Kapur and Mehta, 2002). Members of Parliament (MPs) are less interested in legislation than undertaking “study” tours to places where hapless public sector enterprises are obliged to lavishly host them. MPs expect (and get) “royal” treatment on their “investigative” travels by state owned enterprises and banks. In exercising their oversight of PSUs, MPs avail themselves of hospitality from those they are investigating. The resulting moral hazard

means that MPs are usually less interested in seeking answers from PSU managements than ensuring deference and obsequiousness which is amply supplied.

## **THE “PRIVATIZATION” OF THE INDIAN STATE ?**

The discussion until now has focused on a narrow definition of “privatization” – control of state assets legally passing into private hands. Although, this has happened only to a limited extent as yet, it is growing. However, in a looser sense privatization has become much more potent in the Indian landscape. From the privatization of public space through the growth of gated communities, to a growth in the private provision of social services, the growth of private security services to private modes of transportation replacing public modes, to privately appropriating public assets as in the power sector and the “sale” of public jobs, the trends are unambiguous. Private townships and buildings, with their own water, power and sanitation systems have exited from the public sector. With the state unable to extract work from its own employees the outsourcing of government work to private agencies has been increasing. In Delhi, the finance ministry has out-served the cleaning of its toilets; in Hyderabad and Chennai the civic function of cleaning streets has been privatized.. In some of Delhi’s bhavans, even security is now provided by private security firms. In Madhya Pradesh government hospitals have been handed over to local committees to oversee and run (with reported dramatic results in terms of improved service). Even bills and legislation are being outsourced. The drafting of 'The Andhra Pradesh Infrastructure Development Enabling Act, 2001' (arguably a landmark in infrastructure-enabling legislation), was outsourced to a private law firm (Nitish Desai Associates with consultancy inputs from the rating agency, CRISIL). Even hitherto public limited companies are increasingly delisting from stock exchanges and going private! The exit of India’s elites from public services, is both a positive and a negative trend. Positive in that they appropriate a smaller fraction of scarce public resources. Negative, in that when the powerful exit, the state has even less incentive to perform.

The “market” for public office in the India state is not new (see Wade, 1984).

The recent case of Ravinder Pal Singh Sidhu, Chairman the Punjab Public Service Commission, who treated his office as a sale depot where every Government job under his control had a price tag attached to it, reveals the extent to which the state has been de facto privatized. Jobs were sold outright based on a rate-chart prepared for various posts under the jurisdiction of the PPSC (a post in the Punjab Civil Service carried the highest 'premium'). In the course of his tenure of six years, he allegedly made nearly 3,500 appointments and in the process reportedly amassed Rs. 100 crores. In Karnataka the Stamps and Registration Department had volunteers' who had been performing the work of the clerical staff. They do not exist in any official records, but each of the 201 sub-registrar offices in the state had between 8 and 15 such volunteers depending on the amount of work. They even had their tables their "wages" was met from bribes. The government employees have essentially sub-contracted the work and paying for the work from bribes received.<sup>9</sup> According to another study the same is true in Andhra Pradesh despite the hype of the CARD experiment.<sup>10</sup> In this case new posts have been frozen for more than a decade. Work is "sub-contracted" to private agents who are paid from the proceeds of bribes!

Even defense production, one of the holiest cows of state regulation, was liberalized in early 2002. With India's defense related imports of the Rs 10,000 crore annually, restrictions on domestic private sector production were yet another example of shooting oneself in the foot. Of the total Rs 13,000 crore worth of production by the defencs PSUs and the Ordnance Factories Board (OFB) PSUs and OFB, 40 per cent of their purchases are already outsourced to the private sector. The new policies allow 100 per cent private investment in the defense industry sector, with up to 26 per cent foreign direct investment. Another sacred monopoly -- in radio and television -- cracked a decade ago. Channels are auctioned to private parties and consumers have a choice of 100 TV channels and even more radio channels.

In transportation the share of road transport in surface traffic movement has increased from 20 per cent of passenger traffic and 11 per cent of freight traffic in the 1950s to 80 per cent and 60 per cent respectively. Road transport is largely private while

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<sup>9</sup> Estimates of the bribes in this department alone were Rs 200 crores. *Economic Times*, April 13, 2002.

<sup>10</sup> Pavan Malhotra, Senior Thesis, Harvard University, 2002.

the other principal mode – railways -- is largely public. Elites do not travel by train any longer. In air transport the first switch occurred from the public sector airline to private sector airlines. And now with the four major international airports of Mumbai, Delhi, Chennai and Kolkata being offered on a 30-year lease to private players while the new Bangalore and Hyderabad airports will be in the private sector as well, elites will be able to completely bypass the public sector transportation system.

In the social sector the low degree of satisfaction with public services has led to exit raising the demand for the private provision of services. The results of a recent study focusing on the five basic public services that are of special concern to the poor -- drinking water, health and sanitation, education and childcare, public distribution system (fair price shops) and road transport – are revealing. Using ``satisfaction'' as a measure of the citizen's overall assessment of essential public services the survey finds:<sup>11</sup>

- only 13 per cent are satisfied with the behavior of doctors and paramedical staff
- only 16 per cent are satisfied with the performance of the teachers
- 5 per cent were satisfied with the sanitation in the schools.
- In the case of drinking water levels of satisfaction varied from 25 per cent in Kerala to 53 per cent in Tripura.
- 22 per cent were satisfied with the public transport system

The state's failure to deliver services has also increased the attractiveness of sectarian organizations. The Vidya Bharti schools run by the RSS cover the gamut from primary to higher secondary level and some colleges, training schools and vocational training colleges. Along with Shishu Vikas and Sanskar Kendras, this system claims to be “the largest non-government educational organization” in the country with 14,000 educational institution, 73,000 teachers and 1.7 million students.<sup>12</sup> In West Bengal, budgetary support for *madrasas* has increased from a few lacs in 1977 to more than two hundred crores in the late 1990s.

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<sup>11</sup> Public Affairs Center, 'State of India's Public Services: Benchmarks for the New millennium', Bangalore. The study was conducted between April and July 2001 by ORG-MARG in 24 States, covering 37,000 households.

<sup>12</sup> Source: <http://www.rss.org/VIDYA%20BHARTI.htm>

In health the ratio of private to public expenditures has increased noticeably in recent years (Table 4a, 4b, 4c).

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Table 4a, 4b, 4c here

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## THE ROAD AHEAD

During the 1990s, the Achilles heel of the reforms was an inability to rein in the dangerously high fiscal deficits. If anything the problem worsened, especially at the state level. 43 central PSUs consistently ran losses during 1991-2000 with cumulative losses of at Rs 34,261 crore at the end of fiscal 2001. Just five of them accounted for three-fourths of the accumulated losses.<sup>13</sup> The BIFR's portfolio has 178 PSUs that have been referred to it (Table 4).

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Table 4 here

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The one major weakness of privatization was a lack of strategy on the uses of the proceeds of privatization. The money was basically used to plug the fiscal deficit. A more imaginative strategy would have been to earmark privatization revenues *ex ante* for social sector and pro-poor expenditures. This would not only have build political support for the program but would also have been a hand-tying strategy that would have ensured that the revenues from privatization did not become an excuse to postpone critical expenditure reforms. Although there has been more earmarking more recently, it has not been done in a way that would sell the program to the masses (say the funding of a specific rural roads or water supply program) rather than issues that concern policy makers (like debt reduction).

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<sup>13</sup> These were Hindustan Fertiliser Corporation, Fertiliser Corporation of India, Rashtriya ISPAT Nigam, Indian Iron & Steel Company and Indian Drugs & Pharmaceuticals with accumulated losses of Rs 6,133 crore, Rs 5,468 crore, Rs 4,429 crore, Rs 1,576 crore and Rs 1,415 crore, respectively over the last 10 years. Hansika Pal, *Times News Network*, March 24, 2002.

The current momentum in privatization will see a major change in the ownership structure of central government PSUs. The major exceptions will be in three areas. In the case of the major loss making manufacturing and mining PSUs the going will be much more difficult since private buyers will not be forthcoming in the absence of major labor retrenchment. In the case of critical infrastructure sectors – ports, railways and airports – there will be greater outsourcing and entry of the private sector (especially through long-term leasing) rather than outright sales. State-run major ports are being corporatized, container berths are to be leased out to private operators on 30-year leases and private firms are being encouraged to set up greenfield ports. Unlike other countries India is using the landlord model of port privatization where the private companies operate only a part of the port (while they manage the whole port elsewhere) and are dependent on the port trusts to provide marine services like pilotage and towage. The Railways will privatize (through out-sourcing) part of their operations, such as the recent decision to hive off its parcel business, but otherwise the status quo will continue. In any case as the British experience has so painfully demonstrated, conventional privatization can be very problematic in this sector (Wolmar 2001).

For the central government the sector that poses the biggest challenge to privatization is the financial sector both due to the size of the unions and the enormous rents as evident in the numerous (and costly) “scams”. The strategy again has been to liberalize private sector entry rather than privatization. The entry of private sector banks (9 licenses since 1993), and liberal licensing of more branches by foreign banks and the entry of new foreign banks has led to greater competition in the banking system. In the three-year period between 1998-99 to 2000-0, nationalized banks opened 914 branches (and closed down 200 branches) while private sector banks opened 575 branches.<sup>14</sup> Since non-bank intermediation has increased, even the public sector banks have had to improve efficiency, however gradual, to ensure survival. Unlike privatization of PSUs, ownership changes in banking well have to wait the passage of necessary legislation, notably a Bill amending the State Bank of India Act and preceding that the Banking Companies (Acquisition and Transfer of Undertakings) and Financial Institutions Laws

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<sup>14</sup> The total number of branches was 67,929 as on March 31, 2001. Reserve Bank of India, 'Branch Banking Statistics - volume 2: March 2001.

(Amendment) Bill, 2000. The former was introduced in Parliament in December 2000 where it has been pending with the Standing Committee on Finance. Among other things, it seeks to reduce the limit on the government holding in public sector banks from the present 51 per cent to 33 per cent. The passing of this bill will be landmark in the privatization of the financial sector.

But the next stage of privatization has to extend down to the State level. State level PSUs are in abysmal shape. The stark contrast between the returns on government investment and the opportunity cost of funds (proxied the interest rate on government debt), is self evident (Table 5). Given the deteriorating fiscal health of the states, there is movement, although at a snail's pace.

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Table 5 here  
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The sector where the need for privatization is most critical and the political and institutional constraints most acute is the power sector. Out of the total energy generated in the country, only 55 per cent is billed and only 41 per cent is realized. According to a recent report the gap between average revenue realization and average cost of supply has been constantly increasing. During the year 2000-01, the average cost of supply was 304 paise per unit and average revenue was 212 paise per unit -- a gap of 92 paise of every unit of power supplied.<sup>15</sup> All this has caused a hemorrhaging SEB finances, whose annual losses have reached a level of about Rs 26,000 crore. The report found that "estimates reveal that theft alone causes losses of about Rs 20,000 crore annually."

Any privatization in the power sector has to be preceded by establishing regulatory commissions. By early 2002 twelve states that had set up Electricity Regulatory Commissions and had begun rationalizing power tariff structures by cutting cross subsidies. However, the poor record of privatization experience in Orissa is a warning that unlike other sectors, the sheer magnitude of rents in this sector will make it impossible to reform unless the utilities have labor market flexibility.

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<sup>15</sup> "Power on Demand by 2012," April 2002

The other sector that is a big drain on state finances is state road transport corporations. Since 1950, when the Road Transport Corporations Act was passed, 70 State road transport undertakings have been created all over the country. During 1999-2000 these undertakings incurred a total loss of around Rs. 2,000 crores, forcing States to embark upon restructuring exercises. Unlike power, where the failure to reform is having serious consequences for the rest of the economy, this is much less the case in passenger road transport were there private operators are fairly common.

We have stated earlier that labor has not been as recalcitrant and an obstacle as it is often painted. However, at the state level the picture is more bleak. Even here, as the recent example of Kerala state government's employees 32-day strike demonstrates, the unions finally caved in because of a general lack of public sympathy for their cause. Kerala is one of the states where the government employee salary bill now exceeds the state's tax revenue and is also one of the dozen states that are finding it difficult to pay salaries on time. The states are increasingly faced with a Hobson's choice. The price of fiscal mismanagement is rapidly increasing, and willy-nilly states will be forced to bite the bullet of privatization.

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**Table 1. Disinvestment Targets and Receipts (April 1991 to March 2002) and Methodologies Adopted (Rs crores)**

Year	No of Cos in Which Equity Sold	Target Receipt for the Year	Actual Receipts	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	362	Equities of 4 companies auctioned and government piggy backed in the IDBI fixed price offering for the 5 <sup>th</sup> 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 FIIs (CONCOR, GAIL). Cross purchase by 3 oil sector companies, ie, GAIL, ONGC and Indian Oil Corporation.
1999-2000	2	10,000	1829	GDR-GAIL VSNL-domestic issue, BALCO restructuring, MFIL's strategic sale and others.
2000-01	4	10,000	1870	Strategic sale of BALCO, LJMC; KRL (CRL), CPCL (MRL).
2001-02	10	12,000	5640**	Strategic sale of CMC-51%, HTL-74%, VSNL-25%, IBP-33.58%, PPL-74%, and other modes: ITDC, HCI, STC, MMTC.
2002-03	2	12,000	590**	Strategic sale of JESSOP-72%, HZL-26%, MFIL-26% and other modes: HCI.
Total	47*	66,000	26738**	

\* Total number of companies in which disinvestment has taken place so far.

\*\* Figures inclusive of amount expected to be realized, dividend/dividend tax and transfer of surplus cash reserves prior to disinvestment, etc. Source: Baijal,, 2002.

**Table 2. PSE Profitability Compared to the Private Sector**  
**Profit after tax (PAT)/net sales**  
 (percent)

As on March 31	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98
Pure Manufacturing CPSUs	-4.50	-5.30	-5.40	-6.90	-2.30	-2.40	-4.30	-3.90
Manufacturing private sector	5.70	4.90	4.90	6.60	9.10	9.00	7.00	6.20

Source: NCAER Report, cited in Baijal.

**Table 3. PSU's and Employment**

	<i>Total (1000s)</i>		<i>% Scheduled Caste</i>		<i>% Scheduled Tribe</i>	
	<i>1971</i>	<i>2001</i>	<i>1971</i>	<i>2001</i>	<i>1971</i>	<i>2001</i>
Group "A"	31.3	203.3	0.52	10.8	0.17	3.0
Group "B"	35.8	191.7	0.54	11.5	0.16	4.6
Group "C"	351.3	942.5	5.59	18.9	1.3	8.8
Group "D" Excl. Safai Karamcharis	129.2	388.1	16.0	22.9	5.9	11.3
Group "D" Safai Karamcharis	5.65	21.2	81.8	75.9	1.4	3.4
<b>TOTAL</b>	<b>553.2</b>	<b>1,746.9</b>	<b>8.2</b>	<b>18.8</b>	<b>2.2</b>	<b>8.16</b>

Source:

**Table 4a . Public-Private Sector: Use for Outpatient Care: All India  
(Percentage distribution)**

	Rural		Urban	
	1986-87	1995-96	1986-87	1995-96
Share of Public Sector	25.6	19.0	27.2	19.0
Share of Private Sector	74.5	80.0	72.9	81.0

Sources: NSSO 1992, Statements 13R and 13U, pp 67-68, Statement 2R and 2U, pp 53-54.  
NSSO 1998, Table 4.10, p 22; Table 4.16, p 28.

**Table 4b . Public-Private Sector: Use for Inpatient Care: All India  
(Percentage distribution)**

	Rural		Urban	
	1986-87	1995-96	1986-87	1995-96
Share of Public Sector	59.7	45.2	60.3	43.1
Share of Private Sector	40.3	54.7	39.7	56.9

Sources: NSSO 1992, Statements 13R and 13U, pp 67-68, Statement 2R and 2U, pp 53-54.  
NSSO 1998, Table 4.10, p 22; Table 4.16, p 28.

**Table 4c . Average Expenditure on Medical Care: All-India, 1995-96  
(Rs per illness episode/hospitalization)**

	Rural		Urban	
	1986-87	1995-96	1986-87	1995-96
Private:Public ratio Outpatient care	1.05	1.44	1.08	1.20
Private:Public ratio Inpatient care	2.29	2.07	3.13	2.43

Sources: NSSO 1992, Source Table 11.00, p S-516, Statement 6, p 59.  
NSSO 1998, Table 4.19, p 32; Table 4.21, p 33.

**Table 5. BIFR referred cases of PSUs as of end-2001**

	Central PSUs	State PSUs
No. of cases	76	102
Net Worth (Rs. billions)	79.6	18.9
Accumulated Losses (Rs. billions)	188.2	38.8
Workers (1000s)	735.9	242.6

Source: BIFR

**Table 5. State-Level PSUs. Investment and Returns**

	Year	Investment (Rs. crores)	Return (%)	Interest rate on state govt. borrowings
<b>Andhra Pradesh</b>	1999-2000	3832.34	0.08	11-12.25
<b>Arunachal Pradesh</b>	1999-2000	12.34	0.001	14,11.30
<b>Assam</b>	2000-2001	475.98	0.15	8.75-14.00
<b>Bihar</b>	1998-1999	14.03	Nil	12.5
<b>Delhi</b>	2000-2001	775.42	1.12	
<b>Goa</b>	1998-1999	131.05	0.33	12.15, 12.50
<b>Gujarat</b>	1999-2000	3771.71	0.71	12.25, 12.15
<b>Haryana</b>	1999-2000	2568.20	0.30	11.85,12.25
<b>Himachal Pradesh</b>	1998-1999	972.75	0.055	12.50
<b>Jammu &amp; Kashmir</b>	1999-2000	355.05	2.18	11.85-21.42
<b>Karnataka</b>	1999-2000	3532.18	0.34	11.08,11.85,12.25
<b>Kerala</b>	1999-2000	1774.80	0.56	11.85, 12.25
<b>Manipur</b>	1998-1999	80.66	0.06	12.50
<b>Meghalaya</b>	1999-2000	98.36	0.61	11.85, 12.25
<b>Mizoram</b>	1999-2000	10.98	Nil	12.25
<b>Nagaland</b>	1998-1999	41.51	5.13	12.15, 12.50
<b>Orissa</b>	1998-1999	1346.56	0.02	12.15, 12.50
<b>Punjab</b>	1998-1999	2341.53	0.05	12.15, 12.50, 12.47
<b>Rajasthan</b>	1999-2000	2560.08	0.21	11, 11.85, 12.25
<b>Sikkim</b>	1999-2000	44.54	2	12.25, 11.85
<b>Tamil Nadu</b>	1999-2000	2724.44	1.54	12.25, 11.85, 11.74
<b>Tripura</b>	1999-2000	177.98	Nil	12.25
<b>Uttar Pradesh</b>	1998-1999	2357.72	0.19	12.15-12.50
<b>West Bengal</b>	1999-2000	3654.30	0.03	11.85, 12.25

Source: Audit Reports from the Comptroller and Auditor General of India <[www.cagindia.org](http://www.cagindia.org)>