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# INTRODUCTION

**What Does *Disinvestment* Mean?**

* The action of an organization or government selling or liquidating an asset or subsidiary.
* A reduction in capital expenditure, or the decision of a company not to replenish depleted capital goods.
* A company or government organization will divest an asset or subsidiary as a strategic move for the company, planning to put the proceeds from the divestiture to better use that garners a higher return on investment.
* A company will likely not replace capital goods or continue to invest in certain assets unless it feels it is receiving a return that justifies the investment. If there is a better place to invest, they may deplete certain capital goods and invest in other more profitable assets.
* Alternatively a company may have to divest unwillingly if it needs cash to sustain operations.
* In finance and economics, **divestment** or **divestiture** is the reduction of some kind of asset for either financial or ethical objectives or sale of an existing business by a firm. A divestment is the opposite of an investment.

**Motives**

Firms may have several motives for divestitures.

First, a firm may divest (sell) businesses that are not part of its core operations so that it can focus on what it does best. For example, Eastman Kodak, Ford Motor Company, and many other firms have sold various businesses that were not closely related to their core businesses.

A second motive for divestitures is to obtain funds. Divestitures generate funds for the firm because it is selling one of its businesses in exchange for cash. For example, CSX Corporation made divestitures to focus on its core railroad business and also to obtain funds so that it could pay off some of its existing debt.

A third motive for divesting is that a firm's "break-up" value is sometimes believed to be greater than the value of the firm as a whole. In other words, the sum of a firm's individual asset liquidation values exceeds the market value of the firm's combined assets. This encourages firms to sell off what would be worth more when liquidated than when retained.

**Divestment for financial goals**

Often the term is used as a means to grow financially in which a company sells off a business unit in order to focus their resources on a market it judges to be more profitable, or promising. Sometimes, such an action can be a spin-off.

# DISINVESTMENT AND PRIVATISATION IN INDIA

Employing about 19 million persons, public sector currently contributes about a quarter of India’s measured domestic output. Administrative departments (including defense) account for about 2/5th of it, the rest comes from a few departmental enterprises (like railways and postal services), and a large number of varied non-departmental enterprises producing a range of goods and services. These include, close to 250 public sector enterprises (PSEs) owned and managed by the central government, mostly in industry and services (excluding the commercial banks and financial institutions). At the state level, production and distribution of electricity and provision of passenger road transport form the principal activities under public sector, run mostly by autonomous boards and statutory corporations. Though public investment in irrigation would perhaps rank next only to electricity in most states, it is generally viewed as public service, hence counted as part of public administration. Besides, there are about 1,100 state level public enterprises (SLPEs) that are relatively small in size. While the contribution of all these varied publicly owned and managed entities to national development is widely acknowledged, their poor financial return has been a matter of enduring concern – especially since the mid-1980s when, for the first time, the central government’s revenue account turned negative – an imbalance that has persisted ever since.

In 1991, a small fraction of the equity in selected central PSEs was sold to raise resources to bridge the fiscal deficit. Though quantitatively modest, the ‘disinvestment’ signaled a major departure in India’s economic policy. While there have been instances of sale of publicly owned enterprises as running concerns on pragmatic considerations, it is only in the last decade that such sales (and sale of limited equity) acquired the status of public policy. According to the Industrial Policy Statement in 1991, the Government of India (GOI) will strengthen those public enterprises which fall in the reserved areas of operation or are in high priority areas or are generating good or reasonable profits. Such enterprises will be provided a much greater degree of management autonomy through the system of memoranda of understanding. Competition will also be induced in these areas by inviting private sector participation. In the case of selected enterprises, part of Government holdings in the equity share capital of these enterprises will be disinvested in order to provide further market discipline to the performance of public enterprises. There are a large number of chronically sick public enterprises incurring heavy losses, operating in a competitive market and serve little or no public purpose. These need to be attended to. The country must be proud of the public sector that it owns and it must operate in the public interest.

Such a shift in policy is in tune with the widespread move away from public ownership since it was initiated in the late 1970s in the UK, and in the early 1980s in Chile – a change that has swept the world since then. Structural adjustment lending that was initiated around the same time by the Bretton Woods institutions’ included privatisation as an integral component of the policy based lending for the economies in financial distress. Such an initiative was buttressed by the World Bank’s influential official publication, Bureaucrats in Business (1995), which was a serious indictment of how the extension of the state in provision of private goods and services resulted in serious loss of efficiency, waste and lost growth opportunities for many less developed economies.

In macroeconomics, especially after the Latin American debt and inflationary crisis in the 1980s, privatisation was widely advocated as a quick and sure means of restoring budgetary balance, to revive growth on a sustainable basis. At the micro level, the change in ownership is often advocated to increase domestic competition, hence efficiency; and encourage public participation in domestic stock market – all of which is believed to promote ‘popular’ capitalism that rewards risk taking and private initiative, that is expected to yield superior economic outcomes. Thus, these changes are part of a wider reversal in perception and policy in the recent times.

**Review of Disinvestment and Privatisation**

Disinvestment was initiated by selling undisclosed bundles of equity shares of selected central PSEs to public investment institutions (like the UTI), which were free to dispose off these shares in the booming secondary stock market. The process however came to an abrupt halt when the market collapsed in the aftermath of Harshad Mehta led scam, as the asking prices plummeted below the reserve prices. Since the stock market remained subdued for much of the 1990s, the disinvestment targets remained largely unmet.

The change of government at the Centre in 1996 led to some rethinking about the policy, but not a reversal. A Disinvestment Commission was constituted to advise the government on whether to disinvest in a particular enterprise, its modalities and the utilization of the proceeds. The commission, among other things, recommended (Disinvestment Commission, 1997):

* Restructuring and reorganization of PSEs before disinvestment,
* Strengthening of the well-functioning enterprises, and
* To utilize the disinvestment proceeds to create a fund for restructuring of PSEs.

In response to the public debate, and to the commission’s recommendations, some large and well-functioning PSEs were declared “jewels” (Navaratnas) in the government’s crown, and were granted greater managerial and financial autonomy. However, disinvestment did not pick up as the share prices remained subdued because of the scandals that rocked the financial markets. But, by the turn of the decade, there was some improvement mainly in response to the stock boom engineered by Ketan Parikh. Apparently some PSEs stocks were part of the scandal, which this time also involved the UTI.

The new government that came to power in 1998 preferred to sell large chunks of equity in selected enterprises to “strategic” partners – a euphemism for transfer of managerial control to private enterprises. A separate ministry was created to speed up the process, as it was widely believed that the operating ministries are often reluctant to part with PSEs for disinvestments as it means loss of power for the concerned ministers and civil servants. The sales were organised through auctions or by inviting bids, bypassing the stock market (which continued to be sluggish), justified on the grounds of better price realisation. Notwithstanding the serious discussion on the utilization of disinvestment proceeds, they continued to be used only to bridge the fiscal deficit.

Strategic sale in many countries have been controversial as it is said to give rise to a lot of corruption, discrediting the policy process. Aware of such pitfalls, efforts were made to be transparent in all the stages of the process: selection of consultants to advice on the sale, invitation of bids, opening of tenders and so on. Between 1999 and 2003, much greater quantum of public assets were sold in this manner, compared to the earlier process, though the realised amounts were consistently less than the targets – except in 2003

Nonetheless, there are series of allegations of corruption and malpractice in many of these deals that have been widely discussed in the press and the parliament. Instances of under pricing of assets, favouring preferred buyers, non-compliance of agreement with respect to employment and retrenchment, and many incomplete contracts with respect to sale of land, and assets have been widely reported.

Thus, during the last 13 years Rs. 29,520 crores were realised by sale of equity in selected central government PSEs, (in some cases) relinquishing managerial control as well. This formed less than one per cent of central government’s cumulative fiscal deficit in this period.

Amid disinvestment and privatisation, some new PSEs are also created. For instance, many departmental activities were being corporatised (setting up of BSNL for instance) with a view to disinvestment. New PSEs are also formed to take up newer activities like road development corporations (promoted by state governments to execute highways and irrigation projects).

**PSU DISINVESTMENT**

The Centre can turn adversity into opportunity by aggressively pursuing the privatisation program, thus sending a strong signal about the economy and reforms

**August 1996**: Disinvestment Commission, chaired by G V Ramakrishna, set up to advice, supervise, monitor and publicize gradual disinvestment of Indian PSUs. Its first report offers recommendations on privatisation of 58 PSUs.

**November 1999**: The Commission ceases to exist with the government’s refusal to renew its mandate.

**December 1999** : An independent Department of Disinvestment is set up to give a fresh impetus to the privatisation program, with current Information and Broadcasting minister Arun Jaitley in charge.

**July 2000**: Former journalist Arun Shourie takes over the reins of the ministry; vows to bring in widespread privatisation.

Figures from the Department of Disinvestment reveal that against an aggregate target of Rs 54,300 crore to be raised from PSU disinvestment from 1991-92 to 2000-01, the finance ministry has managed to raise Rs 20,261 crore (less than half) by divesting 16% equity in 42 PSUs. Interestingly, the government was able to cross its target on only 3 (out of 12) occasions; in the remaining nine years the target remained unaccomplished. As a matter of fact, in 1993-94, net proceeds from PSU disinvestment were nil over a target amount of Rs 3,500 crore.

# GOVERNMENT PROGRAMME ON DISINVESTMENT: TARGET VS. ACTUAL

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Year | No. of PSUs in which equity sold | Target receipt (Rs cr) | Actual receipt (Rs cr) | Disinvestment Methodology |
| 1991-92 | 47 | 2,500 | 3,038 | Minority shares sold through auction method |
| 1992-93 | 35 | 2,500 | 1,913 | Shares sold separately for each PSU by auction |
| 1993-94 | N.A | 3,500 | Nil | Equity of 7 PSUs sold by auction but proceeds received in 1994-95 |
|  |  |  |  |  |
| 1994-95 | 13 | 4,000 | 4,843 | Sale through auction |
| 1995-96 | 5 | 7,000 | 362 | Equity of 4 PSUs auctioned; fixed-price offering for 1 |
| 1996-97 | 1 | 5,000 | 380 | VSNL GDR issue |
| 1997-98 | 1 | 4,800 | 902 | MTNL GDR issue |
| 1998-99 | 5 | 5,000 | 5,371 | VSNL GDR issue and domestic offerings in Concor and Gail and cross purchases by 3 oil PSUs |
| 1999-2000 | 3 | 10,000 | 1,584 | Gail GDR, Modern Foods strategic sale and VSNL domestic issue |
| 2000-01 | 3 | 10,000 | 1,868 | Balco, Kochi Refineries, Mangalore Refineries through strategic sale/acquisition |
| 2001-02 | 6 | 12,000 | 5,000 | VSNL, IPCL, IBP, CMC, Paradip Phosphates, Hindustan Zinc and Jessop & Co |
| 2002-03 | 2 | 12,000 | 3,360 | Maruti Udyog (rights issue) and IPCL |

Compare this with developed nations. The World Bank has reported that developing countries garnered $ 66.6 billion through privatisation in 1997. While China mopped up $ 9.1 billion, Latin America raised $ 34 billion, and India’s share, as usual, was a meagre $ 1 billion.

Germany had privatised 13,500 companies by selling off its stake in a span of two years. The Margaret Thatcher government, too, went on an aggressive PSU disinvestment spree in the 1980s in Britain; letting loose most of their stakes at one go. British Telecom, British Air, British Power, British Petroleum and British Rail are just a few examples. Interestingly, during its first wave of large-scale privatisation, UK witnessed about 670 PSUs worth $ 5.3 billion being privatised.

Amidst much fervor, Union Finance Minister Yashwant Sinha in his budget speech had announced a target of Rs 10,000 crore to be raised by divesting PSUs, despite this the ministry has garnered only Rs 1,868 crore (18% of the Rs 10,000 crore target) in 2000-01. This included the strategic sale of Balco’s 51% equity to Sterlite for Rs 551.5 crore in February 2001, probably India’s first big-ticket privatisation. The only two strategic sales in India, besides Balco, have been Modern Food Industries (MFIL) and Lagan Jute Machinery Company (LJMC).

MFIL was privatised in January 2000 with the government selling off 74% stake to Hindustan Lever for Rs 105.45 crore; and another 74% stake was sold off in LJMC to Muralidhar Ratanlal Exports in May 2000 for Rs 4.03 crore. This was then followed by some big-ticket privatisations. CMC's 51% stake was sold off to Tata Consultancy Services at Rs 197 per share for a total consideration of Rs 152 crore. In February 2002, VSNL's 26.97% was sold off to the Tatas at Rs 202 per share for Rs 1,439.25 crore. In the same month, IBP's 33.58% was sold to IOC at Rs 1,151.25 per share for Rs 1,153.68 crore.

Disinvestment in Paradeep Phosphates, Jessop, Hindustan Zinc, Maruti Udyog and IPCL soon followed. And the government fixed a target to raise Rs 12,000 crore from disinvestment in fiscal 2002-03. A couple of PSUs have been cleared for immediate disinvestment.

**The Importance of PSU Disinvestment**

The government roughly has about Rs 2 lakh crore locked up in PSUs. Disinvestment of government stake is, thus, far too significant to be forgotten. Consider this: we require funds for financing the gaping fiscal deficit. Funds are also needed for large-scale infrastructure development and to make our economy turn around. Funds need to be utilized for retiring government debt as well as for social programs like health and education. Almost 40-45% of the Center’s revenue receipts go towards repaying public debt. And, most importantly, the government needs to hand over control to prove its commitment to the reforms process.

Privatisation also assumes significance primarily due to the prevalence of a competitive environment in the market, which makes it tough for PSUs to survive.

Unfortunately, besides political opposition, the investment environment has also put a brake on the PSU disinvestment momentum. The post-budget market crash by 177 points was followed by the Rs 137-crore pay-order scam in Bank of India, the Tehelka scam, Sebi ban on badla, introduction of rolling settlement and the ushering of options and futures on the Indian shores, resulting in low volumes and falling stock prices.

As if this was not bad enough, the rupee witnessed an all-time low of Rs 47.84 early September 2001. FIIs, unhappy with the pace of reforms, particularly PSU disinvestment, cut down on purchases heavily. They then turned into net sellers of Rs 223.3 crore (gross sales of Rs 1,372.6 crore and gross purchases of Rs 1,149.3 crore) in the ten trading days since the beginning of September 2001. The most devastating blow was the collapse of the market below 3,000 points, on the second day after terrorists struck in New York and Washington in the US.

**Is This the Right Time for Disinvestment?**

With the equity market in shambles (with the terrorist attack in US, the global economic environment seems to have changed to the worst) is this the right time for disinvestment? Can the market handle the huge magnitude of paper? Will the government be able to realize the maximum potential of PSUs in this market situation?

Like most other stocks, PSUs also have been nose-diving to new lows everyday, particularly after the recent controversy over the disinvestment of the oil PSUs where different political parties mounted an attack on the disinvestment ministry. Considering this, wouldn’t it be prudent to let the market rise before thinking of disinvestment? In a bad market condition like this where valuations are affected by market environment, PSUs may fail to realize their optimum worth.

**Modus Operandi**

Though there is agreement that the Centre should go ahead with privatisation without losing any more time, there is no consensus on the manner of disinvestment. In the early stages, stakes were offered to the public and institutions at large. Minority stakes were being divested on and off, giving the impression that the objective of disinvestment was largely to curb fiscal deficit. Then, in 2000, the government modified its policy to emphasize the strategic sale route. As per this, it is first ensured that a valuation expert evaluates the PSU on the block and then placed with a strategic partner to realize its full potential.

Public offers have been one of the frequently used techniques in the UK to transfer state assets and businesses to private ownership. The method has been fairly successful, having increased the shareholding population from 4% to 25% and resulting in a 60% reduction in public sector employment. The Indian government, though, prefers the strategic sale route, if the recent privatisation of Balco, Modern Foods and Lagan Jute Machinery are anything to go by. In all three cases, a huge stake of the government was instantly sold off to a single strategic partner.

**Creating the Right Environment**

The government’s approach to PSUs is said to have a three-fold objective: revival of potentially viable enterprises, closing down PSUs that cannot be revived and bringing down government equity in non-strategic PSUs to 26% or lower. The government intentions sound noble. But what’s the ground reality?

Political opposition and a host of bureaucratic hurdles are cited as major reasons for the flip-flop on letting go control. It largely appears that the government aims to fund the fiscal deficit rather than achieve the goal of privatisation through disinvestment.

Though the government clung to its control by retaining a majority stake in the PSUs divested earlier, in recent strategic sales, it has offloaded majority stake. In Modern Food Industries and Lagan Jute Machinery, the government offloaded 74% stakes to private partners, while 51% of Balco was handed over to Sterlite.

Often, even if the bidders are finalised, the process gets delayed due to political and bureaucratic considerations.

The head of research of a leading brokerage house points out that one of the bidders for the Madhya Pradesh-based Hindustan Zinc was mandated to set up a plant at Rajasthan which was supposedly to please some minister. "Setting up plants should purely be based on economic feasibility rather than the whims and fancies of some minister," he states. The government needs to create the right environment for disinvestment to succeed. This will also indicate its commitment towards the reform process.

Control is another thorny issue. Let’s take the case of Air India in which the government intended to offload 40% stake. The only bidder finally left were Tatas and Singapore International Airlines (SIA) combine, which earlier intended picking up 40% (26% and 14% respectively). However, SIA later expressed an interest to pick up a 49% stake by itself. But as the Cabinet Committee on Disinvestment disallows foreign airlines to pick up more than 26%, SIA stepped out of the deal, leaving the Tatas as the sole bidder. After all, which foreign company would part with huge funds for a minority stake (14%) and invite bureaucratic troubles in return? Natarajan says the government should be ready to let go of management control and offer full ability to the private manager to run it.

Foreign bidders, fed up with delays in decision-making and lack of political will, are gradually withdrawing. Air India started with preliminary bids from the Tatas-SIA combine and Hindujas. But now, only the Tatas are left. Indian Airlines, on the other hand, has no bidder left. VSNL, too, is sailing in the same boat and is constantly losing market share. Its market capitalization has witnessed huge erosion over the past 18 months. It is in these PSUs where disinvestment process needs to be hastened. A three-pronged strategy for disinvestment is as follows:

* In the first stage, focus on loss-making PSUs like Air India and Indian Airlines.
* In the next stage, go for privatisation of public sector banks and financial institutions.
* In the third stage, privatise companies unable to bear the brunt of international competition like Shipping Corporation of India and Nalco.

An important aspect needed for a successful privatisation is labour. The labour is unsure of their position in the company post-privatisation. And, hence, even before the government begins to think of disinvestment in a state or Central PSU, it must ensure its labour laws are in place to prevent problems of retrenchment later.

Take the case of Balco. The government sold off 51% in Balco to Sterlite group in March this year, but not before its 7,000 employees went on a 67-day long strike to protest privatisation. The government needs to make the labour activists understand that a social security net will be created to make them feel secure. Or else, they can be shown the Profit & Loss account of the Indian economy to understand the importance of disinvestment.

Privatisation has been taking place the world over and governments are keen on getting out of manufacturing businesses and focusing solely on the economy.

# DISINVESTMENT OF INDIA’S PUBLIC SECTOR UNITS

The role of the State vs. Market has been one of the major issues in development economics and policy. In a mixed economy such as India, historically the public sector had been assigned an important role. However, in the year 1991 the national economic policy underwent a radical transformation. The new policy of liberalization, privatization and globalization de-emphasized the role of the public sector in the nation’s economy. The faculty at IIT-Bombay has been studying various aspects of the New Economic Policy such as financial sector reforms, fiscal implications of reforms, and of globalization.

To date several arguments have been proffered by the apologists of market-oriented economic structures:

* the government must not enter into those areas where the private sector can perform better
* market-driven economies are more efficient than the state-planned economies
* the role of the state should be as a regulator and not as the producer
* Government resources locked in commercial activities should be released for their deployment in social activities.

It is also contended that the functioning of many public sector units (PSUs) has been characterized by low productivity, unsatisfactory quality of goods, excessive manpower utilization, inadequate human resource development and low rate of return on capital. For instance, between 1980 and 2002, the average rate of return on capital employed by PSUs was about 3.4% as against the average cost of borrowing, which was 8.66%. Disinvestment (or divestment) of the PSUs has therefore been offered as one of the solutions in this context.

Disinvestment involves the sale of equity and bond capital invested by the government in PSUs. It also implies the sale of government’s loan capital in PSUs through securitization. However, it is the government and not the PSUs who receive money from disinvestment.

The fixation of share/bond price is an important aspect of disinvestment. Now, the Disinvestment Commission determines the share/bond price. Disinvested shares are listed, quoted and traded on the stock market. Indian and foreign financial institutions, banks, mutual funds, companies as well as individuals can buy disinvested shares / bonds.

Disinvestment is generally expected to achieve a greater inflow of private capital and the use of private management practices in PSUs, as well as enable more effective monitoring of management discipline by the private shareholders. Such changes would lead to an increase in the operational efficiency and the market value of the PSUs. This in turn would enable the much needed *revenue* *generation* by the government and help reduce deficit financing.

However, to date the market experience has been otherwise. The large national budgetary deficit on revenue account has been increasing. The government has not used the disinvestment proceeds to finance expenditure on capital account; i.e. the disinvestment policy has resulted in capital consumption rather than generation. Administrative costs of the disinvestment process have also been unduly high.

The actual receipts through disinvestment have often fallen far short of their target (see figure). During the period 1991-92 to 2002-2003, the government had targeted the mobilization of about Rs. 78,300 crores through disinvestment, but it could actually mobilize only Rs. 30,917 crores.

# PROBLEMS ASSOCIATED WITH DISINVESTMENT

A number of problems and issues have bedeviled the disinvestment process. The number of bidders for equity has been small not only in the case of financially weak PSUs, but also in that of better-performing PSUs. Besides, the government has often compelled financial institutions, UTI and other mutual funds to purchase the equity which was being unloaded through disinvestment. These organizations have not been very enthusiastic in listing and trading of shares purchased by them as it would reduce their control over PSUs. Instances of insider trading of shares by them have also come to light. All this has led to low valuation or under pricing of equity.

Further, in many cases, disinvestment has not really changed the ownership of PSUs, as the government has retained a majority stake in them. There has been some apprehension that disinvestment of PSUs might result in the ‘crowding out’ of private corporate (through lowered subscription to their shares) from the primary capital market.

An important fact that needs to be remembered in the context of divestment is that the equity in PSUs essentially belongs to the people. Thus, several independent commentators have maintained that in the absence of wider national consensus, a mere government decision to disinvest is not enough to carry out the sale of people’s assets. Inadequate information about PSUs has impeded free, competitive and efficient bidding of shares, and a free trading of those shares. Also, since the PSUs do not benefit monetarily from disinvestment, they have been reluctant to prepare and distribute prospectuses. This has in turn prevented the disinvestment process from being completely open and transparent.

It is not clear if the rationale for divestment process is well-founded. The assumption of higher efficiency, better/ethical management practices and better monitoring by the private shareholders in the case of the private sector ‘all of which supposedly underlie the disinvestment rationale‘ is not always borne out by business trends and facts.

Total disinvestment of PSUs would naturally concentrate economic and political power in the hands of the private corporate sector. The US economist Kenneth Galbraith had visualized a role of ‘countervailing power’ for the PSUs. While the creation of PSUs originally had economic, social welfare and political objectives, their current restructuring through disinvestment is being undertaken primarily out of need of government finances and economic efficiency.

Lastly, to the extent that the sale of government equity in PSUs is to the Indian private sector, there is no decline in national wealth. But the sale of such equity to foreign companies has far more serious implications relating to national wealth, control and power, particularly if the equity is sold below the ‘correct’ price!

If the disinvestment policy is to be in wider public interests, it is necessary to examine systematically, issues such as - the ‘correct’ valuation of shares, the ‘crowding out’ possibility, the appropriate use of disinvestment proceeds and the institutional and other prerequisites.

**PSU Disinvestment**

IN the last decade, many steps have been taken to disinvest public sector enterprises in India, both in terms of listing central public sector enterprises companies on the stock market and selling controlling interest. After a lull, disinvestment is now back on the UPA government’s agenda. There appears to be a political consensus on disinvestment in non-*navratna* profit making enterprises, and in chronic loss making PSUs. Hence, it is important to revisit the issues of rationale and mechanisms of disinvestment.

The main rationale for disinvestment is the increased efficiency of utilisation of resources of the economy, both labour and capital. An excessive focus on the fiscal aspects of disinvestment leads to undesirable consequences. Even partial privatisation, with the government retaining control, has yielded improved productivity. Disinvestment of profit making enterprises by public offering of shares is desirable insofar as it takes India towards a greater mass of companies with dispersed shareholding and avoids concentration of economic power.

However, for chronically loss making PSUs, the public at large is neither interested in buying shares, nor is it able to effect a transformation of management. For these firms, strategic sales are the best option, where full control of the PSU is auctioned off to the highest bidder. Some of these firms are in such bad condition with chronic losses and requiring regular infusions of capital, that the highest bid may be negative– the government should be willing to *pay* someone to take the PSU.

**PSU Disinvestment: Endemic Problems**

IT IS fairly clear now that disinvestment on any significant scale has lost its steam. The `socialist lobby' has succeeded, at least for the time being, in forcing the Cabinet to `reconsider' the matter. So, this may be a good time to look at the major issues involved in a dispassionate manner.

Public sector units in all countries typically suffer from three major problems.

First, the soft budget constraint: Unlike private companies, many loss-making PSUs are kept afloat by either direct government subsidy or by directed bank credit from state-owned banks. In the past, even `sick' private companies have been taken over by the state, out of political considerations, creating a further drag on state finances. In fact, these have been major factors behind the near-bankruptcy of many State governments and some public sector banks.

Second, multiple objectives: PSUs were often not designed to be primarily profit-making enterprises. They were expected to promote social objectives such as generating guaranteed employment, taking industries to backward areas, buying inputs from other PSUs to support them, providing output at `reasonable' prices to people, irrespective of costs, and so on. Their performance was not to be judged by commercial profitability. Apart from the confusion created in the minds of managers as to what goals to be given priority, it provided convenient excuses to hide inefficiencies. A manager of a perennially loss-making PSU can always claim to be promoting `social' profits.

Third, multiple-control authorities: Unlike the private sector manager, the public sector manager is subject to control and scrutiny by different ministries, the Bureau of Public Enterprise, various parliamentary committees and investigating agencies. Result: *Status quo* is the safest option for the manager. No bold decision on modernization, diversification or technological upgradation is taken. For instance, automation may displace labour, and changing the supplier may disturb the existing patronage system. The promotion and career prospects of the manager are not usually linked to his dynamism or entrepreneurship and often have more to do with keeping his political bosses in good humour.

**The Disinvestment Dilemma**

That India has not been able to realise much out of disinvestment of public sector equities down the years despite setting up of ambitious target on this count year after year is by now familiar.

Undeterred by ground realities which offer scant comfort for the authorities to devise any pragmatic privatisation of public sector undertakings (PSUs), the policy makers of the Tenth Five Year Plan have set out to glean an annual disinvestment proceeds of Rs 16,000 crore in the draft Approach Paper.

Yet the experience of both developed and developing nations on this needs to be kept in view even as the Government of India had been endeavoring a menu of options on disinvestment since the late 1990s in the aftermath of the economic reforms.

In the first flush, India gave PSU equities to trade sales to a core group of shareholders such as mutual funds, public financial institutions and to a limited extent to PSUs own employees. But no less a body than the Controller and Auditor General of India (CAG) has roundly rapped the Government for the way in which the scripts were priced.

In the second phase, equity offers of PSUs were given to strategic sales where domestic companies either alone or through foreign partners were allowed to bid for PSU scripts, the latest example in the category being the Cabinet decision to award equities of Air India to Tata-SIA.

Though originally a few bidders were there such as Videocon, Hindujas and Tata-SIA, it was only Tata-SIA which ended up successful as others were eliminated for not conforming to parameters set by the Disinvestment Department. In the case of Balco disinvestment too, a domestic company successfully bid for it, though the whole issue evoked flak from State government of Chhattisgarh and other Opposition parties.

# How to Get Disinvestment Going "Building India’s Future"

**Why Disinvest?**

Since reforms began in 1991, this is the first time after 1993-94 that one feels that reforms are going to go forward. Except industrial delicensing and some changes in the financial sector, almost nothing has so far happened on domestic economic reforms. The second generation of reforms is about domestic economic reforms. And domestic economic reforms have to begin with public sector reform and privatization. Without this as a prerequisite, nothing else is possible. Nothing else can happen. Modern Foods is a good beginning. This report will express some skepticism about what is proposed for Indian Airlines. But more than these two, what has been reported in the media about the government’s intentions is the really positive signal. Why is disinvestment necessary?

* The future of India is at stake.
* India’s balance sheet is in a mess. It is obvious that over the last 50 years huge amounts of Public money have been invested into the public sector. Hundreds and thousands of Crores of Public money has been invested into various Public Sector Units. However, these investments have not resulted in creation of value on the balance sheet. All in all investments have yielded very little or no return on investments, but creating a huge hole in the balance sheet. This huge hole in the balance sheet is being further exasperated through the excessive borrowings every year and the resultant interest burden
* India’s revenue, Profit & Loss statement is also in a mess. If one adds up four items of current revenue expenditure – interest payments, defense expenditure, wages and salaries of government employees and subsidies – and compares this figure with total current revenues (tax plus non-tax), there already is a deficit. That means that even if the government stops functioning and ceases to do anything else, there will be a deficit.
* This is not tenable. The government should have a surplus on the revenue account to finance a deficit on the capital account. Capital expenditure is what the government should be doing. But there is no money for this. The government should be spending on infrastructure – social and physical. The government should be spending on primary education and rural health care. But there is no money for this.
* The situation is worse. A deficit can only be financed through borrowing, which pushes up interest rates and crowds out necessary private sector investments, or through monetization of the deficit and resultant inflation. Inflation is the most regressive form of taxation that there is. It hurts the poor more than the rich; the poor don’t have inflation-indexed incomes. The government doesn’t have a treasure chest. The poor will pay through higher interest rates or higher inflation.
* Inefficient PSUs are largely responsible for the macroeconomic crisis India faced in the 1980s, a phenomenon that spilled over into a balance of payments (bop) crisis in 1990-91.
* Some of these PSUs shouldn’t have existed in the first place. That is, they are sick private sector units that should have been closed down. Instead, to protect a few existing jobs, they were absorbed into the public sector.
* It is necessary of course to point out that the public sector can mean various things. The government itself (Centre or State) sometimes runs undertakings, these are PSUs proper. Then there are departmental enterprises like railways, post offices or telecommunications, which are not separately incorporated, but are run as government departments. Finally, there are those that are separately incorporated and are run as independent companies. Since such distinctions are not important for this report, when the expression public sector is used, it means all three types.

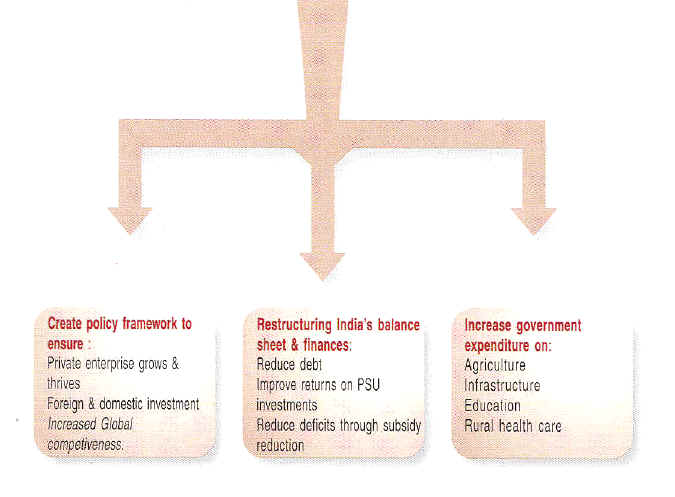
**EMPLOYMENT**

* A large chunk of revenue expenditure is interest payments on past government borrowing. If the interest payment problem can be solved, there will no longer be a fiscal deficit problem and the government will have money to spend on capital expenditure or infrastructure. In a country like India, there cannot be a moratorium on interest payments. While borrowing at market-determined interest rates and curbing present government expenditure disciplines future borrowing, the only solution to the debt overhang of earlier borrowing is disinvestments that can be used to retire public debt. That is what the ordinary citizen stands to gain from successful disinvestment.
* This argument can be reinforced. PSUs (public sector undertakings) were not created only for the purpose of providing employment. They were meant to generate surpluses that flow into the government’s non-tax revenue. This hasn’t happened. Disinvestment will improve PSU performance, it will improve PSU competitiveness. Those who have jobs in PSUs will enhance their job and economic security. Disinvestment accomplishes more.

**RETURNS**

* Inefficient PSUs also constrain the efficient performance of the private sector, since the private sector requires inputs and infrastructure services provided by monopoly suppliers in the public sector. Not everyone can have a job in a PSU. Disinvestment improves efficiency and pushes up growth rates. Growth provides jobs and employment. If the Indian economy can grow at around 7.5%, the backlog of unemployment will begin to disappear.
* These points were made with the Central government in mind and the Central government has equity in around 240 PSUs, 27 banks and 2 insurance companies. But at the level of the States, where there are around 1000 PSUs3, the situation is even more serious. Most States are bankrupt. They don’t have money to pay wages and salaries of government employees, forget education and health care, or infrastructure.
* India is bound to have a current account deficit in the foreseeable future. This current account deficit has to be financed through capital account inflows. Such inflows can be borrowing or non-debt creating inflows like foreign direct investments (FDI). As the East Asian experience also demonstrates, non-debt creating capital inflows like FDI are preferable. Disinvestment helps to attract global capital. In fact, it helps to attract domestic capital as well.

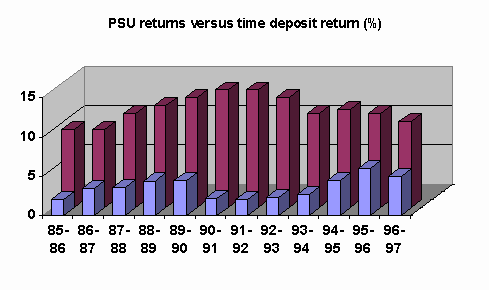
**BUILDING INDIA’S FUTURE SECOND GENERATION REFORMS**

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PSUs have never earned profits that have exceeded 6 per cent of capital employed (Table1).Their return on capital has been between 5 and 7 percentage points below the rate of interest on long term government bonds. That is just one measure of the lost opportunity cost of return.

**Table 1: Profitability of Indian PSUs**

|  | **91-92** | **92-93** | **93-94** | **94-95** | **95-96** | **96-97** |
| --- | --- | --- | --- | --- | --- | --- |
| **No of PSUs** | **237** | **239** | **240** | **241** | **239** | **236** |
| **PAT as % of CE** | **2** | **2** | **3** | **4** | **6** | **5** |
| **PAT as % of GS** | **2** | **2** | **3** | **4** | **4** | **4** |
| **No of profitable PSUs** | **133** | **131** | **121** | **130** | **132** | **129** |
| **No of non profitable PSUs** | **104** | **108** | **116** | **109** | **102** | **104** |



These poor returns have occurred despite huge rents that accrue from government monopolies like petroleum and power. Once these are netted out, PSUs show negative return (Table 2).

**Table 2: Differential PSU profitability (%)**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **PAT/Net Sales** | **91-92** | **92-93** | **93-94** | **94-95** | **95-96** | **96-97** |
| **All non-service PSUs** | **2** | **2.2** | **3** | **4.4** | **4.9** | **4.4** |
| **Less petroleum** | **0.1** | **- 0.1** | **- 1.2** | **1.6** | **3.4** | **2.7** |
| **Less petroleum & power** | **- 2.4** | **- 2.3** | **- 3.4** | **- 0.2** | **1.3** | **0.1** |
| **Less petroleum, power, coal & lignite (pure manufacturing PSUs)** | **- 5.3** | **- 5.4** | **- 6.9** | **- 2.3** | **- 2.4** | **- 4.3** |

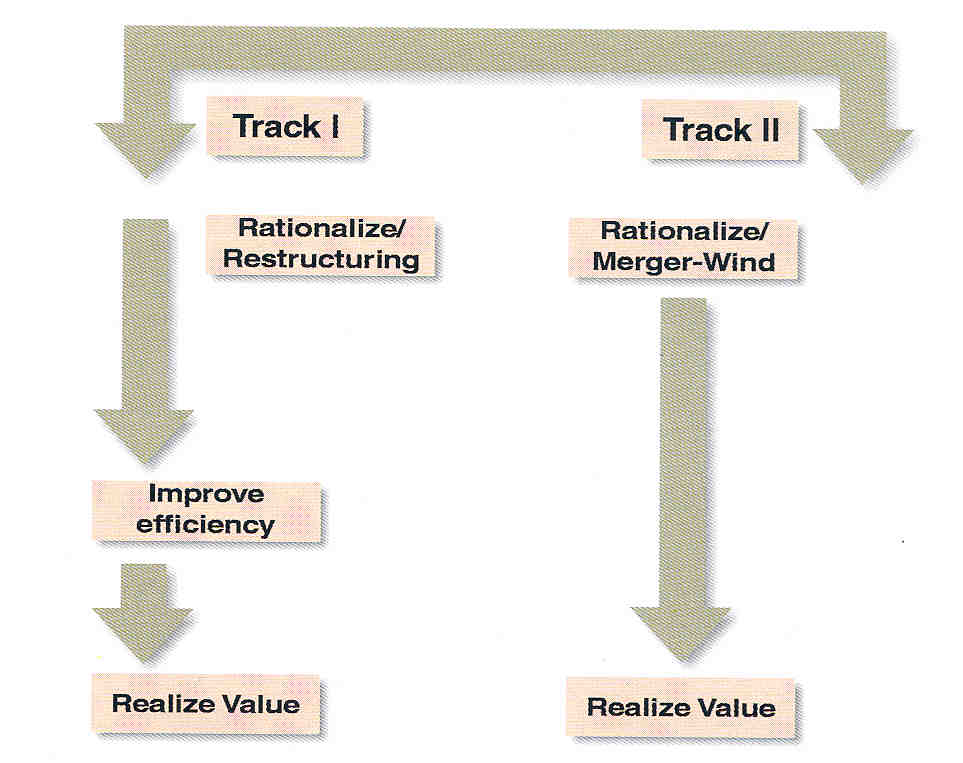
* The controlling shareholder of PSUs has distinctly different objectives. Commercial viability, profitability, cost minimization, optimal investment decisions rarely figure among the concerns of a typical Member of Parliament or a Minister. Next in the hierarchy of shareholders’ representatives come the civil servants. Bureaucrats specialize in proper procedures. This creates an inconsistency between the organizational forms of governments and those of modern financial and industrial entities: governments and their agents are process oriented, whereas firms have to be result oriented. The mismatch gets exacerbated by a civil servant’s aversion to risk taking.
* Given such non-commercial objectives of the representatives of shareholders, most chief executives of PSUs quickly adopt the line of least resistance; develop the ‘don’t rock the boat’ syndrome. Thus, organizational changes are not made, erring staff remain undisciplined, loss-making plants are neither down-sized nor closed, wages are not linked to productivity, and redundant workers are not retrenched.
* Above all this, there is Article 12 of the Constitution of India, which defines ‘the State’ as "the Government and Parliament of India and the Government and Legislature of each of the States and all local or other authorities within the territory of India or under the control of the Government of India". Since most PSUs have more than 50% government ownership, they fall under the ambit of ‘the State’. This has affected PSUs in several adverse ways.
* All PSUs are expected to achieve a wide variety of non-commercial objectives which are imposed by the Ministries and the Parliament.
* There is an annual audit by the Comptroller and Accountant General (CAG) in addition to the audit by the statutory auditor. The area where CAG audits inflict the greatest ex ante damage is in purchases and tenders. PSU managers invariably veer towards selecting the lowest bid, even when they know that the quality is poorer. Innumerable CAG allegations of financial impropriety only on the basis of rejecting the lowest bid have taught PSU managers that propriety dominates profitability.
* There are constraints on appointment of senior management personnel, which can only be done through the Public Enterprise Selection Board (PESB) and, thereafter, clearance from the Department of Personnel, the Home Ministry, and, in many instances, by the Office of the Prime Minister. This has led to delays, non-appointment of CEOs and executive directors, and excessive emphasis on seniority — which means that very few CEOs can enjoy their full term.
* Since PSUs are interpreted as ‘the State’, they are subject to writ petitions to the Supreme Court under Articles 32, and High Courts under Article 226 of the Constitution.
* Again by virtue of being considered as servants of ‘the State’, managers of PSUs are often subjected to criminal investigation by the Chief Vigilance Commissioner and the Central Bureau of Investigation.
* State status limits managers from down-sizing plants, retrenching or re-deploying employees.
* Finally, the directors of PSUs have little autonomy in finalizing investment decisions.

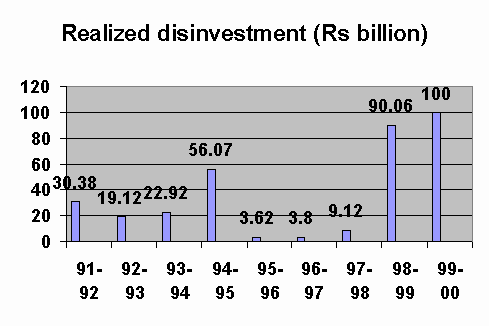
For a while, governments tried the system of having target-setting memoranda of understanding (MOUs) between PSUs and their administrative ministry. The idea was to make a PSU achieve greater efficiency without diluting the government’s majority ownership and control. Despite the Department of Public Enterprises showing high ‘success’ rates, the MOUs failed.  First, there is a sample selection bias: virtually no loss-making PSU signs a MoU. Thus, over 55% of the PSUs remain outside the MOU ambit. Second, the targets are set low enough to ensure achievement. The post-MOU performance of the so-called ‘excellent’ and ‘very good’ achievers is no better and often worse than before.

**Tactics and Strategy**

There is a difference between tactics and a strategy. So far, disinvestment has been driven by the tactical compulsion of financing the fiscal deficit. This is perhaps the reason why the word privatization has not been used until recently, the word disinvestment tending to imply a soft choice. This is in contrast to a country like Britain, where privatization and disinvestment were driven by a conscious recognition that this improves efficiency. However, there are no soft choices. As countries like Peru, Brazil, Chile, France, Morocco, Poland, Indonesia, Malaysia, the former German Democratic Republic, the Philippines, Pakistan, Sri Lanka, Taiwan, Indonesia and New Zealand have recognized the fiscal deficit or releasing resources for social or infrastructure sectors cannot be the only reasons for disinvestment. Other reasons are improved efficiency and competition and broadening and deepening the capital market.

PSU reform attempts go back to the 1980s, where there was some attempt to increase functional autonomy of PSUs, without privatization and disinvestment. Post-1991, there were ad hoc equity sales in around 50 PSUs, with equity sales ranging from 5% to 49%. There was a hang-up about letting go of more than 51% equity. This led to some improvement in efficiency and pre-tax profit as a percent of capital employed in PSUs more than doubled from the base figure of 3.4% in 1990-91.This illustrates what is possible with full-fledged reforms.

**SECURING THE FUTURE OF INDIA’S PSUs**

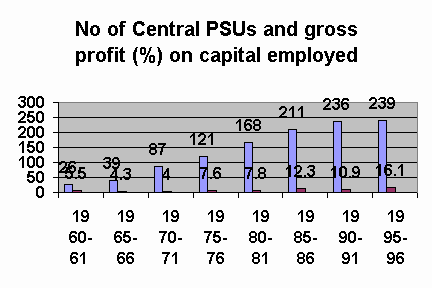


The hang-up about giving up more than 51% equity was possibly given up with the setting up of the Disinvestment Commission in 1996, a commission that has now been wound up. The Disinvestment Commission examined 50 PSUs, ostensibly non-strategic and non-core, where government equity could be brought down to zero and management handed over. In most cases, it is now accepted that government equity can be brought down to 26%. The 51% figure is important. Any firm where the government has more than 50% equity is legally interpreted as part of Article 12 of the Constitution and is accountable to administrative ministries, government audits and Parliament. There will also be the Central Vigilance Commission (CVC) and the Central Bureau of Investigation (CBI). Moreover, with a 51% hang-up, new private shareholders will always be a minority on the boards. Naturally, bids would have been higher had the government agreed to dilute equity to 26% in a time-bound fashion.

However, driven by tactical considerations, the entire disinvestment process so far has been left to bureaucrats who do not necessarily have a perfect understanding of how capital markets operate or how international investor decisions are taken. Therefore, issuance is piecemeal; there are long delays in appointment of lead managers and finalization of IPOs (initial public offerings) and flawed criterion used in selection of lead managers. There has been lack of transparency, a fact that reports of the Comptroller and Auditor General (CAG) of India have also commented on. It should not be surprising that foreign investments in the disinvestment process in India are a trickle compared to global investments that flow into disinvestment processes world-wide. It is remarkable that not a single PSU is yet under autonomous private management and the cross-holdings by oil companies are a particularly perverse illustration of this phenomenon.

It is only recently that the government has become a bit more serious about disinvestment. As the following will make clear, this report favours what has been done for Modern Foods, but not what has been done for Indian Airlines, unless that is a temporary step.

Unlike what happened historically, a strategy will have a proper vision and plan of action.



First, the management and responsibility of the entire disinvestment process should exclusively be with the Disinvestment Ministry (DM). Setting up such a DM ensures transparency and fairness and also contributes to a comprehensive approach to disinvestment, as opposed to ad hoc decisions. This is one reason why most developing countries have opted for formal structures. Other ministries can be co-opted only if it is absolutely necessary. The Secretary of DM must have sufficient capital market experience. For each proposal, the DM will be responsible for taking the proposal to a Cabinet Committee on Disinvestment that will consist of the Prime Minister, the Finance Minister, the Disinvestment Minister and any other economic ministry that may be necessary from the point of view of the specific proposal. The DM will be a specific pre-determined target of capital that will be raised over a fixed time horizon, say the next two years. Thus, for the next two years, the DM will develop a plan and course of action that addresses individual companies and sectors and draws up a strategy for each. The strategy need not be the same across all companies or across all sectors. To ensure a realistic and successful course of action, the DM will have an Advisory Board. The Advisory Board will have as members, individuals who have sufficient capital market and international investor experience. Examples are representatives from financial institutions, management consultants, merger and acquisition (M&A) experts and private companies. It is important to ensure that the DM and politicians and bureaucrats involved in the disinvestment process are granted immunity from prosecution and investigation by the Central Bureau of Investigation (CBI) or Central Vigilance Commission (CVC). If the process is transparent, as is argued in this report, the need for these will not arise. In this framework, there is no need to revive the Disinvestment Commission. It has no further role to play.

**HOW MANY OF THESE JUSTIFICATIONS FOR PSUs ARE VALID NOW?**

Second, the candidates for disinvestment must be chosen carefully. Stronger PSUs are the ones that must enter the market first, in the immediate short run (the first four years). This will whet the appetite of investors and make India a success story, a phenomenon that tends to snowball. Creation of markets is in fact indirect positive fallout of successful disinvestments. In the medium term however, all government companies that are non-strategic should be candidates for disinvestment. Strategic or core must be carefully defined. Other than arms, ammunition and defense equipment, atomic energy, radioactive minerals and railway transport, there is nothing else that can appropriately be defined as strategic or core. Therefore, in every other case, there is no reason why government equity should not be brought down to 26% and this includes banking, insurance, aviation, the petroleum sector and tourism. 26% equity is enough to ensure that the government has some influence over corporate decision making. The only caveat to 26% can be if prior privatization of management enhances valuation. The disinvestment process is best managed if there are a defined number of large transactions per year, as opposed to a large number of small transactions. Perhaps some overall restructuring of PSUs through mergers and acquisitions (or even winding up) is therefore necessary prior to disinvestment.

Stated differently, one of the first decisions the DM has to take is on the extent of disinvestment. Will there be total disinvestment? Will there be partial disinvestment with managerial control retained by the State? Will managerial control be handed over to a strategic investor, with only minority share holding granted to such an investor? As the statements above indicate, this report argues for total disinvestment. The selling of bundles of portfolios of shares will not work. Moreover, selling lots of 5 or 10% is counterproductive because buyers know that further shares will be offered. The mindset that a PSU, even if does not make losses, is a going concern must change. Instead, the block of assets must be sold. Whether the enterprise will continue to be a going concern or not, is for the new management to decide.

There is some urgency in doing this. Before liberalization, many PSUs were monopolies. They are now being exposed to competition. This process will intensify as further liberalization of trade (cuts in tariffs and elimination of quantitative restrictions) and investments (foreign direct investments) take place. To get a good value for these PSUs, the time to disinvest is now. Not later.

Third, the present system of selecting lead managers on the basis of bidding for fees is entirely unsatisfactory. Second-best lead managers are chosen and are often not interested, or do not deliver their best resources, to issuances. Globally, there are only 5 or 6 top lead managers. All these should be empanelled and additions to this panel can be through co-managers from smaller investment banks. The norms for fees can be fixed and such norms can be suggested by a team of financial institutions that have requisite expertise. These empanelled lead managers can be allotted initial issuances in random fashion and further issuance mandates can be based on performance (over-subscription, market-making, pricing). All this will eliminate delays in the process of selecting lead managers.

Fourth, the process of disinvestment need not be completely capital market driven, as it is today. The capital market focus, the small percentage of equity disinvested and an overall lack of clarity result in a less than optimum value being derived from the disinvestment process. There are nine, not mutually exclusive; options possible for the disinvestment process and PSU reform and all nine can be used to ensure flexibility and maximum value from disinvestments. Often, the choice may be dictated by whether the eventual shareholding is meant to be narrow or wide. These nine options are the following. First, there can be strategic majority sales to a partner and global trends show that there is more realizable value (about 20 to 30% more) through strategic sales to companies in the same sector. 51% or even 100% equity can be sold to such strategic buyers. Second, there can be open public auctions for units to bidders, with or without pre-qualifications. However, sales should not be only to public sector financial institutions and their subsidiary mutual funds. Third, there can be public sales through stock exchanges in the domestic capital market. One can continue with capital market disinvestments, except that larger shares of equity must be off-loaded through initial IPOs. It is necessary to privatize management before IPOs for value to be maximized. Global trends are that 20 to 30% more value is obtained through disinvestments after privatization of management than before privatization of management. Fourth, it is possible for PSUs to enter into joint ventures (JVs) with the private sector and transfer their business for stock in the new enterprise. However, in such cases, shareholder agreements between the private company and the PSU must over-ride government decision making or policy. Once the JV route has been followed, capital market transactions are possible. Fifth, GDRs/depository receipts can be issued in international capital markets. Sixth, as an imperfect framework of disinvestments, there can be management contracts for limited periods of time with private operators. Seventh, there can be sales in blocks. Eighth, despite all attempts at reform, there will be some clear cases of winding up. Ninth, there can be mergers and restructuring. For Central PSUs, this report later gives suggestions about what modality can be attempted for which PSU.

Since employees and Indian citizens in general have to be part of the disinvestment process, employees must first be given up to 10% of stock at par or at discounts on market values. This can be spliced with deferred payment for employees and loyalty bonus of shares if shares are held for a minimum period. In addition, a small additional IPO or up to 10% of capital can be offered to Indian citizens in individual capacity. There can be a caveat that a single individual cannot have more than 1000 shares. This will eliminate some resistance to disinvestment and employees or others will become part of the process that creates more value for their company. PSUs will move from being employment creators for those who are employed with the company to enterprises that create wealth for their share-holders, the citizens of India. This is what should have happened with PSUs in the first place. In addition, it may be necessary to ensure that willing employees are provided attractive severance packages. Without the possibility of surplus manpower being shed, bids will be marked down. The role of a media campaign in generating consensus also needs to be emphasized.

**What is the Need to Privatize Profit Making PSUs?**

There will continue to be a problem with loss-making PSUs, many of which historically are loss-making private sector enterprises that should have been closed down, but were nationalized in the 1970s. The Board for Industrial and Financial Reconstruction (BIFR) is supposed to examine these and recommend ones that cannot be revived. Not a single one has been closed down, primarily because of court intervention on labour grounds. While loss-making PSUs that have positive market value can be sold, this is also true of loss-making PSUs that have eroded their net worth, provided that the assets are sold as a block. There may be a few cases where actual closing down is necessary. Properly used, the National Renewal Fund (NRF) can be used to retrain and re-deploy people who are retrenched because of closing down. However, the NRF cannot be equated with a Voluntary Retirement Scheme (VRS). As originally stated, the NRF was supposed to be used for VRS, retraining and unemployment insurance. Only the first has come about. The proceeds of disinvestment should not go into the Consolidated Fund of India. They have to be used to retire the public debt or for a genuine NRF (from which Rs 1000 crore can be earmarked for VRS). In fact, the present value of future wage and pension flows of workers is easy to compute. From funds obtained through sales, this amount can be set aside, so that a worker who loses a job does not lose the income security.

There has to be fresh legislation to ensure fast transfer or leasing of government land and user rights. This can even provide for special tribunals, without violating Article 14 of the Constitution. Otherwise, the entire process can get stuck in the court system.

**Sequence and Transition**

For the entire mechanism and process to be credible, two units must be sold by 31 March 2000. Thereafter, there should be a clear target for the next two years. 12 billion US dollars over the next two-year time span is a reasonable target, that is, Rs 52,000 crores.

It is not possible for this report to be specific about the time sequencing of disinvestment. However, some principles can be mentioned. First, there is urgency about sectors where monopoly is being threatened because of liberalization. Second, the government is generally bad in areas where there is a service orientation. Therefore, services, manufacturing and trading are sectors where the initial flush of disinvestments can take place. This emphasis on service orientation also explains why banks have to go first.

Barring the strategic sectors, no more than 26% government equity need be retained. But in the interim period, the government might wish to continue as the single largest shareholder. Retaining government shareholding directly will constrain PSUs because of interference from government ministries, Parliament and government audits. Once government equity is below 50%, decisions on appointing management must be left to Boards and not to Joint Secretaries in administrative ministries. Another advantage of bringing equity down to 26% is avoidance of the Central Vigilance Commission (CVC), the Central Bureau of Investigation (CBI) and the Prevention of Corruption Act (PCA). Section 13 of the Prevention of Corruption Act defines that a public servant is guilty of criminal misconduct (corruption) if a decision taken by the public servant benefits a third party, unless it can be proved that this benefit to the third party is in the public interest. Any decision taken benefits a third party and it is impossible to prove that this benefit to the third party is in the public interest. Therefore, public servants become risk averse and don’t take decisions. There is no point asking PSUs to function along commercial principles as long as such a section continues.

Ideally, until the government shareholding is brought down to below 51%, there should be a National Shareholding Trust as a non-profit trust under the Societies Registration Act or the Companies Act. The entire government shareholding can be transferred to this Trust. On the advice of the DM, the Trust will sell equity in block sales to banks, financial institutions or mutual funds or directly to retail investors. In the interim, there can be a stipulation that shares held by the Trust will not drop below the 26% threshold. The Trust will be preferable to a Special Purpose Vehicle as it will take the enterprise out of the purview of the CVC, CBI, PCA, government ministries, Parliament and government audits. However, if this is not done and government shareholding is more than 50%, the enterprise must still explicitly be taken outside the CVC, CBI, PCA, government ministries, Parliament and government audits. The salaries paid to management must also be delinked from government salary structures. Management salaries have to be decided by boards and by no one else.

There has to be a proper competition policy to cover unfair and restrictive trade practices and issues like transfer pricing. The competition policy must also cover mergers and acquisitions. At present, no prior approval is required for mergers and acquisitions, although that is the practice in many developed countries also. Subsequent de-monopolization through breaking up involves significant transaction costs. It is a better idea to require prior approval.

One must also be careful in some service sectors. With many individual countries, service sector liberalization depends on reciprocity clauses – banking and aviation are examples. These may have to be renegotiated if government equity drops below 50%.

Incidentally, there is no reason to exclude banking from disinvestments, although changes in the Banking Regulation Act will be necessary. Banks, when privatized, can have certain guidelines on lending for priority sectors. But these guidelines must be set out by the Reserve Bank in the offer letter itself, and not introduced subsequently.

In line with these points, this report suggests the following modalities for Central PSUs. In the annexure table, "X" indicates that the route is appropriate for a PSU; the absence of "X" indicates that for that PSU, that route is not appropriate.

**The Road Map**

* Explain to citizens the benefits of disinvestment – more expenditure on education, health care and infrastructure, higher growth, more employment, lower interest rates, lower inflation and costs of the present status quo. Use media campaigns.
* Disinvestment should be driven by efficiency, rather than fiscal deficit compulsions.
* There should not be ad hoc sales, or any hang-ups about clinging on to 51% equity. With a 51% threshold level, new private shareholders will be in the minority on boards and realizations will be higher without this limit.
* If government equity is brought down to 26%, the enterprise will no longer be "State" as defined by Article 12 of the Constitution. It will thus be outside the ambit of the Central Vigilance Commission (CVC), the Central Bureau of Investigation (CBI), administrative ministries, government audits and accountability to Parliament.
* Disinvestment cannot be left to bureaucrats who have no experience of capital markets or international investor sentiments. They will delay appointment of lead managers, finalization of IPOs (initial public offerings) and develop non-transparent processes. As a result of this, not a single PSU has changed hands since 1991.
* There must be Disinvestment Ministry (DM); other ministries can be co-opted only if absolutely necessary. The Secretary of DM must preferably have capital market experience. DM will be responsible for taking the proposal to a Cabinet Committee on Disinvestment consisting of the Prime Minister, the Finance Minister, the Disinvestment Minister and any other economic ministry considered necessary. There is no need for a Disinvestment Commission. The DM will have an Advisory Board consisting of members who have sufficient capital market and international investor experience and there will be a transparent and strategic approach.
* The DM will have a specific pre-determined target of capital that will be raised over a fixed time horizon, such as, 12 billion US dollars over the next two years.
* The DM and politicians and bureaucrats involved in the disinvestment process must be granted immunity from prosecution and investigation by the Central Bureau of Investigation (CBI) or Central Vigilance Commission (CVC). If the process is transparent, the need for these will not arise.

**POSSIBLE STRATEGY FOR DM (Disinvestment Ministry)**

* Candidates for disinvestment must be chosen carefully by the DM. The stronger PSUs must enter the market first, so as to create an appetite for investors. Before this, there may be a need for mergers and acquisitions and winding up among existing PSUs.
* All non-strategic government companies should eventually be brought down to 26% government equity, unless prior privatization of management ensures better valuation. 26% is enough to ensure influence on managerial decision making. There must be a defined number of large transactions per year, not a large number of small transactions.
* Arms, ammunition, defense equipment, atomic energy, radioactive minerals and railway transport are the only strategic sectors. Everything else can eventually be divested, including banks.
* The present system of selecting lead managers on the basis of bidding for fees is unsatisfactory. Globally, there are only 5 or 6 top lead managers and they can constitute the panel.
* Empanelled lead managers can be allotted initial issuances in random fashion and further issuance mandates can be based on performance (over-subscription, market-making, pricing).
* The disinvestment process should not be capital market driven and all nine forms of disinvestment and PSU reform can be judiciously used by the DM – first, strategic majority sales; second, open public auctions for units to bidders, with or without pre-qualifications; third, domestic public sales through stock exchanges; fourth, joint ventures, where shareholder agreements must override government decisions; fifth, GDRs/depository receipts; sixth, management contracts; seventh, block sales; eighth, winding up; and ninth, mergers/restructuring.
* Until government shareholding is brought down to below 51%, there should be a National Shareholding Trust as a non-profit trust under the Societies Registration Act or the Companies Act. The entire government shareholding can be transferred to this Trust. On the advice of the DM, the Trust will sell equity in block sales to banks, financial institutions or mutual funds or directly to retail investors. The Trust will be preferable to a Special Purpose Vehicle as it will take the enterprise out of the purview of the CVC, CBI, Prevention of Corruption Act, government ministries, Parliament and government audits.
* However, if this is not done and government shareholding is more than 50%, the enterprise must still explicitly be taken outside the CVC, CBI, Prevention of Corruption Act, government ministries, Parliament and government audits. Managerial salaries should be delinked from government salaries.
* To address the political economy of the disinvestment process, employees can be given 10% of stock at par or at a discount on the market value. There can also be an additional IPO of up to 10% to citizens in individual capacity, with a stipulation that no individual can hold more than 1000 shares.
* PSUs that have eroded their net worth must be closed.
* Disinvestment proceeds should not flow into the Consolidated Fund of India and be used to finance revenue expenditure. A stipulated percentage can be earmarked for capital expenditure and building physical and social infrastructure. Another percentage can be used for retiring public debt. The remainder, which should be a smaller percentage, can be used for a National Renewal Fund, which should not be equated with a Voluntary Retirement Scheme only.
* There must be fresh legislation for the transfer of government land and assets. Special tribunals to dispense with time-consuming court procedures need to be set up
* Enact a competition policy and renegotiate reciprocal service sector agreements where necessary.

| PSU | Strategic sales | | | | Open public auctions to select bidders | | | | | | | | Domestic capital market sales to public | | | | Joint ventures | GDRs, ADRs | | | | Management contracts | | | | | | | Block sales | | | | Winding up | | | | Mergers, restructuring |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Air India, Pawan Hans | X | | | |  | | | |  | | | | | | | | X |  | | | | | | | |  | | |  | | | |  | | | |  |
| Indian Airlines |  | | | |  | | | | X | | | | | | | |  | X | | | | | | | |  | | |  | | | |  | | | |  |
| Airports Authority | X | | | |  | | | |  | | | | | | | | X |  | | | | | | | | X | | |  | | | |  | | | |  |
| Bank of Baroda, Bank of India, Canara Bank, Corporation Bank, SBI, Syndicate Bank, PNB |  | | | |  | | | | X | | | | | | | |  | X | | | | | | | |  | | |  | | | |  | | | | X |
| All other banks |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | | X | | | | X | | | | X |
| BCCL, CCL, NCL, SECL, WCL, Coal India |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | | X | | |  | | | |  | | | |  |
| Bharat Earth Movers | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | | X |
| BHEL | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | |  |
| PSU | | Strategic sales | | | | Open public auctions to select bidders | | | | | | Domestic capital market sales to public | | | Joint ventures | | | | | | GDRs, ADRs | | | Management contracts | | | | | Block sales | | | Winding up | | | | Mergers, restructuring | |
| IOC, ONGC, GAIL |  | | | | X | | | |  | | | | | | | |  | X | | | | | | | |  | | |  | | | |  | | | |  |
| BPCL, HPCL, IPCL, IBP, Bongaigaon Refinery, Cochin Refineries | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | | X |
| Cement Corporation |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | | X | | | |  | | | |  |
| Central Inland Water Transport  Corporation | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | | X | | |  | | | |  | | | |  |
| Central Warehousing Corporation | X | | | |  | | | | X | | | | | | | |  | X | | | | | | | |  | | |  | | | |  | | | |  |
| PSU | | | | Strategic sales | | | | Open public auctions to select bidders | | | Domestic capital market sales to public | | | | | Joint ventures | | | | GDRs, ADRs | | | Management contracts | | | | Block sales | | | Winding up | | | | Mergers, restructuring | | | |
| Cochin Shipyards, Goa Shipyards, Hindustan Shipyard |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | | X | | |  | | | |  | | | |  |
| Container Corporation | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | |  |
| CMC | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | |  |
| Cement Corporation |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | | X | | | |  | | | |  |
| DTC |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | | X | | |  | | | |  | | | |  |
| PSU | | | Strategic sales | | | | Open public auctions to select bidders | | | Domestic capital market sales to public | | | | Joint ventures | | | | | GDRs, ADRs | | | | | | Management contracts | | | Block sales | | | Winding up | | | | Mergers, restructuring | | |
| Dredging Corporation |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | |  |
| EIL/EPIL | X | | | |  | | | |  | | | | | | | | X |  | | | | | | | |  | | |  | | | |  | | | |  |
| ECGC |  | | | |  | | | | X | | | | | | | |  | X | | | | | | | |  | | |  | | | |  | | | |  |
| Fertilizer Corporation, FACT, GSFC, Madras Fertilizers, National Fertilizers, Southern Pesticides | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | | X | | | |  | | | | X |
| Paradeep Phosphates |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | | X | | | |  | | | | X |
| FCI |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | | X | | |  | | | |  | | | |  |
| Handicrafts & Handloom Exports Corporation |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | | X | | |  | | | |  | | | |  |
| Hindustan Antibiotics | X | | | |  | | | |  | | | | | | | | X |  | | | | | | | |  | | |  | | | |  | | | |  |
| HAL (spinning off airframes, engine maintenance) |  | | | |  | | | |  | | | | | | | | X |  | | | | | | | | X | | |  | | | |  | | | |  |
| Hindustan Cables, Hindustan Copper, HEC, Hindustan Fertilizers, Hindustan Fluorocarbons, Hindustan Latex, Hindustan Insecticides | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | | X | | | |  | | | |  |
| HMT |  | | | |  | | | |  | | | | | | | | X |  | | | | | | | |  | | |  | | | |  | | | | X |
| Hindustan Newsprint, Hindustan Paper | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | |  |
| HOCL | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | | X | | | |  | | | | X |
| HTL | X | | | |  | | | |  | | | | | | | | X |  | | | | | | | |  | | |  | | | |  | | | |  |
| Hindustan Zinc | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | |  |
| Hotel Corporation | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | | X | | | |  | | | |  |
| HUDCO |  | | | |  | | | | X | | | | | | | |  | X | | | | | | | |  | | |  | | | |  | | | |  |
| Indian Additives | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | |  |
| IDPL | X | | | |  | | | |  | | | | | | | | X |  | | | | | | | |  | | |  | | | |  | | | |  |
| IFCI, IDBI, LIC, GIC |  | | | |  | | | | X | | | | | | | |  | X | | | | | | | |  | | |  | | | |  | | | | X |
| ITI | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | |  |
| IISCO, Sponge Iron |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | | X | | | | X | | | | X |
| ITDC | X | | | |  | | | | X | | | | | | | |  |  | | | | | | | | X | | |  | | | |  | | | |  |
| KRIBHCO |  | | | |  | | | | X | | | | | | | |  | X | | | | | | | |  | | |  | | | |  | | | |  |
| Kudremukh Iron Ore | X | | | |  | | | |  | | | | | | | | X |  | | | | | | | |  | | |  | | | |  | | | |  |
| Konkan Railway, IRCON, RITES |  | | | |  | | | | X | | | | | | | |  | X | | | | | | | |  | | |  | | | |  | | | |  |
| Lubrizol India | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | |  |
| MTNL |  | | | | X | | | | X | | | | | | | |  | X | | | | | | | |  | | |  | | | |  | | | |  |
| MMTC, STC |  | | | | X | | | | X | | | | | | | |  | X | | | | | | | |  | | |  | | | |  | | | |  |
| BALCO, NALCO | X | | | | X | | | | X | | | | | | | | X | X | | | | | | | |  | | |  | | | |  | | | | X |
| NBCC |  | | | |  | | | | X | | | | | | | |  | X | | | | | | | |  | | |  | | | |  | | | |  |
| NHPC, NTPC |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | | X |
| NFDC |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | | X | | |  | | | |  | | | |  |
| National Seeds | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | |  |
| NTC |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | | X | | | | X | | | |  |
| PSU | | | Strategic sales | | | | Open public auctions to select bidders | | | Domestic capital market sales to public | | | | Joint ventures | | | | | GDRs, ADRs | | | | | | Management contracts | | | Block sales | | | Winding up | | | | Mergers, restructuring | | |
| Neyveli Lignite | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | | X | | | |  | | | | X |
| PFC |  | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | | X |
| Power Grid Corporation |  | | | |  | | | | X | | | | | | | |  | X | | | | | | | | X | | |  | | | |  | | | |  |
| Semiconductor  Complex | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | | X | | | |  | | | |  |
| SCI | X | | | |  | | | | X | | | | | | | |  | X | | | | | | | | X | | |  | | | |  | | | |  |
| SAIL | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | |  | | | |  | | | |  |
| VSNL |  | | | | X | | | | X | | | | | | | |  | X | | | | | | | |  | | |  | | | |  | | | |  |
| Vizag Steel | X | | | |  | | | |  | | | | | | | |  |  | | | | | | | |  | | | X | | | |  | | | |  |