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

by

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Privatization, a key component of economic liberalization remained dormant for the nearly the entire first decade of significant economic reforms in India. The usual explanations have been that weak governments could not overcome the many vested interests or that there has been ideological resistance to economic reforms among India's elites.

Indian privatization came out of the shadows, however, when the Indian President 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> in his opening address to Parliament in the 2002 budget session. How does one explain both the gradualism during the 1990s and the recent episodic 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 "vested interests" alone, but institutional structures, in particular those embedded in the judiciary, parliament and India's financial institutions, that account for the lag between the onset of economic liberalization and privatization and its episodic nature. Changes in the perceived costs of the status quo of state-owned enterprises also played a role in the timing of reforms. 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 (SOEs). The passage of time has also resulted in significant changes in Indian policymakers and citizens' attitudes regarding the relative effectiveness of state and markets in commercial activities, as well as their assumptions about the Indian state being a "guardian of the public interest."

### **PRIVATIZATION IN THE 1990s: Slow, but Escalating Commitment**

One dimension on which countries' privatization programs can be compared is the speed with which they are implemented. The vast majority of countries (including India) have implemented privatization gradually. (Ramamurti, 1999) A few countries, such as Argentina or the Czech Republic, implemented privatization programs rapidly, with large

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<sup>1</sup> Address at the opening of the budget session of parliament, February 25, 2002.

portions divested within 3-5 years of launching the effort (Alexander & Corti, 1993), but such rapid privatization is the exception rather than the international norm.

Though clearly gradual, India's commitment to privatization did escalate steadily, through the 1990s. Although there was a noticeable increase in the commitment to privatization after the BJP-led governments came to power, over the years there was more continuity than discontinuity in the privatization program.

First, the government's privatization program began as a divestment program. The policy aim was merely to reduce the government's holdings by up to 20 percent, principally to raise resources to reduce the budget deficit. The program was, accordingly, labeled "disinvestment" and the term "privatization" assiduously avoided. The next stage of escalation included raising the amount that would be divested, while still retaining control. This did not alter the fundamental character of the enterprise but mobilized more resources to reduce the large budget deficit that, 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 (though not controlling) voice in the enterprise. Finally, outright divestment became acceptable, initially for loss making enterprises and later even for profitable enterprises. The government escalated its commitment from merely privatizing *ownership* to privatizing *control*. It was not until 2000-01, nearly a decade after the onset of the reforms, that the Finance Minister Yashwant Sinha actually used the term "privatization" (during the budget debate) to describe the government's program for reforming SOEs.

Second, the government expanded the range of sectors in which SOEs could be sold. The term "strategic" was frequently used to describe those state-owned enterprises (SOEs) that the government intended to retain control of over the long term. The definition of "strategic," however, became progressively tighter so that the number of SOEs that could be divested expanded. The Ministry of Petroleum, for example, initially argued that oil companies were strategic, but by 2000 the Cabinet Committee on Disinvestment had classified it as non-strategic (although the Petroleum Ministry continued to use the term to rationalize its foot dragging). Eventually only nuclear power, defense and railroads were left in the strategic category while everything else was eligible

for privatization. Greater deregulation and outsourcing of activities increased the role of the private sector in defense and railroads. To be sure, the debate on which sectors were strategic was contentious, but it led to progressively narrower definitions, despite three changes in the party in power.

Finally, the restrictions on who could buy SOEs also declined progressively. The auction of shares was initially restricted to public financial institutions that were expected to offload them over time to private investors. Equity was being offered to foreign institutional investors and multinational enterprises, however, by 1996. This followed three concomitant trends: the willingness of the government to sell SOEs to “strategic investors,” that is, to private investors who would own large blocks of shares and enjoy management control; the liberalization of rules governing foreign direct investment; and the opportunity to list Indian firms on foreign stock exchanges through American Depository Receipts (ADRs) and Global Depository Receipts (GDRs). Thus, foreigners owned portions of Videsh Sanchar Nigam Limited (VSNL) and Mahanagar Telephone Nigam Limited (MTNL) through ADRs traded on the New York Stock Exchange while the ceiling on foreign shareholding in Shipping Corporation of India (SCI) was raised from 26 percent to 49 percent to attract greater foreign interest.

The criteria for selecting SOEs for divestment were also clarified by 2000. Priority was given to large SOEs that could yield higher revenues to the government, to firms that could be sold quickly, or to SOEs whose mounting losses and concomitant drain on the budget could be curtailed swiftly through privatization. In contrast, lower priority was given to SOEs where the risk of monopolization was high or where a regulatory framework needed to be set up before privatization.

To be sure, there are still milestones that the Indian privatization program was slow to pass by. Compared to the Latin American experience, the Indian government crossed the threshold of selling control of a large, important firm to multinational firms late with the sale of car-maker Maruti Udyog Limited (MUL) to Suzuki of Japan in May 2002.<sup>2</sup> Nevertheless, taken together, the escalation in the Indian government’s

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<sup>2</sup> 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

commitment to privatization over the decade is quite remarkable, if one recalls the political climate in the beginning of the period. From “disinvesting” five to twenty percent of the shares of non-strategic SOEs to dispersed domestic investors, it had become acceptable to privatize control of even large, important firms, including selling them to foreign investors.

## **WHY GRADUALISM IN THE 1990s?**

### **Economic and Political Circumstances**

From a politico-economic perspective, India was not a likely candidate for rapid privatization. Economic liberalization, including privatization, is generally thought to take place more often when there has been a severe macroeconomic crisis including high inflation, and when there is a strong executive that can ram policies through reluctant legislatures.<sup>3</sup> India had neither.<sup>4</sup>

Many countries that privatized rapidly did so under macroeconomic conditions that included hyperinflation, shrinking GDP, as well as severe balance of payments crisis and/or a sharp political discontinuity leading to a regime change (such as the ouster of a military dictatorship or the fall of communism). Privatization, as part of a larger package of economic reforms, may have been more acceptable as a way of raising foreign exchange and of reining in inflation by reducing the fiscal deficit under these conditions. The severe macroeconomic conditions were also the culmination of a long period of poor economic performance, so that change may have been more welcomed. 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

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like oil, petrochemicals, or airlines, foreign multinationals may emerge as the eventual owners of privatized firms.

<sup>3</sup> Molano (1997), for example, has shown that privatization was more likely in presidential systems if the party in power also controlled the legislature. This insight is also relevant to parliamentary systems in which the government can have varying degree of control over the rest of the parliament.

<sup>4</sup> These conditions are far from a guarantee of rapid privatization. Developing countries such as Brazil and Turkey experienced several bouts of macroeconomic instability, yet did not privatize rapidly. Many countries that satisfied both criteria 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.).

Czech Republic, central planning and state ownership were so discredited that sweeping privatization was politically 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. The country was in the midst of a balance of payments crisis and sought IMF assistance when reforms began in 1991, 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 and nearly \$90 billion by late 2003. While these results were not spectacular compared to the high-growth Asian economies in their heyday, they were 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 controversial structural reforms like privatization.

At the same time the executive branch in India was weak throughout the 1990s. Through the 1990s, governments in India either had bare majorities or were coalition governments in which the leading party did not have a majority on its own. In Argentina, in contrast, President Menem had much greater powers to push policies through, including relying on presidential decrees for some of the most important steps in privatization. In the Czech Republic, too, President Havel and Prime Minister Klaus had a very broad mandate and both were ideologically committed to privatization. Progress in India's democratic setting with multiple institutional constraints 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 initiated the radical changes, but continued its ritualistic genuflection to the Nehruvian legacy of planning and SOEs. The Swadeshi Jagaran Manch and other elements of the Bharatiya Janata Party (BJP) from the right and the Communist Party of India-Marxists (CPM) from the left had similar unfavorable views of economic

liberalization. The caste-based parties—the Bahujan Samaj Party (BSP), the Samata Party (SP), and the Rashtriya Janata Dal (RJD) – concerned that economic liberalization would limit hard-won jobs for their supporters, 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 often undertaken by stealth (Jenkins, 1999). No Prime Minister, including Vajpayee, was willing to go to canvas public support for privatization. Under these circumstances, it is hardly surprising that India's privatization was gradual over the 1990s – indeed one may ask why it occurred at all.

### **Actors and Interests**

Most analyses of the political economy of privatization blame the slow pace of reform on the nexus of self-interested rent-seeking politicians, bureaucrats, and labor unions. Ministers, who would stand to lose the many benefits of departmental enterprises, have repeatedly scuttled the disinvestment of SOEs under their administrative charge. Sharad Yadav, as Civil Aviation Minister, scuttled the sale of Indian Airlines. In three cases -- Indian Petrochemicals Ltd. (IPCL), Hindustan Zinc Ltd (HZL) and Maruti - - the concerned ministers allegedly tried till the very end to scuttle the privatization. Initially they tried to find a variety of reasons to block the privatization of the firms under their ministries and when overridden by the cabinet, resorted to foot dragging to delay the sale and tire out potential private bidders. In IPCL's case, Oil and Natural Gas Corporation (ONGC) threatened to stop supplying the firm with gas when IPCL's sell-off began, even though its contract ran to 2006 irrespective of ownership and the same ministry supervised both ONGC and IPCL. Fourteen months earlier the petroleum secretary had assured the cabinet secretary that ONGC would abide by the contract. When the sale deadline neared the government did not have a formal assurance, however, and the minister cited the possible non-availability of gas to IPCL to try and postpone the sale. In the case of Hindustan Zinc, the concerned Minister insisted until the last minute that that HZL should not be sold off until a 'control premium' was added to the overall

price. The minister for heavy industry was similarly unwilling to let go of the control of companies under his ministry, including Maruti Udyog Ltd. On two occasions the Minister stalled critical meetings claiming the file on Maruti's divestment had been “misplaced.” He raised objections that a privatized Maruti would increase auto component imports at the expense of domestic component manufacturers. And like virtually all Ministers wanting to delay sales, he justified his opposition on the grounds that a delay would result in a better valuation and safeguard workers' interests.<sup>5</sup>

Another obstacle to privatization came from chief ministers of states where the enterprise to be privatized was located. Even supposedly pro-reform chief ministers like Chandrababu Naidu of Andhra Pradesh oppose privatization when it occurs within their own state; the case of perennial loss-making steel company Rashtriya Ispat Nigam illustrates the point. Similarly, the divestment of four India Tourism Development Corporation hotels was stalled because the Ministry of Disinvestment needed the concurrence of state governments that provided land for these joint sector hotels.

Although all political parties opposed privatization, they took more varied stands by the end of the 1990s. Although both the BJP and Congress backed privatization in 2002, each qualified its support in different ways. The Congress, for instance, at its 2002 conclave supported privatization in principle but opposed “mindless” privatization. The Shiv Sena party, nominally an ally of the BJP and a member of the ruling National Democratic Alliance (NDA), publicly opposed disinvestment in the ministries manned by its ministers. The left-of-center political parties opposed it as well, but their opposition was less vociferous than in the past. Right-of-center groups like the Swadeshi Jagaran Manch opposed privatization because of their antipathy to foreign capital and fears that foreigners might gain more from privatization than nationals. Parties with a following among Dalits or Other Backward Castes opposed privatization because of its possible effects on jobs for their constituencies, but these fears were allayed as privatization agreements typically safeguarded the short-term interests of workers. In any case, although these groups had a considerable stake in employment in SOEs (see Table 1), they were more opposed to the downsizing of government departments (where the bulk of public sector employment is located) than SOEs.

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<sup>5</sup> Based on interviews by authors with Disinvestment ministry officials.

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Table 1 here  
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Despite the calumnies heaped on labor, it has not yet been a critical obstacle to privatization, in part because sales of the large SOE employers—banks, coal mines, state electricity boards (SEBs) and Mahanagar Telephone Nigar Ltd. (MTNL)—have not yet been on the cards. BALCO was the big battle on this front and in the end labor regretted its decision to oppose privatization. Recourse to voluntary retirement schemes (VRS) helped reduce labor redundancies both before and after privatization in a politically acceptable manner. Other incentives, such as granting a fraction of shares to employees at a discounted price, also helped. However, as demonstrated by the unhappy experience in the Grid Corporation of Orissa (GRIDCO), the privatized Orissa power distribution company, the interests of organized labor are more heterogeneous than is often realized. The sheer magnitude of rents in State Electricity Boards (SEBs) vastly exceeds any payments that can realistically be offered under a VRS. The fact that such rents are much lower or absent in manufacturing makes their privatization easier. Ongoing reforms in the electricity sector will gradually lower these rents, and only then can one expect significant movement.

Ironically, an important obstacle to privatization has been Indian business. This is not surprising in view of the nexus between business and politicians nurtured in the long decades of the Control Raj. The influence of corporate houses has been apparent in the multi-party Joint Parliamentary Committee investigations of the stock market scams, 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. The former chairman of SEBI, expressed grave disquiet over the fact that corporations had become very powerful: “They are powerful in terms of their sheer size. The moment you start taking some action, they jump on you.”

Disinvestment Minister Arun Shourie put it succinctly:

“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>

## **IMPLICATIONS OF GRADUALISM**

This early gradualism, stemming from a variety of political economy factors, may, however, have had some benefits in addition to its frequently noted disadvantages. We will next consider the implications of the Indian-style gradual escalation of privatization. International agencies like the World Bank tend to focus on its disadvantages, which are real and important (see, for example, World Bank 1995). Gradualism, however, has potential advantages that tend to be overlooked, both for consensus building as well as avoiding serious mistakes (given the initial lack of experience and expertise). The latter poses serious political risks, since it can become a lightning rod for those opposed not just to privatization but to economic reforms per se.

### **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. Such resistance can 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

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<sup>6</sup> Arun Shourie’s address at a plenary session of the Confederation of Indian Industries’ annual meeting. *Indian Express*, May 7, 2002.

state-owned enterprises (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 telephone licenses. Each such misstep was followed by a lull in privatization (see Table 2). 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).

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Table 2 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 was more efficient than the public sector in India (Table 3). Given the negative rates of return in many SOEs, postponing privatization also exacerbates the stress on government finances.

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Another potential cost of gradualism is that the performance of SOEs deteriorates in the run-up to privatization if there is uncertainty about policy intent. In countries like the United Kingdom, the performance of SOEs improved significantly in the run-up to privatization, because the newly appointed CEOs of these companies used the several years between the announcement of privatization and actual divestment to improve labor productivity, shut down unprofitable plants, or streamline the product mix. Indeed, the productivity of British SOEs improved as much or more in the run-up to privatization as it did after privatization. (Yarrow 1992)

The Indian experience appears to have been different, however, because the period leading to privatization was marked by considerable policy uncertainty. Unlike Prime Minister Thatcher, who unambiguously announced 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 controlling voice after disinvestment, managers of the firms behaved as if the changes expected of them were incremental and marginal. An initiative to downsize the workforce through generous voluntary retirement schemes was the most important reform that gathered any steam.

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 reduces 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 state-owned oil companies. While this allowed the government to claim that it had disinvested its holdings in three SOEs and raised more than \$1 billion for the treasury, the stock market interpreted this pseudo-privatization as a 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 one-half to one-third the value of comparable private firms (Government of India, Department of Disinvestment, 2000). Once lost, credibility is hard to regain. Only by early 2002, after successfully privatizing control of Videsh Sanchar Nigam Ltd. (VSNL), Maruti, and IPCL had the government regained lost credibility, only to lose it again when a controversy erupted in late 2002 over the privatization of two oil companies, Bharat Petroleum Corporation Limited (BPCL) and Hindustan Petroleum Corporation Limited (HPCL).

The government's commitment to transferring control over SOEs to the private sector resulted in higher proceeds for state coffers while it lasted. 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—Indian Oil Corporation (IOC), BPCL, and HPCL—was 4.9, 4.4 and 6.0, respectively. In comparison, the strategic sales yielded P/E ratios of 19 for Bharat Aluminum Corporation (BALCO), 12 for Computer Maintenance Corporation (CMC), 37 for Hindustan Teleprinters Limited (HTL), 63 for Indo-Burmah Petroleum (IBP), and 11 for VSNL.<sup>7</sup> The earlier strategy of selling only a minority of shares in the open market was, however, helpful in two respects: one, it established an objective baseline of how markets valued the “family silver;” two, it 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. It follows that gradual privatization risks lowering the revenues to the government from privatization, because SOEs' performance may deteriorate in the run-up to privatization and investors may apply a “government-control discount” in valuing SOEs. Another cost is the negative signaling effect of repeated delays. The result is both lower stock values of

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<sup>7</sup> These figures should be treated with caution. It is possible that the government may have assumed off-balance sheet liabilities of these companies, in an effort to get higher evaluations resulting in higher P/E ratios.

public enterprise shares as well as well as negative market perceptions of the course of economic liberalization.

### Advantages

One of the main advantages of gradual privatization is that it increases the likelihood that complementary, efficiency-enhancing reforms, such as deregulation and liberalization, will be implemented before or alongside ownership changes. It also gives policymakers time to build support for and consensus on privatization. Finally, it provides the opportunity for policymakers to incorporate lessons from earlier rounds of privatization in later rounds. Merely delaying privatization does not guarantee the realization of these advantages, but it does make them possible so long as governments keep up some forward momentum in privatization. This momentum was kept up in the Indian case, despite changes in governments, because two structural factors kept up the pressure on successive Indian governments to continue with SOE reforms.

The first structural factor was the government's high budget deficit, running through the decade at 5-10 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-draining 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 government replaced the Commission with a Department of Disinvestment and a Cabinet Committee on Disinvestment, and so on.

## *Complementary Policies*

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 have shown that market institutions do not develop spontaneously once SOEs are privatized. 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 compensate for regulatory uncertainty.

We will illustrate the point about the importance of reforms that complement privatization with three examples: deregulation of sectors in which Indian SOEs operated; 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 could be implemented 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” *ex post*. Experience has shown that in such a scenario private owners will lobby to lock-in their rents, 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. . 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).

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, labor unions and SOE employees do not appear to fully recognize 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 - can force internal reforms in state-owned enterprises, thereby yielding some of the benefits of privatization. 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 largely to employees close to retirement. Workers were not 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) gradually spread to SOEs in nearly all sectors and have become an important instrument for all large organized sector employees, in both public and private sector enterprises.

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 without precipitating widespread labor unrest and potentially derailing the entire reforms. 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.

The increased competition after deregulation, however, can also decrease the sale price of state-owned enterprises. The delay in the sale of Indian Airlines (allegedly sabotaged in part by the concerned Minister and in part by a private sector rival), for example, proved costly for the Indian government precisely because of the complementary reforms. 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' aging fleet) and in part, the decline in market share (by March 2002 Indian Airlines' market share had sunk to 39.9 percent while privately-owned Jet Airways' market dominance grew to 48.9 percent).<sup>8</sup>

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.

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<sup>8</sup> Figures compiled by the Director General of Civil Aviation. Cited in: <http://www.rediff.com/money/2002/may/16ia.htm>

Again, without proper price signals, privatization is unlikely to yield the anticipated improvements in allocative efficiency.

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 Telecommunications Regulatory Authority of India (TRAI), Securities and Exchange Board of India (SEBI), Tariff Authority for Major Ports (TAMP), Central Electricity Regulatory Commission (CERC), 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 might turn into monopolies or cozy oligopolies. Similarly, the privatization of the National Thermal Power Corporation (NTPC) may have to await the privatization of at least a few State Electricity Boards (SEBs) to whom NTPC sells most of its output.

### *Building Support*

A second major benefit of gradual privatization is that it gives policymakers 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 (and the media) becomes a stronger 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. A strike by Indian Airlines workers prior to deregulation, for example, would have crippled passenger air transportation. After deregulation the same strike would only have bolstered rivals like Jet Airways or Sahara.

### *Learning*

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 commenced, and a decade later. 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. Although the last did not result in smooth sailing, it at least pinpointed the locus of opposition.

### **WHY EPISODIC ACCELERATION AMIDST GRADUALISM?**

Political compulsions, fiscal pressures, 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. The Minister of Disinvestment in the NDA government, Arun Shourie, was a strong champion. The combination of self-confidence and perception of pecuniary integrity (rare in the case of politicians), was reinforced by transparent procedures ranging from the selection of

advisors, the final selection of the strategic partner, and open competitive bidding. Once transactions were completed, all files were handed over to the Comptroller and Auditor General's office. This procedural transparency played a critical role in the strength of the Supreme Court's BALCO judgment (discussed below), which in turn significantly legitimized the program.

Although the interest of key actors undoubtedly plays a role in shaping public policy, they are not the only determinant. Institutions also play a significant role, and in the Indian case, they included notably the Supreme Court and Parliament. The 1980s and 1990s witnessed a shift in power away from the legislative and executive arms of government toward the judicial branch, in part because of erosion of the other two institutions and in part because of macro-political changes that caused greater political instability.

However, the growing influence of Indian courts is not necessarily a change for the better. The disjuncture between the speed of judicial decision making and the rapidity with which market forces operate today has meant that the opportunity cost of delays is high. Not surprisingly, the privatization process was frequently held hostage to court challenges. In an atmosphere of general distrust of the state's capacity to conduct financial transactions properly, it was easy to make allegations. In this regard, the BALCO case was an important milestone in India's privatization.

BALCO was India's third largest aluminum company, located in Korba in the newly-created state of Chattisgarh.<sup>9</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 Congress Chief Minister of Chattisgarh, Ajit Jogi (a former member of the Indian Administrative Service) strongly opposed it, charging that the BALCO sale 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 Public Interest Litigation (PIL) 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

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<sup>9</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, 2001.

Jogi instigated a labor strike in the plant, claiming that workers' future would be jeopardized by privatization. The plant came to a halt for 67 days, inflicting crippling losses, especially because alumina production is a continuous process.

Ironically, these political and legal challenges were the best thing that opponents of privatization could have done for accelerating the program. In December 2001, a three-judge Bench of the Supreme Court not only upheld the sale, but, in a landmark decision, unequivocally silenced the critics of not only the BALCO deal but other privatizations as well.

First, regarding the alleged malfeasance in the case, the court stated that

“...the facts herein show that fair, just and equitable 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 judgment was not simply a strong rebuke to the credibility of Jogi, it served to forestall further challenges by state governments to the federal government's right to privatize.

Second, the Court circumscribed the extent to which courts should scrutinize economic policy, including disinvestment. In this it built upon other recent judgments, signaling a retreat from the judicial expansion over the previous two decades. In a judgment 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 Supreme 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 would 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 judgment 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 said, “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 in India was challenged on the grounds that employees were not consulted or that their views were not taken into account. In the case of BALCO, the Court found that the Government had exerted itself to protect the

interests of employees of the company.<sup>10</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 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,” said the court.

Although the Supreme Court judgement gave a fillip to privatization, the momentum was short lived. Dozens of court cases continued to be filed in various High Courts, and while many were dismissed based on the Supreme Court’s BALCO ruling, other judgments continued to put a break on the process. The case of Jessop Company Limited (JCL, a company engaged in manufacturing rolling stock for the railways) was a case in point. A petition had been filed by the company union in the Kolkata High Court challenging the sale of the company on the grounds that the company fell in the “strategic” sector. Therefore, as per the government’s own policies, it could not unload majority shares to a private party. Although the judge held against the petitioners, agreeing with the Government that JCL did not fall in the strategic sector, he enlarged the scope of the writ petition on the basis of supplementary affidavits. Contrary to the Supreme Court’s BALCO judgement, the judge pronounced on the government’s decision-making process and on this basis set aside the disinvestment of JCL. The government filed an appeal in to a larger bench of the Kolkata High Court, which overturned the earlier order acidly observing that, “an entirely new case was sought to be built up which was never put up in the proceedings” and where the petitioners had no *locus standi* in the case to begin with.<sup>11</sup> Nonetheless this too was appealed to the

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<sup>10</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.

<sup>11</sup> Based on the judgement of the Kolkata High Court, July 8, 2003. The original single judge judgement was made on March 25, 2003.

Supreme Court and more than a year and half after the privatization, the case was still caught up in legal limbo.

A much greater systemic challenge to privatization, however, came from a Supreme Court ruling in September 2003. The ruling was on a narrow question of law: could the government privatize two large oil companies (Bharat Petroleum (BPCL) and Hindustan Petroleum (HPCL)) that had been nationalized through acts of parliament in the heyday of economic nationalism in the 1970s without repealing or amending the said laws? Amending the laws would require going back to parliament, which the government wanted to avoid since it did not enjoy a majority in the upper house. The Court ruled that the specific language in the ESSO Acquisition Act required the government to seek parliament's approval. Since many PSUs had come into being after nationalization (or where a nationalized firm was merged with an existing PSU), the implication of the Supreme Court verdict, that the sale could take place only after legislative approval rather than simply executive action, was evident. The massive immediate decline in PSU stocks (exceeding \$2 billion) reflected market perceptions that the decision implied substantial delays for further privatization.<sup>12</sup>

Another institution that shaped privatization was Parliament. As discussed earlier, for a variety of reasons at the rhetorical level at least, political parties did not back privatization enthusiastically, although in private their leaders may have acknowledged that reform was necessary. Parliamentary standing committees also invariably criticized privatization decisions. Thus, with regard to the government's decision to privatize Shipping Corporation of India (SCI), 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 criticized the government on the issue of land valuation in privatization transactions, saying asset valuation guidelines were "inadequate and vague" and that land should be valued separately and factored into total asset value. Parliamentary committees and other critics often cited under-valuation of land as an example of SOEs being sold at "throwaway" prices, even though the market value of

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<sup>12</sup> In the two days following the Supreme Court decision the aggregate market capitalization of 35 quoted PSUs declined by Rs 11,472 crore (down 4.61 per cent). *Financial Express*, September 18, 2003.

such land was limited by the fact it could not usually be sold without the permission of the state government.

Parliament played a more important, and negative, role through its unwillingness or inability to pass legislation that would undo or modify prior law, or help create new regulatory institutions. Unfortunately, Parliament's legislative output dropped by one-third in the 1990s relative to previous decades, even as the need rose for new legislation to see through economic reforms (Kapur and Mehta, 2002).

## **EPISODIC MOMENTUM**

Over the last few years, three privatizations stand out as having set precedents for the program. Foremost was the case of BALCO, which we discussed in detail earlier. Though the privatization was fiercely resisted both by the Chief Minister of the state where the firm was located (Ajit Jogi), as well as labor, the story was quite different less than a year later. Post-strike, workers returned with a court-brokered agreement that protected their jobs and paid them full salary for the strike period. In an 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 union leader who led the strike admitted that, "[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 Chief Minister also made a *volte face* insisting, "who says we protested against disinvestment? We only protested against the company's valuation. We are disinvesting all over the state."<sup>13</sup> Under Jogi's leadership the state of Chhattisgarh emerged as the vanguard of state-level SOE reforms, closing as many as thirty of them. The post privatization success of BALCO and Modern Foods was particularly important in that it demonstrated that labor was not necessarily a casualty of privatization.

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<sup>13</sup> Outlook, March 2002

The privatization of Paradeep Phosphates for Rs. 151.70 crores, below the reserve price of Rs 176 crores was another important landmark.<sup>14</sup> This was the first time in the government's disinvestment drive that the government agreed to a bid price 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 report by the Comptroller and Auditor General (CAG) had claimed that the government had sold shares below the reserve price. The ensuing criticisms coming as they did at a time when the stock market had fallen, resulted in the government putting a brake on the sales of PSU shares, fearing of charges of undervaluation (Ahluwalia, 2002).<sup>15</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 Air India's Managing Director 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 second largest petrochemicals producer) to Reliance Industries (the largest), giving the latter a dominant position 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 SOEs even if it resulted in a monopoly, provided the assets divested were in the manufacturing sector. The underlying logic was that for tradable products import competition would impose the necessary discipline. However, this required the

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<sup>14</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.

government to reduce tariffs as well, and this inexplicably it did not. As a result the winning bidder's market dominance gave it monopoly profits. However, in the services sector – airlines, banking, oil retailing – sector which are largely non-tradeable and hence protected from global competition, the government decided to not allow the divested assets to go to a company if it led to a monopoly status. The government followed a similar logic in barring the acquirer of one oil company from bidding for other oil companies.

### **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. However, in a broader sense, privatization was becoming much more potent in the Indian landscape even under the “gradualist” regime. Land and space were being privatized through the growth of gated communities, social services were increasingly provided by private players, private security services and private transportation were replacing their public substitutes, and so on. In general there was a perceptible decline in the “publicness” of public services. Private townships and buildings, with their own water, power and sanitation systems have taken over functions once performed by the public sector. With the state unable to extract work from its own employees, outsourcing of government work to private agencies has also been increasing. In Delhi, the finance ministry has outsourced the cleaning of its toilets, and even security in some of its buildings is provided by private firms. The civic function of cleaning streets has been privatized in Hyderabad and Chennai. In Madhya Pradesh, government hospitals have been handed over to local committees to oversee and run (with reportedly dramatic improvement in services). The exit of India's elites from public services is a positive development inasmuch as it frees up scarce public resources. However, when powerful actors exit the system, the public sector has even less incentive to perform. Even the drafting of bills and legislation are being outsourced: ‘the Andhra

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<sup>15</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.

Pradesh Infrastructure Development Enabling Act, 2001,' arguably a landmark in infrastructure-enabling legislation, was outsourced to a private law firm with consultancy inputs from the credit rating agency, Credit Rating Information Services of India Ltd. (CRISIL).

Even defense production, one of the holiest cows of state regulation, was liberalized by early 2002. Forty percent of the purchases by defense SOEs and the Ordnance Factories Board (OFB) were outsourced to the private sector. One hundred percent private ownership, including up to 26 percent of foreign ownership, was permitted in the defense sector. Another sacred public monopoly, in radio and television, was opened to private participation a decade earlier. Channels were auctioned to private parties, and consumers had a choice of 100 TV channels and even more radio channels.

Road transport's share of surface transportation rose from 20 percent of passenger traffic and 11 percent of freight traffic in the 1950s to 80 per cent and 60 per cent, respectively. Road transport was largely private, while the other principal mode, railways, was largely public. India's 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 plans to turn over the four major international airports of Mumbai, Delhi, Chennai and Kolkata to private players on a 30-year lease, and proposals to let private investors build new airports at Bangalore and Hyderabad, elites will 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 private provision. 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>16</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 sanitation in the schools.

- satisfaction with drinking water ranged 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. In education, 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>17</sup> In West Bengal, budgetary support for *madrasas* increased from a few lacs in 1977 to more than Rs. 200 crores in the late 1990s. And in health, the ratio of private to public expenditures has increased noticeably in recent years (Table 4a, 4b, 4c).

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The "market" for public office in the India state is hardly a new phenomenon (see Wade, 1984). The recent case of the Chairman the Punjab Public Service Commission (PPSC), who treated his office as a sales agency where every government job under his control had a price tag attached to it, revealed 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').<sup>18</sup> In Karnataka, the Stamps and Registration Department had volunteers' who performed the work of the clerical staff. They were not part of any official roster, but each of the 201 sub-registrar offices in the state had between 8 and 15 such volunteers, depending upon the amount of work. They even had their table of "wages," which was

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<sup>16</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>17</sup> Source: <http://www.rss.org/VIDYA%20BHARTI.htm>

<sup>18</sup> According to news reports, in the course of his tenure of six years the Chairman of the PPSC made nearly 3,500 appointments and in the process allegedly amassed Rs.100 crores.

paid out of bribes. In other words, government employees were subcontracting work to “volunteers,” whom they paid out of the bribes collected from the public.<sup>19</sup>

## **THE BUMPY ROAD AHEAD**

By 2002, the privatization program appeared to be on a roll. 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, and greater margins and investments. The government had finally managed to successfully sell large firms like VSNL, IPCL and Maruti to strategic investors, including foreign firms like Suzuki, without controversy, without charges of corruption, and major without legal challenges. However, when it sought to privatize two large oil companies (BPCL and HPCL), deep differences within the cabinet stalled the sales. Finally, a compromise within the ruling coalition, appeared to set the process back on track in early 2003. With a successful offering of the remainder of the government’s shares in Maruti through an IPO in spring 2003, there appeared to be renewed momentum.

However, the Supreme Court’s ruling in September 2003 was a reminder that India’s privatization program would continue to zigzag in the future as it had in the past. The ruling also highlighted the one singular weakness of India’s privatization program – the failure of the political leadership to aggressively make the case for the program to the public and craft imaginative solutions that would link the privatization proceeds to visible programs benefiting the poor. In the absence of such an effort it was easy for many to view privatization as one more aspect of liberalization that had little to do with their daily lives.

During the 1990s, the Achilles heel of India’s economic reforms was the inability to rein in the dangerously high fiscal deficits. If anything, the problem worsened, especially at the state level. Forty-three central government SOEs consistently ran losses during 1991-2000, with cumulative losses of Rs 34,261 crores at the end of fiscal 2001.

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<sup>19</sup> Estimates of the bribes in this department alone were Rs 200 crores. *Economic Times*, April 13, 2002.

Just five of them accounted for three-fourths of the accumulated losses.<sup>20</sup> The Bureau of Industrial Finance and Reconstruction's portfolio included 178 SOEs owned by the central government (Table 5). In short, the poor performance of SOEs will continue to put pressure on the government to restructure or privatize SOEs.

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Privatization will be particularly difficult in three types of SOEs. First, there are the loss-making SOEs, whose privatization has been problematic in the past. Of nine attempts to divest such SOEs through mid-2003, not one resulted in a consummated deal. In one case, Hindustan Organic Chemicals, the liabilities of the firm were so high that it would have had to be sold for a negative price. Shutting down such firms and selling their assets, and using these proceeds to pay off workers dues, will be the likely solution in many such cases. This is particularly so in those cases where the enterprise is sitting on prime urban land. Although this did not work for many years in the case of textile mills belonging to the National Textile Corporation (many of which were closed for more than a decade without their assets being sold off), there has been some movement in this regard of late.

Second, SOEs in infrastructure sectors – ports, railways, road transport, or power – will present special difficulties. In these cases, the private sector will have to be encouraged to enter through long-term leasing of state assets rather than outright sales which create local monopolies. Several major ports have already been corporatized and placed on 30-year leases with private operators, and private firms have been encouraged to set up greenfield ports. Similarly, in the case of the giant Indian railways, one will witness greater outsourcing (such as the decision in 2002 to hive off the parcel business), public-private partnerships (such as in the construction of some new lines) and restructuring as it struggles to cope with its mounting pension liabilities. However,

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<sup>20</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.

deeper privatization is unlikely and, as the deeply problematic British experience has demonstrated, perhaps unwarranted as well (Wolmar 2001).

Road transport is another sector that has severely drained the finances of state governments. Since 1950, when the Road Transport Corporations Act was passed, seventy 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 state governments to embark on restructuring programs. However, unlike power, where the failure to reform has serious consequences for the rest of the economy, alternative suppliers in the private sector make reform of state road transport less critical.

Power is the one sector whose reform is both critical to India's economic growth but particularly difficult to implement. Out of the total energy generated in the country, only 55 per cent was reportedly billed and only 41 per cent was realized. In 2000-2001, the average revenue realized per unit of power (212 paise) was 92 paise below the average cost of supply (304 paise).<sup>21</sup> As a result, the annual losses of state electricity boards reached Rs 26,000 crores, with theft alone contributing to Rs. 20,000 crores in losses. Any privatization in this sector will have to be preceded by the establishment of regulatory commissions and the ending of cross-subsidies. By early 2002, twelve states had done so. However, the poor record of privatization in one of the earliest reformers—the state of Orissa—was a painful reminder of the barriers to effective reform of the sector. Nonetheless even here, with the passage of the Electricity Reform Act in 2003, a greater private sector role is inevitable, and as fiscal pressures mount in the states, is likely to occur faster than in the last decade.

Finally, some of the greatest challenges to privatization will arise in the financial services sector, both due to the size and power of the unions and the knotty regulatory issues presented by the sector. The strategy again has been to liberalize private sector (nine licenses since 1993) as well as permit existing foreign banks to open more branches. In the three-year period from 1998-1999 to 2000-2001, state-owned banks opened 914 branches and closed down 200 branches, while private sector banks opened

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<sup>21</sup> "Power on Demand by 2012," April 2002

575 branches.<sup>22</sup> Since non-bank intermediation has increased, even the public sector banks have had to improve efficiency, however gradually, to ensure survival. However, the privatization of existing state banks requires the passage of the necessary legislation by Parliament, notably bills amending the State Bank of India Act, the Banking Companies (Acquisition and Transfer of Undertakings), and the Financial Institutions Laws (Amendment) Bill, 2000. This is unlikely in the immediate future.<sup>23</sup>

In the near future (and in contrast to the past), the states are poised to become the standard bearer of privatization in India. In comparison to public sector undertakings owned by the federal government, those owned by states, while smaller in size, have always performed much worse. The stark contrast between the returns on government investment and the opportunity cost of funds (proxied by the interest rate on government debt) is self evident (Table 6).

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Opposition parties might decry privatization by the federal government as “anti-people” but in many of the states where they are in power, they have quietly begun to either privatize or close their SOEs, virtually all of which have been hemorrhaging red ink. Labor resistance to privatization has been fiercer at the state level. However, the failure of strikes by state government employees in Kerala and Tamil Nadu (underlined by the lack of public support), and the shrinking size of discretionary budgetary resources, has made it easier for an increasing number of state governments to travel down this hitherto taboo path. This politically difficult path is being greased by both multilateral and bilateral lending, which has become more persuasive as the states fiscal space shrinks. Like hanging, bankruptcy concentrates the mind, and this is true of the

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<sup>22</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.

<sup>23</sup> The former was introduced in Parliament in December 2000 where it was pending with the Standing Committee on Finance. Among other things, it sought to reduce the minimum government holding in public sector banks from 51 per cent to 33 per cent. The passing of this bill would be a landmark in the privatization of the financial sector.

Indian state as well – and that, rather than conviction, will continue to ensure that privatization in India continues slowly but surely down a bumpy road.

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**Table 1. SOEs 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
TOTAL	553.2	1,746.9	8.2	18.8	2.2	8.16

Source: Department of Public Enterprises, Annual Report, 2001-02.

**Table 2. 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.
<b>Total</b>	<b>47*</b>	<b>66,000</b>	<b>26738**</b>	

\* 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: Bajjal,, 200

**Table 3. SOE 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 central government SOEs	-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 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 SOEs as of end-2001**

	Central SOEs	State SOEs
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 SOEs. Investment and Returns**

	<b>Year</b>	<b>Investment (Rs. crores)</b>	<b>Return (%)</b>	<b>Interest rate on state govt. borrowings</b>
<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>