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India's Privatisation Drive

Be careful what you wish for

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The case for privatisation is based on the belief that the private sector is more efficient, and that public sector units do better when in private hands. But what does the evidence tell us? These are issues to ponder as India embarks on a major sell-off.

India, it seems, is on the verge of its most ambitious privatisation drive ever. In the Union Budget for 2021-22, Finance Minister Nirmala Sitharaman announced that outside four strategic sectors, public sector units (PSUs) in the non-strategic sectors would be privatised or closed. In the strategic sectors themselves [1] a bare minimum of PSUs will be present.

We have not been told the time frame for implementation of this policy. The expression being used is 'privatisation', not 'divestment', which is the sale of minority stakes in PSUs. The change in lexicon has been widely noted. The government's privatisation programme has the support of much of the intellectual community. Several economists have been urging the government for years to step up privatisation, most recently at a meeting with the prime minister in early January.

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The government has, however, not articulated the case for privatisation at any length. The *Economic Survey* of 2019-20 highlighted the efficiency gains from privatisation. In recent months, economists have said that the government needs to increase investment in infrastructure and, in the present fiscal situation, the necessary resources can come only from privatisation.

There you have the two principal reasons for privatisation. The ideological reason is the superior efficiency that is said to be associated with the private sector relative to the public sector. The practical reason is that the government's finances are strained and it looks to augment its resources by selling government assets, notably PSUs.

The two are seen as complementary. If the government lacks resources, why not sell PSUs to the private sector that will put them to better use? This proposition is taken as self-evident—to question it is to be 'anti-reform'. Yet, as we shall see shortly, the academic literature provides little basis for any sweeping presumption about privatisation.

Any approach to privatisation in India must be informed by an awareness of what the literature has to say on the following questions:

(i) Why would private ownership produce better outcomes than public ownership?

(ii) What is the empirical evidence on performance under private ownership versus that under public ownership?

(iii) Does the method of sale matter?

In what follows, we address these questions in turn. We then attempt to outline possible lessons for Indian privatisation.

1. Why private ownership would produce better outcomes: The theoretical case

Why would firms under private ownership perform better than those that are publicly owned? Two reasons are cited in the literature. One, managers are better monitored in the private sector than in the public sector. And, two, incentives are vastly superior in the private sector. Let us take up these points in turn.

In the private sector, large firms are listed on the stock market and boards of directors are invested with the task of protecting the interests of shareholders. If the management does not perform, the board will replace it. If private firms fail to perform, they will be subject to the market for corporate control, that is, they can be acquired by more efficient firms. Public sector firms, in contrast, are monitored by politicians and bureaucrats who come and go and have no particular incentive to maximise firm performance. As they are fully owned by the government, they are not subject to the market for corporate control. In short, governance is superior in the private sector.

A moment's reflection should show that these points are applicable to government firms that are not listed in the market. Listing PSUs, as has happened to many in India, does subject them to market discipline. True, under government ownership, it is the dominant owner, the government, that calls the shots, not the dispersed body of retail and institutional shareholders. But that is also true of most private companies in India. It is the promoter or the industrial house that is the dominant owner in these companies.

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This highlights a central issue of governance in India. The Anglo-Saxon model of professional managers being answerable to shareholders is not the norm in India. Whether it is the public sector or the private sector, there is a dominant owner. The 'agency' problem—in this case, the problem of how minority shareholders are to monitor their agents, the managers—is thus the same in both the public and private sectors.

The market for corporate control, whereby a non-performing management is removed, is limited in its operation even in the west; it does not operate freely where large companies are involved. In India, institutional shareholders tend to be passive. Promoters, whether government or the private sector, hold dominant stakes. As a result, the market for corporate control is even more limited in its operation. The contention that the private sector in India is subject to superior governance is thus suspect.

Let us turn now to incentives. Undoubtedly, pecuniary incentives are superior in the Indian private sector. It does not follow, however, that, for this reason, we should expect superior performance. There is no simple link between incentives and performance, if only because performance is more difficult to measure than is commonly supposed. More incentives do not mean better performance. They could lead to a focus on short-term performance at the expense of sustainability. Pecuniary incentives are not the only incentives that people respond to—job security, autonomy, involvement in decision-making, a commitment to worthy social goals are all important motivators.

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There is scope for improving incentives in the public sector. The important element that is missing is the award of stocks or stock options to employees. This translates into a huge difference in reward at the top. Whether the quality of managerial talent is lower in the public sector on this account and whether that is the material factor in any difference in performance can be debated. Top PSU executives land lucrative assignments before and after retirement, so it cannot be that the public sector lacks talent.

It is more plausible that a relative lack of autonomy in commercial matters is what leads to inferior performance at many PSUs. It is not obvious that this problem is intractable. Over the years, PSUs have come to enjoy more autonomy than before. There is no reason why we cannot travel further down this path.

On theoretical grounds, it is hard to make the case for privatisation unless one accepts that the scope for PSU reform is exhausted.

2. Empirical evidence on private and public ownership

Do private firms perform better than government-owned ones? Two kinds of studies have attempted to answer this question. One compares the performance of private firms with that of PSUs. Another compares the performance of PSUs before and after privatisation.

The first set of studies has thrown up diverse results, depending on the sample, the period, the country etc. ((Galal et al, 1994). A problem with many of these studies is that they compare private and state firms operating in different sectors. Other studies have sought to address this problem by comparing private firms and PSUs in the same sector. Many of these studies have cast doubt on the supposed superior efficiency of the private sector. Martin and Parker (1997) review a number of international studies that compared private and state ownership and conclude that the evidence is mixed.

There is a large number of studies that compares pre- and post-privatisation performance of firms. A comprehensive review of these studies is provided by Megginson and Netter (2006). They conclude, based on their survey, that “privatisation works”, that is, firm performance improves after privatisation. However, most of the studies relate to developed economies. A number of studies in less developed economies and the transition economies have cast doubt on the efficacy of privatisation.

Secondly, many of the studies look at a limited number of years before and after privatisation, say, three years, and come to conclusions. We can see how this is a serious limitation. A state enterprise may have done well for many years. When its performance begins to suffer, it comes up for privatisation. There could be an improvement in performance for a limited number of years for a number of reasons that we shall mention shortly—what happens over a longer period is not captured.

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Thirdly, many studies do not control for business cycle effects, that is, for improvements that may have occurred mainly on account of the business cycle in the period examined. Nor do they take into account the effects of deregulation or liberalisation in the period under study. They simply ascribe any improvement to a change of ownership.

The most talked about privatisation initiative is the one initiated in the UK under Margaret Thatcher. There is a perception that this brought about a sea-change in firm performance and set the stage for Britain’s economic transformation. At least one comprehensive study (Martin and Parker, 1997) covering 11 high-profile cases of privatisation, such as British Airways and British Gas, found no evidence of any systematic improvement in performance consequent to privatisation.

The study is notable in that it addresses two of the shortcomings in privatisation studies that we mentioned earlier: the short period over which performance comparisons and made and the failure to take into account business cycle effects. The authors conclude, “Generally, the great expectations for privatisation evident in ministerial speeches have not been borne out.”

It is important to understand why performance often improves under private ownership. One, PSUs that are not listed depend on funding from government budgets. When the government’s finances are stressed, state enterprises are starved of funding. The government decides to privatise these firms. Private firms that acquire these PSUs infuse capital and—lo and behold!—performance improves. The improvement has little to do with superior managerial efficiency; it simply has to do with availability of capital.

> The superior performance of the private sector thus reflects the failure to take into account negative externalities associated with private ownership and positive externalities associated with public ownership.

When the government announces that a particular PSU will be up for sale, employees lack the motivation to perform. Why grow or meet targets when the owner is going to change? Performance suffers. The private owner then comes in and employees have to perform. The firm’s performance improves but for reasons that have little to do with superior managerial capability.

Again, when a firm is privatised, a large number of workers are axed. There is a saving in costs that shows up as higher profit. Higher profits are a straight transfer from workers to shareholders. This is hailed as superior efficiency. However, there is an adverse impact on employment, at least immediately. Indeed, a number of privatisation studies show a decline in employment consequent to privatisation.

This brings us to an important issue that is completely neglected in the debate on privatisation. There are a number of negative externalities associated with a transfer to private ownership. The short-term impact on employment, for one. Another is the relatively inegalitarian compensation structure under private ownership relative to PSUs. The average pay at PSUs in India is often higher than in their counterparts in the private sector. This is because of the huge disparities in pay in private firms. Private ownership worsens inequality just as state ownership limits it. Do we attach any value to worsening inequality? Not in conventional accounting.

Private ownership often produces superior business outcomes because of sharp business practices that PSUs cannot emulate. But what do sharp practices mean for the health of a democracy? What do job insecurity or relentless work pressure that is associated with the private sector mean for the health and well-being of families?

There are ways in which the welfare effects of ownership can be factored into comparisons of performance but this is seldom done. The superior performance of the private sector thus reflects the failure to take into account negative externalities associated with private ownership and positive externalities associated with public ownership.

3. Method of sale

How to sell is an important question in privatisation. From 1992 until 2000, the preferred method of sale in India was disinvestment or the sale of minority stakes in PSUs. Only thereafter, did strategic sale, that is, the transfer of ownership to private hands at one go begin to talked about. In the literature, disinvestment is referred to share issue privatisation (SIP) and strategic sales as asset sales.

The method of sale matters because it has a bearing on the price realised. What is the right price? Well, a PSU would have a certain value under government ownership. The presumption is that private ownership would result in superior efficiency, that is, the value of the PSU would rise. At the very least, the PSU must be sold for the value it commands under government ownership.

If it is sold below this value, the private owner has no particular incentive to improve efficiency. In theory, the private ownership must strive, not just to improve efficiency, but to maximise the same. To do so, the government must aim to sell the PSU to the highest bidder. In the process, it can also meet its other objective, namely, maximising revenues.

This is more easily said than done. Selling to the highest bidder requires an efficient auction. The conditions for an efficient auction—multiplicity of bidders, the absence of collusion, setting a correct reserve price, etc—are so onerous that these are rarely met. Setting the reserve price correctly is crucial. Yet, even in listed firms, setting the reserve price correctly is a challenge. The current market price of a share or the average over the past few months can be misleading because market prices tend to diverge from the correct price for long periods.

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The reserve price is often set assuming no further improvement is possible under government ownership. Yet, we have seen the performance of PSUs improve under greater deregulation, autonomy and competition. Strategic sale of a PSU at a time when the PSU is under-performing can thus lead to gross under-pricing of a PSU.

For these reasons, SIP has been the preferred method of privatisation internationally. Even if the ultimate intention is to transfer ownership to a private entity, divesting shares in tranches is conducive for better price discovery. At the initial tranche, the markets may have under-stated the price. Over time and especially as improvements in performance happen, the share price moves up. The government can hope to realise better revenues as a result.

The empirical evidence on the method of sale used worldwide is instructive. One study looked at PSU sales in 108 countries in the period 1977-2000. (Megginson, Nash, Netter and Poulson, 2002). It found that nearly two-thirds of the sales were done using SIPs and the remaining one-third using asset sales. In the larger enterprises especially, SIP was the preferred route. The authors found that asset sales dominated in South America, where 85 per cent of sales were done using this route; in western Europe. Asia/Australia and other parts, SIPs were preferred.

It is said that only outright transfer of control to private hands would make for improved performance. The findings of research, stated above, contradict this assertion. The improvements in performance post-privatisation pertain overwhelmingly to SIPs as these have been the preferred mode of privatisation. The tall claims made for strategic sales are clearly not supported by the literature.

4. Lessons for India

Private ownership uniformly produces superior performance. Just sell the PSUs to private ownership and be done with it. Statements of this sort are common in public discourse. As we have seen above, these are little more than ideological preferences. They have little basis in empirical fact.

The reality is rather more complex. Private ownership is superior often but not always. Getting the sale price right, which means using the right method of sale, is crucial to both maximising revenue and maximising efficiency. Selling off PSUs right, left and centre in order to deal with short-term fiscal pressures is about the worst thing a government can do. It may not result in an improvement in firm performance and it will end up damaging the government's finances in the long run.

In India, the task of privatisation is rather more challenging than in many other economies. Many PSUs sit on large tracts of land and own residential and commercial buildings. The valuation of the firm does not typically include the value of the land and buildings. This can prove hugely controversial where the land value is significant. That is why, in the case of Air India, the government moved much of the real estate to another entity before putting the airline on the block.

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Even then and despite some of the loans being taken off the books of Air India, the sale has stretched on and on. In the meantime, the airline suffers from lack of capital, its performance is adversely impacted and its valuation will likely take a beating. There is no promise that jobs will not be lost and there is also a question mark over employee benefits, including retirement benefits, under private ownership.

It is important that privatisation of a firm be quickly completed if performance is not to suffer. Yet, given the many issues involved, strategic sale is difficult to conclude quickly. That is another reason that disinvestment commends itself. Even if a particular tranche is under-priced, this can be corrected in future tranches and controversy avoided.

What to sell is an important issue. Profitable firms are easily sold and, if listed, the valuation could be a little simpler. The government's finances are easily augmented. However, not much may be gained by way of firm efficiency. Selling unprofitable PSUs is more important for improving productivity. However, with loss-making PSUs, under-valuation and an attendant controversy are more likely. We have not touched upon the privatisation of banks, a subject in itself given that it raises concerns about financial stability

Whether India's fractious democracy will permit large-scale privatisation of the sort that has happened in other economies is open to question, especially in light of the massive protests against the farm laws passed by the government. We have seen earlier in the case of telecom licences and coal blocks how political controversy can seriously derail the process.

Privatisation, if not conducted properly, is likely to meet the same fate. If privatisation leads to large losses of jobs, as happens at least in the short-term, there is bound to be a massive political backlash. If the public perceives that important public assets are being sold on the cheap—and to a few favoured businessmen—there are bound to be allegations of a 'scam'. Such is the politics of this country that the moment the cry of 'scam' goes up, the institutions of government tend to get paralysed. Not only privatisation but disinvestment will become difficult or, for that matter, any sort of PSU reform. Be careful what you wish for because it might come about briefly, only to result in policy paralysis.

Footnotes:

1 The four sectors that have been designated as strategic, are (i) atomic energy, space and defence, (ii) transport and telecommunications, (iii) power, petroleum, coal and other minerals, and (iv) banking, insurance and financial services.

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