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REFORM AND PRIVATIZATION OF STATE-OWNED ENTERPRISES IN INDIA

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Abstract

The economic reforms in India are notable because of the development of private enterprises that are free from functionary management. In this country, the public sector needs renovation, since it makes a crucial contribution to national investment and growth. This article therefore, aims to analyze partial privatization, and restructuring of India's state-owned enterprises (SOEs), which need more dynamic shaping. Central government SOEs have fostered their profitability, investments and growth since India transferred to market-based prices and incentives with better contract enforcement. In the manufacturing sector, the profitability and efficiency of SOEs are superior to those of private enterprises. However, the performance of SOEs in services is poorer than that of their counterparts. Finally, the study recommends policies to improve the performance of SOEs in India.

Keywords: India, state-owned enterprises, economic reforms, privatization

JEL Classification: O4, O43

Contents

1. INTRODUCTION

Privatization is a very broad concept in economics. It comprises various operations, such as the introduction of private capital, the selling of government-owned assets, and transition to a private economy. Consequently, three major attributes of privatization are as follows: (1) ownership measures, (2) organizational measures, and (3) operational measures. Ownership measures refer to the transformation of the ownership of public enterprises to private owners. Organizational measures relate to the limitation of the state control in public companies. These involve the employment of methods for the leasing and restructuring of the enterprises. Operational measures concern the way to improve the profitability and efficiency of public enterprises.

Nations throughout the world have their own enterprises. Even though the term state-owned enterprise (SOE) has mixed meanings, in general it means that the state has significant control over the ownership of a business enterprise. Indeed, every state has a bound responsibility to have active and professional ownership to create value. Such value can include economic value, social value, sustainability value, livelihood value, and so on. These SOEs have legal bindings to achieve the state's vision and mission. It is also the responsibility of the SOEs to work following a strategic method befitting a business to support themselves, achieve continued development, fulfill the purpose of their existence, and enhance the income of the state without incurring losses. SOEs need to improve the monitoring of the performance of public policy assignments within the scope of their corporate business administration.

People of any nation expect SOEs to act in a commendable way in their chosen area of business. Many managers report that their organizations have achieved sustainable development in the past and expect them to do so in the future. For instance, this brings both tangible and intangible benefits not only to the companies themselves but also to the society. Specifically, tangible benefits arise from reducing the costs and risks of engaging in business, while intangible benefits can increase firms' brand reputation, attractiveness to talent, and competitiveness (UN Global Compact and Accenture 2010, 2013; Haanaes et al. 2011; Haanaes et al. 2012; Kron et al. 2013).

However, evidence and case studies have shown that many SOEs do not contribute in accordance with the expectation of the population or the government policies. Therefore, it is necessary to assess the performance of SOEs, and SOEs in India are no exception. For example, research has identified low performance levels and systematic variations in performance as major weaknesses of India's SOEs (Ahuja and Majumdar 1998). In addition, the labor laws almost entirely ignore the privatization of public enterprises and therefore are unable to support the economic growth of this country (Bharti and Ganesh 2016). The objective of this paper is to identify and discuss the reforms that India has carried out, including the privatization of state-owned enterprises.

The structure of the rest of this paper is as follows. Section 2 presents the historical background of SOEs in India. Section 3 describes Indian SOEs in central and state governments. Section 4 analyzes the role of SOEs in India's economic development. Section 5 discusses the privatization of SOEs in India. Lastly, section 6 concludes.

2. HISTORICAL BACKGROUND OF SOES IN INDIA

India became independent in 1947 and has had to deal with several obstacles, such as massive poverty, high illiteracy and unemployment levels, a low GDP, and disease. As necessity is reportedly the mother of invention, India's necessity prompted the establishment of SOEs in independent India. The challenges including economic, social, developmental, and industrial problems caused India's government to adopt appropriate industrial policies and launch SOEs, which was a major step toward becoming a developed country. In India, the main purpose of the five-year plan [1] is to construct a socialistic model for the society, concentrating on economic growth, self-reliance, social justice, poverty alleviation and the eradication of all its developmental barriers. Hence, the five-year plan led to a mixed economy with due respect and provision for both public sector and private sector entities. The government manages nationalized industries, such as public utilities, railways and communications, because these generate a revenue source. In contrast, due to the high risk and low returns, information shortage, and reluctance on the part of a number of private enterprises, the country has established state capitalist enterprises from imperfect product and factor markets (Gillis 1980). The Government of India has founded hundreds of SOEs covering various manufacturing and service sectors. Similarly, the state (province) governments of various states have founded hundreds of public enterprises since independence.

There are reasons why the Government of India has shown more interest in SOEs since the country became independent. The previous industrial policy in India in the British regime resulted in the slow growth of industries; it appeared that the British rulers were not serious about developing Indian industries but aimed to retain India as a permanent market for British products. Therefore, there was a need for the state to intervene in the economic activities. The then Indian National Congress recommended and its committee emphasized the need for state intervention in all the economic activities of the country, including the establishment of SOEs (Gupta1978). Dhar (1987) reported that a noteworthy record in the public enterprise history was the Burma Oil Company's [2] establishment of the first oil refinery under the British Government initiative in 1921 at Digboi (Chattopadhyay, 1987). Similarly, tea plantations and coal mining[3] were important industries in Assam during the contemporary period.

[1] India's first Prime Minister, Jawaharlal Nehru, presented the First Five-Year Plan to the Parliament of India, and it needed urgent attention. The First Five-Year Plan, which the government launched in 1951, mainly focused on the development of the primary sector.

[2] David Sime Cargill founded the company as the Rangoon Oil Company in Glasgow in 1886 to develop oil fields on the Indian subcontinent. In the late 1890s, it passed into the ownership of Sir Campbell Kirkman Finlay, whose family already possessed vast colonial interests through their trading vehicle James Finlay and Co. It played a major role in the oil industry on the Indian subcontinent for about a century through its subsidiaries and in the discovery of oil in the Middle East through its significant influence over British Petroleum. It marketed itself under the *BOC* brand in Myanmar, Bangladesh (formerly East Pakistan), and Assam (in India) and through a joint venture, Burmah–Shell, with Shell in the rest of India.

[3] The tea industry in Assam is about 172 years old. It occupies an important position and plays a very useful part in the national economy. Robert Bruce, in 1823, discovered tea plants growing wild in the upper Brahmaputra Valley. In 1859, the second most important tea company, the Jorhat Tea Company began operation.

3. INDIAN SOEs OF CENTRAL AND STATE GOVERNMENTS

India has its own model for SOEs, taking into consideration unity in diversity. The central government owns enterprises with a partial funding arrangement from the private sector or equity market, but it controls the enterprises. This arrangement refers to the SOEs of the central government of India. The state governments of different states of India follow the same model. Both the central and the state governments in India own wholly funded and controlled enterprises, like Indian Railways. In these enterprises, the business model involves 100% government decision making, and the governments earn revenues or profits for their exchequer. Yet another truth in the SOE scenario of India is that, at times, the terms SOE, public sector, and so on are used interchangeably, as the difference is marginal. Indeed, both central and state governments of India need to enhance their value in the economy and society; hence, SOEs have acted strategically to position themselves in the competitive world. Evidence has indicated that the role of SOEs has increased in India for the first decade since independence. According to the source of public sector enterprises of the Government of India Department (2018), there are 257 operating central public sector enterprises that are profit making. However, there are some loss-making public sector enterprises. Furthermore, there are public sector undertakings that the state governments of various states of India own and control. According to the Public Enterprises (PE) Survey, Government of India 2011[4] in India, more than 80% of PSEs operate in five sectors, consisting of agriculture, mining, manufacturing, electricity, and services. The Central Exchequer receives the contributions of central public sector enterprises (CPSEs) through dividend payments, interest on government loans, and the payment of taxes and duties (Government of India 2005). Many plants in the public sector operate in backward parts of the county, which lack basic industrial and civic facilities, such as electricity, water supply, townships, and workforce. Therefore, by providing these facilities and founding public sector enterprises, both central and state governments can achieve balanced regional development.

4. ROLE OF SOEs IN INDIA'S ECONOMIC DEVELOPMENT

To understand the importance of Indian SOEs, it is necessary to review the industrialization strategy of this country since the 1950s. Moreover, the Commercial Policy Resolution (1956) sets out the scope of the economy for SOEs.

Although the Constitution protects the private sector and private property, the room for investment is still a limitation. After the country gained independence in 1947, Indian enterprises in utilities and infrastructure, such as railways, ports, airports, and telecommunication and power units, were largely in the public sector. The existing private enterprises in several basic and capital good sectors only operated with the state's permission. By contrast, the trade goods sector and intermediate production goods, such as cement, were open to the private sector (Mohanty and Reddy 2010).

[4] Government of India. 2011. *Public Enterprises Survey 2009–10*. New Delhi.

It is true that Indian SOEs have assisted this country in achieving economic self-reliance. The main purposes of enterprises include building infrastructure for economic development and promoting industrialization; promoting employment and balancing regional development; creating a self-reliant economy through import substitution and developing the capacity to export; generating surpluses for development by earning suitable returns; and preventing the concentration of private economic power (Seabright 1993).

There were only five SOEs with total investment of 290 million rupees (Rs) (equivalent to $60 million at the 1955 exchange rate) in the initial period of the First Five-Year Plan (1952).Since the Second Five-Year Plan, with the implementation of the Industrial Policy in 1956, the government established a number of new SOEs in core and basic industries. It set up units producing steel, heavy engineering, fertilizer, electricity generation equipment, and machine tools, the majority of which obtained technological and financial support from the Russian Federation and other Eastern European countries.

By the 1970s, the government had decided to nationalize the coal industry, large commercial banks, and all insurance companies. As a consequence, state (provincial) governments established a large number of enterprises (SOEs), of which many firms operated in the joint sector and private partners held up to49% of the shares.

When the Indian government launched the program on deregulation and liberalization[5] heading the Seventh Five-Year Plan, the number of CSOEs significantly increased by 244 (excluding commercial banks and insurance companies). By 2005–2006, these had declined to 239 because of the withdrawal and privatization of some leading CSOEs.

The early 1990s witnessed the development of Indian SOEs, since mature public enterprises dominated key sectors; these had successfully expanded their production, opened up new areas of technology, and substituted imports in an array of capital goods sectors, with technical competence, which aided India’s ranking in terms of industrialization, and with a large pool of trained workers with technical skills, especially in the chemical and manufacturing industries.

There is a changing scenario in which SOEs or public sector enterprises are passing through difficult times. Their challenges concern poor management, misuse of resources, poor accountability, and often huge losses. Therefore, governments across the world have been active in selling off these huge behemoths in the last few decades to improve the efficiency of the assets invested and to halt the huge drain on resources. India is no exception. Rama (1999) argued that public sector downsizing is necessary because it assists in reforming SOEs in developing countries. He stated that the reform may improve economic efficiency; however, it is necessary to consider the risks. Chakrabarti et al. (2017) claimed that it is very difficult to achieve this with full privatization, while it is possible to improve SOEs’ performance through corporate governance reforms. Therefore, policy makers should carefully consider massive privatization when restructuring SOEs. Likewise, Joshi (1999) emphasized the role of privatization in reducing social costs and dislocations. He concluded that privatization in South Asian countries cannot enhance the confidence in the private sector and that this leads to large-scale worker retrenchment. Consequently, the Indian government released a new industrial policy on 24 July 1991, which many viewed as a framework for the privatization of many sectors. The restructuring process included entry to the private sector in the place of SOEs, disinvestment, listing SOEs on the stock exchange,

[5] Liberalization is any process whereby a state lifts restrictions on some private individual activities.

withdrawing budgetary support for loss-making SOEs, more professionalism and corporate culture and so on.

SOEs make important contributions to India's economic development. Although the liberalized economic regime and globalization have transformed the role and functioning of SOEs, these enterprises still play a significant role in the socioeconomic development of this country (Mishra 2014).

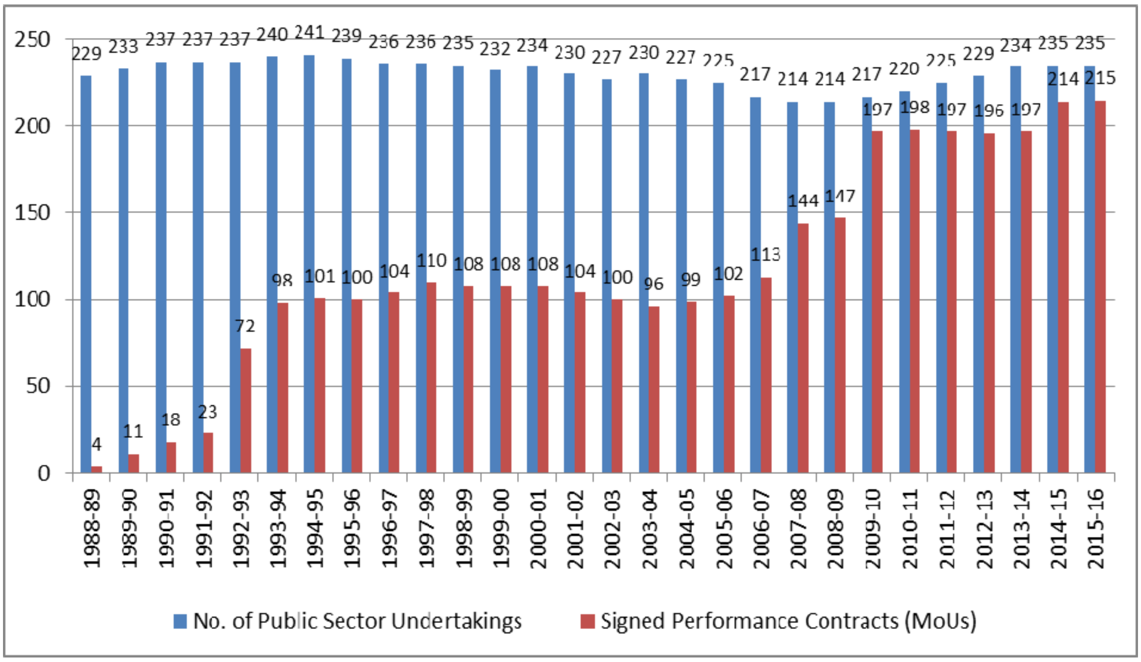
5. PRIVATIZATION OF SOES IN INDIA

5.1 Conceptualization of Privatization in India

The conceptualization of privatization in India consists of the following:

1. Delegation: The government manages the ownership and responsibility of an enterprise. However, private enterprises can deliver the products or services while the state actively participates in this process. Delegation occurs via a contract, franchise, lease, or grant.
2. Divestment: The government sells the majority stake of the enterprise to one or more private enterprises. Therefore, the state manages some ownership and a minority stakeholder
3. Displacement: Deregulation is the first step. This process allows private stakeholders to enter the market and then private companies will displace the public enterprise step by step.
4. Disinvestment: In this case, the government sells a partial or entire public enterprise directly to private parties. In India, privatization is linked to the economic reforms issued in 1991. Generally, privatization means encouraging private sector participation in the management and ownership of public sector enterprises or SOEs. Reviews have shown that, in the late 1980s and early 1990s, it was a global trend to reform loss-making public sector enterprises through the process of privatization. Not only developing countries like India but also certain Western European countries initiated this practice and brought it into force. India is a mixed economy that includes both public and private sector enterprises. Private participation in SOEs accounts for 49%, and the new industrial policy considers this carefully. The need to privatize public enterprises arises because of their poor financial and operating performance. There are many advantages of the privatization of SOEs. They include a considerable amount of reduction in the burden on the government, strengthening of the professional competition, improving of the public finance, funding of infrastructure development, responsibility and accountability to shareholders, reduction of unwanted interference, a committed labor force, and so on. Figure 1 shows the growth of public sector undertakings and performance contracts in India.

Figure 1: Growth of Public Sector Undertakings and Performance Contracts



Source: Public Enterprise Survey, 1988–89 to 2015–16.

Ahuja and Majumdar (1998) assessed the factors affecting the performance of 68 Indian SOEs in the manufacturing sector between 1987 and 1991. They found that both low performance and systematic variations in the performance parameters influenced the performance of Indian SOEs. Size has a positive relationship with efficiency, while age negatively affects efficiency. In addition, the results indicated that economic liberalization and reforms may improve the performance of SOEs. State-owned firms in the manufacturing sector, which are smaller in size, are the prominent candidates for privatization. These firms are also easily transferable to private investors. This result helps policy makers to make pragmatic policies and guidelines concerning state-owned enterprises and their privatization issues.

Another interesting research work has offered an understanding of privatization. Mandiratta and Bhalla (2017) claimed that SOEs have lower proficiency than privately owned firms. Thus, the main objective of disinvestment[6] is to decrease the participation of the public sector in the economic actions of the country to support the private sector. The study investigated the performance of 15 central public sector enterprises (CPSEs) in the manufacturing, mining, electricity, and service sectors of India through the public share offering mode over the period 2003–12. It employed indicators to conduct a ratio analysis, including the computation of the return on assets, return on equity, sales efficiency, net income efficiency, debt equity, dividend payouts, real sales, and employment levels. The results showed that the public offering mode entails performance changes in CPSEs disinvested through the involvement of retail investors. Besides, the research interpreted the achievement and failure of privatization in the Indian context. According to Kikeri and Nellis (2002), it is necessary to consider four determinants, namely commitment, competition, transparency, and mitigation, because these affect the privatization yield in India. Specifically, in the Indian context, the competition and transparency factors have high scores, while commitment and mitigation

6 Government of India. 1993. Report of the Committee on the Disinvestment of Shares in PSEs (Rangarajan Committee), April. New Delhi.

obtain poor scores. To overcome the issues of privatization, the government should implement options such as partial privatization, the streamlining of objectives, increased autonomy, and managerial accountability (Kay and Thompson 1986; Yarrow 1986; Vickers and Yarrow 1991).

India's privatization of SOEs has many advantages and disadvantages. One can always argue for and against privatization. According to Tejvan Pettinger (2017), privatization involves selling state-owned assets to the private sector. There is a belief that the private sector can run a business more efficiently, as it places more emphasis on profit maximization. However, critics have argued that private hands can exert their monopoly power in the market at the cost of the wider social costs. The following table provides points for this argument.

Table 1: Privatization versus Nationalization

Factors	Privatization	Nationalization
Ownership	Firms owned by the private sector	Firms owned and managed by the government
Incentives	The profit motive acts as an incentive for owners and managers	Workers may feel motivated if they feel that the company belongs to them
Externalities	Private firms may ignore external costs(pollution) and external benefits	The government can put social benefits above the profit motive
Efficiency	Incentive to introduce new technology and increase labor productivity	Nationalized firms may find it hard to sack surplus workers
Knowledge	Private firms employ managers with the best skills	Politicians may interfere based on political motives
Natural monopolies	Private monopolies, e.g., water/trains, may charge high prices	The government can set prices based on social factors
Depends on industry	Worked well for BT and BA	Natural monopolies, like trains/water; non-profit services like health care

Source: *Economic Times*, 12 May 2017.

Shirodkar et al., (2017) noted that Air India[7]is currently burdened with a debt of about 52,000 crores and has salary arrears of approximately Rs 1,200 crores, accrued since 2012. The salary for 27,000 pilots and crews of Air India is pending. As a result, the Government of India decided to undertake disinvestment[8] and privatization. Policy makers and policy implementers always remember the key points of the solutions to ensure that the privatization process runs smoothly.

Creative actions of privatization in India include: (1) deregulating—reducing regulations (often a defining characteristic of privatization); (2) contracting with the private sector to purchase a service (road construction); (3) establishing incentives to encourage the private sector to provide a service; (4) abandoning or shedding services; (5) reducing the demand for a service; (6) establishing quasi-public organizations (government enterprises or charters); (7) establishing separate corporations—profit and non-profit (authority); (8) supplying temporary help on the part of the private sector; (9) issuing

[7] Air India is the flag carrier airline of India with headquarters in New Delhi. It is owned by Air India Limited, a government-owned enterprise, and operates a fleet of Airbus and Boeing aircraft serving 94 domestic and international destinations. The airline has its hub at Indira Gandhi International Airport, New Delhi, alongside several focus cities across India.

[8] Government of India. 2007. *White Paper on Disinvestment of Central Public Sector Enterprises*. New Delhi: Department of Disinvestment.

vouchers (K-12 education); (10) issuing waivers; (11) selling or giving away government-owned assets; (12) establishing franchises; (13) leasing; (14) subsidizing or making grants available to the private sector; (15) relying on user fees rather than tax dollars to fund a service (hunting licenses); (16) discontinuing subsidies to public entities providing joint funding; (17) establishing public/private partnerships; and (18) setting up consumer self-help processes or using volunteers.

5.2 Advantage of Privatization

There are some advantages of privatization. First, the incentive in private companies is always higher than that in public enterprises. The managers and officials of a private company usually take care in the game, because their income is associated with the performance of the company, while this incentive is not present in public organizations. Consequently, privatization generates greater efficiency of the firm. Second, there is a considerable amount of political interference in a public enterprise, and this interrupts the company in terms of taking economically beneficial decisions. In contrast, private companies do not usually allow political factors to influence their performance. Third, all the goals in the process may be short term, because the government often expects to obtain more votes from the public and therefore is often interested in the upcoming elections. The long-term goals of the company are often based on political decisions. Finally, privatization may enhance the competitive capacity of the firm in the market and consequently benefits consumers.

5.3 Disadvantages of Privatization

However, privatization has some disadvantages. For instance, this process concentrates more on the target in profit maximization, while India is the second-largest democratic country in the world. The social responsibility activities are minimal when compared with those of SOEs. Private sector enterprises do not give much importance to transparency and keep their stakeholders in the dark. To achieve their goals, private enterprises make every effort, such as encouraging corruption, unlawful ways of accomplishing objectives, lobbying, and so on. A review of the privatized status has indicated that privatization results in high employee turnover, retrenchment, low salaries, and so on, causing a certain imbalance in the society. Privatization and price inflation go hand in hand. Many more inconveniences, disadvantages, difficulties, setbacks, and troubles have continued during and after the privatization of SOEs in India.

6. CONCLUSION

Reforms are mandatory in every sector of a society, particularly in developing countries of Asia, as nothing is permanent except change. Policy-making bodies need to discuss the changing environment of the business world and provide policy guidelines for them, inclusive of SOEs. One of the measures of reforms is the privatization of SOEs. The process of privatization has both advantages and disadvantages for a developing nation like India. This paper has presented the salient features of privatization. If public enterprises function like private sector organizations, very efficiently without actually privatizing the enterprises, they can satisfy both the agenda of profit making and the social responsibility. The process of reforms, including full and partial privatization, has to continue day by day to enhance the efficiency of SOEs in India. It is inevitable that social justice is necessary in the process of introducing reforms. Involving members of the public as shareholders of SOEs will certainly improve their performance and accountability. Granting funds and concessions should avoid loss-making and problematic public enterprises.

Despite implementing product mix diversification, Indian manufacturing companies present poor performance, especially financial performance, because of the lack of modernization of machinery and upgrading of people's skills. These firms make positive contributions to the operating margin before direct labor, but most of them lose at the earnings before interest, tax, depreciation, and amortization (EBITDA) level. There are two solutions to this issue, consisting of restructuring and disinvestments (Bose 2011).

To improve the performance of Indian SOEs, the government agreed to allow them greater autonomy and improve corporate governance by adjusting the boards and enhancing the powers of these boards to make investment and strategic decisions (Khanna 2012). Further, it should adopt the following suggestions to reform Indian SOEs: first, enhance the power of SOE boards to undertake decisions after considering all the relevant interests; second, improve the independence of SOE boards; third, reduce the government interventions in the functioning of SOEs; fourth, simplify the ownership of SOEs by consolidating ownership in a single entity, like the State-owned Assets Supervision and Administration Commission (SASAC) in the People's Republic of China, Temasek in Singapore, or Khazanah in Malaysia; fifth, provide greater recognition and protection of minority shareholder interests; and, finally, implement appropriate balancing of the interests of shareholders and other stakeholders (Varottil 2015).

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