

Disinvestment of Public Sector in India: Concept and Different Issues

Sri Santosh Koner¹, Professor Jaydeb Sarkhel²

¹(Head Department of Commerce & Assistant Professor, ChatraRamaiPanditMahavidyalaya, India)

²(Professor, Department of Commerce, The University of Burdwan, India)

Abstract: This paper gives the definition of disinvestment, states the difference between disinvestment and privatisation, gives a brief account of public sector in India and changes in government policy towards the public sector. This Paper also consider some issues related to disinvestment such as why disinvestment, how much disinvestment, how to make disinvestment etc and conclusion.

Key words: Disinvestment, Government Policy, Management, Privatisation, Public Sector.

I. Introduction

After independence when economic planning was introduced India adopted the mixed economic system. The main feature of the mixed economic system is the co-existence of public sector and private sector. The Industrial Policy Resolutions of 1948 and 1956 demarcated the areas of operations of public sector and private sector. There were several objectives for building up the public sector. The objectives range from building infrastructure for economic development to generating investable resources for development by earning suitable returns. The motivation for expanding the public sector extends from the theory of 'commanding heights' to the provision of consumption goods at subsidised rates. Eventually public sector enterprises are now spread over from coal, steel and oil at one end to hotel and bread making at the other. It was earlier thought that by the progressive expansion of the public sector, the country would be able to move towards the socialistic pattern of society which was sought to be achieved as a goal.

1.1 Definition of Disinvestment

The term 'Disinvestment' is the opposite of the term 'Investment'. Investment is acquisition of earning asset with the help of money. For example if bonds are purchased or shares of companies are purchased by spending money it is known as investment. In the case of investment money is converted into earning asset to earn income. On the other hand in the case of disinvestment an earning asset is converted into liquid cash. Here we shall use the term disinvestment in a special sense. By disinvestment we mean the sale of shares of public sector undertakings by the government. The shares of government companies held by the government are earning assets at the disposal of the government. If these shares are sold to get cash, then earning assets are converted into cash. So it is referred to as disinvestment.

1.1.1 Difference between disinvestment and privatization: Before we proceed further let us clear one semantic problem. There is a difference between disinvestment and privatization. Privatization implies a change in ownership resulting in a change in management. But disinvestment need not always imply change in management. Disinvestment is actually dilution of the stake of the government in a public enterprise. If the dilution is less than 50 percent the government retains management even though disinvestment takes place. It is not privatized. But if the dilution is more than 50 percent there is transfer of ownership and management. It will be called privatization. Thus disinvestment is wider than privatization. Privatization implies disinvestment but disinvestment does not necessarily imply privatization. Only when disinvestment goes beyond 51 percent it implies privatization. The extent of dilution of the government's stake is determined as part of the policy of disinvestment.

Before considering disinvestment let us first consider, in brief, the role of public sector in Indian economy. This is necessary in order to understand the perspective in which disinvestment decision has been considered by the government.

1.2 Change in Government Policy towards Public Sector

There was a radical change in government's policy towards the public sector in 1991 when the new industrial policy was adopted. In the new industrial policy of 1991 the role of public sector has been reduced. In the industrial policy of 1956, seventeen industries were reserved exclusively for the public sector. Moreover, there were twelve other industries which were to be progressively state owned. But in the industrial policy of 1991 only eight industries have been reserved for the public sector. These eight industries include defense

production, atomic energy, coal and lignite, mineral oils, iron ore, manganese, gold and diamond, atomic minerals and railways. It has also been stated that if need arises private sector units may also be permitted to enter these industries. Thus in the new industrial policy there is no such thing as the exclusive preserve of the public sector. In the new policy it has been stated that the government will run the public sector on sound commercial principles. Chronically sick public sector units will be referred to Board for Industrial and Financial Re-construction (BIFR) for examining their viability. The unviable public sector units will be closed down. A social security net will be created for the rehabilitation of the workers working in the affected units. Another important feature of the new policy on public sector is disinvestment of some selected public sector units. It has been decided that 20% of the shares of selected profit making public sector units will be sold to financial institutions, mutual funds etc. These institutions will hold the shares for a specified period of time after which they will be permitted to sell the shares in the share market. In the new policy it is also stated that the government will provide more autonomy to public sector units. The government will not interfere in the day to day functioning of the public sector units. Instead these units will be controlled by the government through memorandum of understanding (MOU) reached between these units and the government.

1.2.1 Performance of Public Sector

The performance of public sector units in India can be considered. The performance of public sector units can be judged by several efficiency criteria. However, the financial performance assumes importance because one of the objectives of creating public sector enterprises was to generate investable resources for development by earning adequate returns. Financial performance of public sector units is mixed. In 2001-02, 119 profit making enterprises earned a total net profit of about Rs. 36432 crore and 109 loss making units incurred a loss of Rs. 10387 crore. Thus in 2001-02 total net profit earned by 230 central public sector units was Rs. 26045 crore. A very interesting point about the financial performance of central public sector units is that the major part of the profits was contributed by the petroleum sector enterprises. Thus in 2001-02 when the net profit after tax came to Rs. 26045 crore, the share of the petroleum sector enterprises was Rs 12714 crore that is 49%. The profit of the public sector enterprises would look less impressive if the oil sector is excluded. The rate of return on capital employed (defined as the ratio of net profit to capital employed) in 2001-02 was 6.7%. It should be noted that the capital employed in central public sector enterprises is generally raised by way of long term loans from the market and from financial institutions at a much higher rate of interest; accordingly the rate of return on capital employed is pitifully low.

Many will argue that it is not wise to judge a public sector undertaking by its financial performance because such enterprises are not always guided by the profit motive. Rather they are guided by broader socio-economic considerations. If necessary, a public enterprise can operate even if it is losing, the losses being met from the government budget.

Apart from financial performance one can judge the public sector enterprises in terms of technical efficiency allocative efficiency and dynamic efficiency. Technical efficiency is related to input- output ratio or productivity of inputs. Allocative efficiency is related to the correction of market failure leading to better allocation of resources than what will be decided by the price mechanism. Dynamic efficiency relates to innovations and technological development. Even in relation to these criteria, the results in relation to public enterprises are mixed.

Current profit and/or current loss need not necessarily be the criterion appropriate for disinvestment. Merely because a unit is profitable, it does not qualify to continue in the public sector unless it serves a social purpose. Loss making units need to be excluded from disinvestment if there are buyers who can make it profitable.

1.3 Issues Related to Disinvestment

Before proceeding further let us first consider some issues relating to disinvestment. These issues are: why disinvestment, how much disinvestment, how disinvestment, etc. Let us consider these issues one by one.

1.3.1 Why Disinvestment?

There are two major reasons offered by the government for disinvestment. One is to provide fiscal support and the other is to improve the efficiency of the enterprise. The fiscal support argument runs as follows: Government's resources are limited. These resources should be devoted to areas of social priority such as basic health, family welfare, primary education and social and economic infrastructure. More resources can be devoted to these priority areas by releasing resources locked up in nonstrategic public sector enterprises. The demands on the governments both at the centre and in the states are increasing. There is need to expand the activities of the state in priority areas. It is, therefore, legitimate that a part of the additional resources needed for supporting these activities come out of the sale of shares built up earlier by the government out of its resources.

The second reason for disinvestment is that it will improve the efficiency of working of the enterprise. If the extent of disinvestment is such that the enterprise is privatized and management of the enterprise is taken over by the private sector it will be free from the control of the government and will be able to function more efficiently. It is here taken for granted that efficiency is higher for a private sector than for a public sector unit. Even if the extent of disinvestment is less than 50 percent so that the government retains control of the unit, the induction of private ownership can have a salutary effect on the functioning of an enterprise. It increases the accountability of management. The share-holders have expectations about returns on their investments and their expectations are to be fulfilled. This will compel the enterprise to run more efficiently and earn more profits. Flexibility in ownership structure can, in effect, impart efficiency. In fact, the induction of the public into the ownership structure can also create conditions in which there could be greater autonomy for the functioning of the public sector enterprises. Disinvestment can be regarded as a tool for enhancing economic efficiency.

1.3.2 How much Disinvestment?

The second question with respect to disinvestment is related to the extent of disinvestment to be made in an enterprise. Obviously the level of disinvestment in an enterprise in any year should be derived from the target level of government ownership in that enterprise over the medium term. The target levels of ownership could be 26 percent to ensure limited control over special resolution brought in, in the general body meetings of the enterprise, 51 percent to have effective control and 100 percent for full ownership. The target level of disinvestment should be derived from the desirable level of public ownership in a unit. The Rangarajan Committee (1993) emphasised the need for substantial disinvestment. It stated that disinvestment could be up to 49 percent for industries explicitly reserved for the public sector. It recommended that in exceptional cases, such as the enterprises which had a dominant market share or where separate identity had to be maintained for strategic reason, the target public ownership level could be kept at 26 percent. In all other cases, it recommended 100 percent disinvestment of government stakes. In 1999 the government classified public sector enterprises into strategic and non strategic units for the purpose of disinvestment. Strategic public sector enterprises would be those in the areas of defense production, atomic energy and railway transport. All other public sector enterprises were to be considered non strategic. For non strategic public sector undertakings, it was decided that the reduction of government's stake to 26 percent would not be automatic and the manner and pace of doing so would be worked out in case to case basis.

1.3.3 How Disinvestment?

The third question is what should be the process to be adopted for disinvestment? For this two things are required: first is how to find the valuation of shares and the second is to find the modalities to be adopted for sale. If all the shares of a public sector undertakings are held by the government such shares are not sold in the share market. These shares do not have market prices. Then how to determine the values of such shares? There are three methods to determine the values of shares:

- (i) Net asset value method.
- (ii) Profit earning capacity value method, and
- (iii) Discounted cash flow method.

Different valuation methods give different results. It has also to be noted that while the different valuation methods can provide a benchmark for the price, the price at which a share can be sold is determined more by investor perception than any mechanical measure of intrinsic worth. A rise or fall in share value of an enterprise soon after disinvestment does not by itself indicate that shares were underpriced or overpriced at the time of disinvestment.

Two methods can be used for the sale of shares. One is offering shares at a fixed price through a general prospectus. The other is through auction of shares amongst a predetermined clientele setting a reserve price. Both the methods have advantages and disadvantages. The disadvantage of the first method is that in this method the 'Fixed price' cannot be determined by market forces. But the advantage of this method is that the shares can be distributed among large number of individuals. The advantage of the second method is that since the shares are sold by auction; the government can get more revenue. But its disadvantage is that in this method the shares are owned by a few persons and this increases the concentration of economic power. In the case of those public enterprises for which the first sale of equity is yet to be made the tender system would be advantageous. Once a reasonable market price is established in a normal trading atmosphere over a reasonable period of time, the fixed price method would be appropriate.

In the initial years the government went in for sale of minority stakes without transfer of management control. In recent years the government has modified its policy and has emphasised strategic sale. Strategic sale means sale of majority shares to a partner with transfer of management control. According to the government the disadvantages of sale of minority stakes are follows:

- (i) Lower realisation because the management control is not transferred.

- (ii) With the limited holding remaining with the government after minority sales, only small stakes can be offered to the strategic partner, if it is decided to go for strategic sale subsequently. This depresses the possibility of higher realisation from the strategic partner.
- (iii) The minority sales also give the impression that the main objective of the government is to obtain funds for reducing its fiscal deficit and not to improve performance of the units disinvested.

1.3.4 Disinvestment: Issues

The disinvestment policy of the government has been criticized by various groups- both within the government and outside the government. Critics have raised several issues in connection with the disinvestment policy; some of these issues are as follows:

1. Is the government's classification of 1999 into strategic and non strategic sectors correct?
2. Is it desirable to disinvest profit making public enterprises?
3. What should be the procedure for disinvestment- public offer through the stock exchange or strategic sale to a private partner?
4. Should disinvestment create private monopoly in place of public monopoly?
5. What should be the method of valuation of a public sector undertaking (PSU) before a bid for disinvestment is made?
6. Should PSUs be allowed to participate in the bids for disinvestment of PSU?
7. How should the proceeds from disinvestments be utilized?
8. How should the interest of the workers be safeguarded?

Let us discuss these issues one by one.

Issue of strategic and non-strategic sector:

The advocates of disinvestment argue that the public sector should be limited only to strategic areas. The critics argue that the strategic sector has been narrowly defined in India. Even in the USA the oil sector has been considered as a strategic area. But in India the oil sector has not been recognized as strategic; so is also the case of power generation. The oil units and power generation units should be considered as strategic and PSUs in these areas should be managed by the government.

Privatization of profit making PSUs: Government's policy of disinvesting profit making PSU has also been criticized. The profit making PSUs are like the geese that lay golden eggs and it is unwise to kill these geese. The supporters of disinvestments argue as follows: The rationale for privatising or not privatising a PSU is not based on whether it is making profit or loss but whether it is in a strategic sector or in a non strategic sector, and whether the tax payers' money can be saved from commercial risks by transferring the risks to the private sector wherever private sector is willing to step in and assume such risks.

Methodology for disinvestment: It has been criticised that the government does not have a clear policy on the methodology of disinvestment. Earlier the government followed the policy of open auction sale. This method gave excellent result in 1994-95 when realization was Rs. 4843 crore against the target of Rs. 4000 crore. But later in 1999-2000 the government has shifted to strategic sale. It has been argued by the disinvestment ministry that the public offer method is dilatory and takes a long time to complete the process of disinvestment. In this context it can be pointed that the public offer method was adopted in countries like UK, France, Germany, Malaysia and others. If the method can succeed in these countries there is no reason to believe that it will not succeed in India. This method is transparent and liable to much less abuse. It is really intriguing that in the case of HPCL and BPCL, the government has adopted two approaches. In case of BPCL it will adopt public offering methodology and in case of HPCL it will adopt sale to a strategic investor. It is indeed strange why there should be two approaches for two companies that are otherwise similar and in the same business. Obviously the public offering methodology has logical superiority over the strategic partner method and the public offering method should be adopted in all cases.

Creation of private monopoly in place of public monopoly: It has been argued by the critics that through disinvestment and privatization the government is substituting private monopoly in place of public monopoly. By accepting Tatas as strategic partners in VSNL and Reliance in IPCL the government has substituted state monopolies with private monopoly. Monopoly, whether in public sector or in private sector, is undesirable but between the two, public monopoly is relatively less harmful than private monopoly because public monopoly is accountable to Parliament but in the case of private monopoly there is no such accountability. Private monopoly is therefore not desirable from the standpoint of efficiency. It is really strange that the government is passing competition law to promote efficiency and restrict monopoly on the one hand and promoting private monopoly through disinvestment on the other hand.

Valuation of shares of PSUs slated for disinvestment: The procedure adopted by PSUs slated for disinvestment for the valuation of shares has been criticized. Even the Public Accounts Committee (PAC) or the Comptroller and Auditor General (CAG) has criticized that the shares have been undervalued. There is no transparency in the procedure of valuation. Generally the task of valuation is done by an expert merchant banker and the valuation is placed for consideration by a Committee of secretaries headed by the Cabinet Secretary. There is no expert government agency to crosscheck the valuation made by the merchant banker and the parameters used in the process. Moreover, lands belonging to the PSUs have been left completely out of the exercise of valuation on the plea that they do not earn any income and hence they need not be valued. This is clearly unjustified. Critics have rightly commented that the government is selling PSU silver for a song.

Equity swaps: If the government sells the shares of one PSU to another PSU this is known as equity swap or cross holdings. The question is whether a PSU be allowed to participate in the bids for disinvestment of PSUs? Here again no consistent policy is followed by the government. Earlier ONGC bought 10 percent each of government equity in IOC and GAIL. But when BPCL and HPCL are taken up for disinvestment, the Department of Disinvestment is of the view that cooperative like IFFCO and KRIBHCO should not be allowed to bid for these oil giants. Neither should GAIL or IOC be allowed to participate in the bid. By eliminating PSUs and cooperatives, Department of Disinvestment intends to permit the private sector – Indian or foreign-alone to participate in the sale of BPCL and HPCL. The main argument of the Disinvestment ministry is that the sale of a PSU to another PSU goes against the goal of privatization for which disinvestment is only a means.

Utilization of the proceeds of disinvestment: Disinvestment does not necessarily benefit the enterprises in terms of immediate accrual of resources. The proceeds of disinvestment go to the Consolidated Fund of India from which it meets the budget deficit. A basic criticism of the disinvestment policy is that a fund raised by selling family silver is used to pay the butler. On December 9, 2002 due to strong public pressure, the government announced that it would set up a separate Disinvestment Proceeds Funds to provide complete transparency to the government's commitment to utilization of disinvestment proceeds for social and infrastructure sectors, rather than bridging the fiscal deficit. This is a welcome development. However, care should be taken that since resources become available from disinvestment proceeds, normal funds allocated to social and infrastructure sectors are not reduced. In order to sustain the interest of the enterprises in the process of disinvestment, it may be useful to set aside a certain percentage of the profits – say 10 percent as recommended by the committee on disinvestments – to be given to the enterprises themselves for their own expansion.

Interests of workers and employees: Although the government has announced that interests of workers and employees will be protected and safety net will be provided nothing has been done except providing compensation under VRS. Opportunities for retraining and redeployment have not been developed at all.

II. Conclusion

Disinvestment is a process. We can learn from experience. We can modify the modalities as we go along. It seems that there is no way of retreating from disinvestment. It has come to stay in Indian economy. Two points should be noted in connection with the disinvestment policy. First, some restructuring of PSUs may be needed before disinvestment to enhance the value of shares and increase sale proceeds. The three broad areas of restructuring would be corporate governance, financial restructuring and business and technological restructuring. Secondly, the process of disinvestment has to take into account the conditions in the capital market. Disinvestment should not result in "crowding out" resources available for the private sector.

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