

## **CHAPTER I**

### **Introduction**

#### **1.1 Recent trends**

The last two decades have seen privatization spreading to more and more countries. The ‘international wave of privatisation,’ to use Cook and Kirkpatrick’s phrase, started in the UK in the late 1970s and soon spread not only to other industrialized countries, but also to developing countries. In fact, as Guislain points out, since the launch of the UK privatization programme in the early 1980s, the privatization wave has swept over the world, touching every continent, every political system, and every sector (1997: 287). Though privatization in one form or the other had been undertaken in the past as well, the British privatization programme launched in 1980 by Margaret Thatcher is generally accepted as the forerunner of the current privatization phenomenon (Guislain, 1997).

As a result of this worldwide phenomenon, more than 100 countries, across every continent, have privatized some of their SOEs. The volume of transactions has been equally striking. According to Guislain, in 1994 and 1995 alone, the annual gross revenues from privatizations worldwide were estimated to be in the order of \$80 billion. In comparison, in 1989 the total had been hardly \$25 billion. Guislain indicates that between 1988 and 1993, over 2,600 privatization transactions with sale value exceeding \$50,000 were recorded

worldwide (excluding eastern Germany). These generated receipts of \$271 billion, which was far in excess of the \$150 billion that such operations brought in up to 1988. Of the 2,600 privatization transactions referred to by Guislain, close to 900 were carried out in 1993 alone, as against only about 60 in 1988. It is interesting to note that developing and transition countries accounted for much of this tremendous growth (Guislain, 1997: 1). In fact, Mishra and Bhat point out that while between 1990-2000, more than \$700 billion<sup>1</sup> in assets have been privatized around the world, about 40 per cent of this privatization occurred in emerging economies (2002: 1).

To these figures, one must add the thousands of enterprises which were transferred to private shareholders under the mass privatization programmes implemented in many transition countries, notably Russia and Czech Republic. Guislain indicates that in just over two years, Russia succeeded in privatizing between 12,000 and 14,000 medium-sized and large enterprises with a total of over 14 million employees which represented about half of Russia's industrial labour force. In the process, he points out that about 40 million Russian citizens became shareholders for the first time. Similarly, in Germany, following the fall of the communist regime in East Germany and the reunification, over 15,000 enterprises were sold or liquidated between 1990 and 1994<sup>2</sup>.

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<sup>1</sup> In the World Bank Policy Research Working Paper No. 3765, it is reported that 120 developing countries carried out 7860 transactions between 1990 and 2003, generating close to \$ 410 billion in privatization proceeds. However, the privatization proceeds have been calculated to exclude receipts from management contracts, greenfield investments, investments committed as part of concessions agreements, and from "voucher" privatizations in Eastern Europe (see Kikeri and Kolo, 2005: 2). Hence the difference in figures.

<sup>2</sup> In eastern Germany, Treuhandstalt was set up in March 1990, and by the end of 1994 it had sold over 14,500 companies (see Naib 2004: 142). Similarly, nearly 100,000 small businesses and enterprises were privatized between 1991 and 1994 in Russia alone (see Lieberman and Rahuja 1995: 25).

The collapse of USSR led to the abandonment of socialism worldwide in favour of western-style economic models dependent on private ownership and a greater reliance on the market forces for spurring development in place of state intervention. The ex-Soviet Bloc countries, particularly those in Eastern Europe, faced the new realities by being forced to open up their economies though this meant economic hardship to the people during the transitional period. Governments in different countries have opted for privatization, because of different reasons, in different degrees, using different methods, and coming up with different results. In fact, the lack of uniformity is what makes privatization both unique and complex.

Cook and Kirkpatrick indicate that the policy objectives and motives for privatization have 'varied between countries and have altered with time' (1995: 3). They argue that while in the case of industrialized countries the dominant motive was ideological, in the case of developing countries it was more a response to 'the macroeconomic burden of the public enterprise sector.' Public enterprises were seen to have been an important contributory factor to the mounting fiscal imbalances. This is because financial support for public enterprises reduced the funds available for social services, crowded out private sector borrowing and undermined the development of the private sector (Cook and Kirkpatrick, 1995: 3). In the erstwhile socialist countries, however, privatization came to be viewed as an integral element in the process of transition from a centrally planned to a market-oriented economy (1995: 4).

Other researchers such as Chowdary, on the other hand, see privatization of state-owned enterprises (SOEs) as having been an essential part of the economic reform process that started in the 1980s in both the developed and developing countries (2003: xii). This was seen as being related to the changing role of government in the economic development process. In fact, the rationale for privatization was seen to have emanated from the experience that in many countries, SOEs had not lived up to their developmental expectations. According to Chowdary, due to many inherent problems, scarce resources were being less efficiently used, and their fiscal implications were mounting. In response to these problems it is felt that governments recognized the need to get out of economic activities that competitive markets can do better than the government. This got a further impetus in the early 1990s where governments, wherever possible, reduced their involvement further by pursuing partnership with the private sector in providing infrastructure, social services, and in protecting the environment. This approach was seen to have greatly contributed to the process of re-balancing the respective roles of the government and the private sector in many developing countries. This period also happened to coincide with the mass privatization efforts, which formed an integral part of their reform programmes, pursued by transition economies subsequent to the breakdown of the Soviet Union and the communist system of governments in Eastern Europe (Chowdary, 2003: xiii).

In this global phenomenon, India has not been untouched. After four decades of pursuing inward-looking policies, the last one and half decades have seen India too taking certain tentative steps towards a regime that is at least

partially deregulatory and market-oriented. The fact that it was the macroeconomic crisis of 1991 that led to these measures being initiated in the first place has a significance that is often overlooked by researchers reviewing the developments that have since taken place in India. This becomes clear when one analyses the strategy that India had adopted for economic development ever since she gained independence in 1947. While this would be covered in greater detail later in the dissertation, it would be useful to touch upon it in the introduction also so as to clarify the issues involved.

## ***1.2 Issues involved***

Like many post-colonial countries in the 1940s and 1950s, after her independence from colonial rule, India adopted a developmental policy that was driven by a vision of what Jalan (1991) describes as the ‘welfare-maximizing state.’ He quotes from the Second Five Year Plan document which emphasized that the pattern of development and the structure of socio-economic relations should be so planned that they result not only in appreciable increases in national income and employment but also in greater equality in incomes and wealth (1956: 22). This meant that the state came to adopt a significant role in the economic growth of the country not only as a producer but also as a regulator channelising developmental efforts into what were perceived to be socially beneficial activities. This strategy, which Jalan believes was greatly influenced by the Soviet planning model, gave a central role to the state in the control and direction of economic activity (1991: 22).

As Jalan explains, the state emerged as the mobilizer of savings as well as an important investor and owner of capital. Since the state was to be the primary agent of economic change, it followed that private sector activities had to be strictly regulated and controlled to conform to the objectives of state policy (1991: 22). The primary objective, as Gupta observes, was the attainment of self-reliant growth through policies of import substitution and control over the flow of private investment. The growth of private capital was regulated through licensing and other policies, imposed with the aim of achieving balanced economic development of the country and for checking the growth of private monopoly power in the country (1994: 2). The wide scope of the regulatory framework was also justified, as Jalan points out, by appealing to certain other worthy objectives of development planning, such as a reduction in regional disparities, ensuring social justice, promoting self-reliance, and protecting the interests of the working classes (1991: 86).

The adoption of a centrally planned development strategy (or ‘command-type planning,’ to use Jalan’s phrase) led to two things. To start with, the perception of public sector being the ‘engine of economic growth’ led to massive investments by the government leading to the proliferation of public sector enterprises right through the 1960s and well into the 70s. While initially these investments were made in core sectors such as iron and steel, coal, petroleum, atomic energy, power generation, telecommunications, railways and defence equipment, later on many other items came to be produced in the public sector as well, such as bread, soft drinks, and bicycles, which could have been more

appropriately left to the private sector. In addition, due to social and political reasons, the government was forced to take over several loss-making private sector units on the verge of being closed down so that the employees could be saved from being rendered redundant. This added to the ever-increasing number of public enterprises while adding to the financial burden of the government.

The second consequence of the planning model that India adopted was the creation of a regulatory regime that stifled private entrepreneurship while promoting and protecting an inefficient public sector. The web of controls and regulations that came to be derisively known as the 'license-permit raj' also epitomised bureaucratization at its worst. As Jalan points out, it is well recognized that the industrial licensing system did not achieve its avowed purpose (1991: 88). He quotes from Paranjape who was a member of the Industrial Licensing Policy Enquiry Committee of 1969 to suggest that it was recognized even then that in respect of licensing, the Committee firmly concluded that the system had failed practically on all counts, whether it was regional dispersal, import substitution, or the prevailing concentration of economic power. Commenting on the corruption that it bred, Raj (1986) observed that the industrial licensing system, as it grew over a period of nearly three decades, had accumulated much 'fat and filth.' It was felt to have not only ceased to perform effectively most of the functions it was designed for earlier, but had also become a major source of political and bureaucratic corruption<sup>3</sup>.

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<sup>3</sup> cited by Jalan (1991: 88)

Some researchers, including Jalan, trace the change in the government's approach leading to a 'liberalisation of the licensing system' back to 1973 when in the Industrial Policy Statement of that year the government identified some high-priority industries where investment from large industrial houses and foreign companies was permitted (Gupta, 1994: 52). While certain reforms were effected by the government in the 1980s (such as encouraging foreign investment in high-tech areas through the Industrial Policy Statement of 1980, and opening up the steel sector to private investment in 1986), these were sporadic in nature.

It follows therefore that the first concerted efforts at liberalizing the Indian economy came in 1991 as a consequence of conditionalities laid down by the international financial institutions (IFIs) following the macroeconomic crisis which India faced. Jalan points out that since 1985 successive governments had acknowledged the severity of the economic crisis and attributed it primarily to two factors, namely to the increase in non-Plan public expenditure, particularly on account of subsidies; and to the losses shown by public-sector enterprises (1991: 6). He finds that while successive finance ministers had in their budget speeches given commitments to control budgetary deficits, in reality the budgetary deficits had continued to grow along with public-sector losses (1991: 7). This resulted in increased borrowings. Jalan draws from the World Bank debt data to indicate that India's total outstanding foreign debt increased from \$ 18.7 billion in 1980 to \$ 56.3 billion in 1989, and debt to private creditors increased from about \$ 2 billion to \$ 21.4 billion during this period (1991: 44). This in turn led to the balance-of-

payments problem that triggered off the crisis of 1991, which will be dealt with in greater detail later.

### **1.3 The Argument**

As had been indicated earlier on, different countries have had different reasons for reducing the role of the state in the national economies, while enhancing the scope of private ownership and the private sector (Cook and Kirkpatrick, 1988: 3). It is generally accepted that in the case of developing countries this is more on account of macroeconomic reasons than anything else. This is particularly true for India. It is also true that the IFIs have played a decisive role in fostering privatization as part of their structural reforms programmes. Cook and Kirkpatrick indicate that the World Bank came to see privatisation as an important policy instrument for reducing the drag of the public enterprise sector on the fiscal budget, although the emphasis on privatisation, as distinct from public enterprise reform, only became evident in Bank lending conditionality in the later part of the 1980s (1995: 4).

While for several reasons the Indian government has been hesitant in using the term ‘privatization,’ preferring to call it ‘disinvestment’ instead, it is evident that the reforms initiated after 1991 do indicate a shift in the developmental strategy followed hitherto. Despite the reluctance to use the expression ‘privatization,’ as Trivedi (1993) points out, the debate on the privatization policy assumes the existence of such a policy<sup>4</sup>.

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<sup>4</sup> see Trivedi, P. (1993), “What is India’s Privatisation Policy?” *Economic and Political Weekly*, Vol. XXVIII, No. 22, May 29, 1993, pp. M-71-76. All references used here have been taken from p. M-71. One has to keep in mind that several developments have taken place since then which may make Trivedi’s observations look a bit dated. Nevertheless, his basic premise remains valid even today, which is why it is being referred to here.

Trivedi is of the opinion that there are three reasons that could have been responsible for the government to avoid using the term 'privatization policy' in the Indian context. Firstly, he feels that the term 'privatization' encompasses a large arena by denoting a rolling back of the government's involvement in economy, and using the term in this sense 'can create all kinds of imaginary anxieties.' Secondly, the most common connotation of the word 'privatization' was the selling of public assets which, in his view was clearly not at the forefront of the Indian government's implicit privatization plan. At least, the government did not want to create the impression of emphasizing the sale of public assets as a foundation for its policy toward public enterprises. Finally, he feels that 'privatisation is an ideologically loaded word and in a poor country like ours, an unpalatable word.'

Without attempting to either criticize the policy or to defend it, the effort here will be to critically analyze the changes that have taken place since 1991 in order to try and ascertain whether these denote a genuine move towards privatization or not, and whether such a policy would be sustainable in India, given the economic, political and social compulsions that the country faces. Jalan felt that the government's inability to tackle the macroeconomic problems, despite its firm assurances, was due to the 'push and pull of various interest groups' (1991: 7). The same interest groups, one feels, would undoubtedly create obstacles for the successful implementation of the privatization policy as well.

On the one hand, investment made by the government in the PSEs is too huge to allow it to withdraw totally from these. There are also strategic reasons

why government would be reluctant to part with many of the PSEs it has created over the years. Also, the socialistic vision of the state, as enshrined in the Constitution would preclude disinvestment of large monopolies in critical sectors as this would lead to creation of private monopolies which may be detrimental to the public weal.

On the other hand, it is apparent that the country's increasing budgetary constraints and the IMF conditionalities would compel it to cut down on public sector spending on the one hand and reduce its fiscal deficit on the other. The effort here will be to try and prove that the policy reforms initiated by the government are aimed at achieving these twin objectives. It will attempt to show that because of resource constraints, the government is being forced to increasingly depend on private sector financing for infrastructure development, while its efforts at attempting to attract foreign investment have a dual purpose: for establishment of green field projects as well as improving the balance of payments position. Finally, it will try to show that while the disinvestment in selected public sector enterprises either through sale of a limited percentage of shares or subsequently through strategic sales has not really taken off because of controversies relating to the valuation of shares and privatization of so-called 'navaratnas,' it also seems to have a limited objective of enabling the government to reduce its fiscal deficit by using the receipts from the disinvestment exercise rather than utilizing it for reforming the public sector enterprises themselves.

## **Hypothesis**

Constitutional commitments relating to socialism, huge investments made in the public sector, strategic, social and political considerations would preclude large-scale disinvestment or privatization of PSEs. However, macroeconomic considerations including financial constraints and large-scale requirement of funds in the infrastructure sector would force the government to withdraw budgetary support to PSEs and opt for partial disinvestment in selective undertakings, besides increasingly relying on private capital for infrastructure development.

## ***1.4 Methodology and structure***

### **1.4.1 Research Methodology**

The methodology used in this dissertation is analytical, comparative and doctrinal. The research is done mostly on the basis of an extensive analysis of literature on these issues, study of various documents, and discussion with concerned persons including government officials. The study is primarily based on the normative analysis of largely published and some unpublished data. An analytical framework has been used to examine the various issues and wherever necessary, a comparative analysis has been given. Empirical evidence has also been used wherever necessary. However, the methods employed are generally descriptive and interpretative analyses, which are held to be better suited to understand issues that are central to this thesis. The approach has generally been to examine the theoretical background relating to a particular issue vis-à-vis the actual experience on the ground.

### **1.4.2 Sources**

This thesis is largely based on sources in the form of government documents, reports of governmental and non-governmental organizations, books, articles in journals and newspapers. However, in order to facilitate smooth reading, footnotes have been kept to the minimum. Endnotes after each chapter have also been avoided and references are given at the end of the dissertation, along with a select bibliography.

### **1.4.3 Scope of the study**

The scope of the study is to identify the research problem and to examine the issues involved therein so as to find relevant answers. Since the intention in this dissertation is to look at the issue of privatization (of which disinvestment is a part) in a holistic manner, the scope of the study is not limited to law, and primarily ideas, concepts and research done in other disciplines have also been drawn upon. Because of the very same reason, the study is not limited to India alone, but comparisons have been made with the experience in other countries as well. However, the scope of the study has been restricted to disinvestment in central PSEs only, and it has not attempted to cover the state PSEs. Finally, all issues relating to the subject have been covered, including the legal and labour related issues. This is because as with any policy, there are social costs associated with privatization as well, which would need to be addressed.

### **1.4.4 Chapter scheme**

This dissertation is organized into eleven chapters. While the current chapter was in the nature of a general introduction to the problem, and presented the basic arguments along with a review of the issues involved, Chapter II will examine the

theoretical background of privatization. It will try to understand the concept of privatization and examine the different approaches adopted for achieving this. It would analyze the characteristics of the privatization process and examine the rationale for privatization. Next it will examine the different mechanisms that have been adopted to bring about privatization. Finally, it will look at the consequences of privatization in general terms.

Chapter III will look at privatization in developed countries, in particular, UK. It will trace the situation preceding the privatization and examine the objectives for undertaking the privatization programme. It will study some of the methodologies adopted for achieving this. It will also attempt to examine whether the objectives were met or not, and the consequences of such measures.

Chapter IV will look at privatization in developing countries. It will seek to analyze the problems that have affected state-owned enterprises (SOEs) in developing countries, the factors responsible for the new-found interest in privatization in the developing countries, the problems that have been encountered in doing so, and the ways by which these can possibly be overcome.

The next five chapters focus on the situation in India. Chapter V will look at the background of the developments taking place in India. It will seek to examine first the policy of centralized planning that characterized the developmental efforts in India since its independence which, in turn, led on the one hand to a dependence on the public sector as the engine of economic growth, and on the other to a regulatory regime. It will try to examine the strengths and inefficiencies of the PSEs and the reasons for such inefficiencies. It would also

try to analyze the policy of controls and regulations that was in place since independence, and its impact on the Indian economy.

Chapter VI will then try to trace the factors leading to the macroeconomic crisis of 1991 which led to the introduction of what has come to be known as ‘the reform process.’ It will also look at the policy changes that have taken place in India since then, especially in the areas of industrial licensing, foreign investments, trade and tariff fixation, and in the financial sector. It would also attempt an evaluation of some of the structural reforms introduced so far.

Chapter VII will examine some of the disinvestments carried out in the first phase in India. It would study the objectives for disinvestment of PSEs in India, the process of disinvestment, the methodology followed in the first phase and the problems faced therein. It would examine the techniques for valuation of shares and the linkage between disinvestment and public sector reform.

Chapter VIII will examine the disinvestments carried out in the second and third phase in India. It would study in particular the shift from part sales to strategic sales. It would trace the process of disinvestment, besides examining the methodology followed, apart from analyzing the advantages and disadvantages of the methodology of strategic sales vis-à-vis part sales. It would also examine the techniques for valuation of enterprises.

Chapter IX will make an assessment of the disinvestment process in India so far including its efficacy. It will also attempt to present our perception of the future course of privatization in this country.

Chapter X will look at other issues in privatization, in particular the legal and labour issues involved. It would examine the constitutional provisions and the implications of Article 12 for PSEs, and whether there is a need to amend Article 12. It would further examine whether introduction of a privatization law is called for, and the effect of disinvestment related court judgements.

Finally, Chapter XI will attempt to draw conclusions based on the examination in the earlier chapters. In doing so, it will present a summary of the key findings along with recommendations. Validation of the hypothesis, observations and projections would form the core of this chapter.