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26th Sir Purshotamdas Thakurdas Memorial Lecture

'On Strategies for Disinvestment and Privatisation'

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Shri Nair, Chairman and Managing Director of Union Bank of India, Shri Bhaskaran, CEO of Indian Institute of Banking and Finance and distinguished Guests: I am delighted to be here and I want to thank the President and Members of Indian Institute of Banking and Finance for inviting me to deliver the Sir Purshotamdas Thakurdas Memorial Lecture. A banker friend once told me that one has not arrived if one is not invited to give Sir Purshotamdas Thakurdas Memorial Lecture. So I readily accepted the invitation by Shri O P Bhatt, distinguished Chairman of SBI as it is an honour and also because this is an opportunity to pay tribute to an outstanding banker who was one of the authors of the Bombay Plan. As you know, the Bombay Plan laid the conceptual foundation of India's industrialization strategy which envisaged a strategic role to the public sector enterprises.

2. Over the years, the size of the public sector has increased and currently, there are 473 central PSUs including banks and insurance companies. Out of these, 104 are listed and 369 unlisted; while at the State level there are 1160 State PSUs. It is estimated by informed financial analysts that the valuation of the central PSUs on P/E basis for the listed companies and P/B basis for the unlisted companies is now placed at $ 450-$500 billion dollars or 40-45% of country's GDP. However, according to the latest CMIE data, the net profits of the Central PSUs works out to be only2.2% of their total assets. It is true that this ratio is higher for the oil companies such as ONGC and Oil India, but in general, the net return on the capital employed in PSUs seems to be lower than for the India's private corporate sector. If one includes the State level PSUs, then the private corporate sector would show significantly higher returns on the capital employed. While the public sector or the State-led entrepreneurship played an important role in triggering India's industrialization, our evolving development needs, comparatively less than satisfactory performance of the public sector enterprises, the maturing of our private sector, a much larger social base now available for expanding entrepreneurship and the growing institutional capabilities to enforce competition policies would suggest that the time has come to review the role of public sector, particularly the structural composition of the portfolio of public sector or in other words, of the country's "public capital assets". That is why I have chosen the topic of 'Strategies for Disinvestment and

Privatisation'. I have a feeling Sir Purshotamdas too would have agreed about the importance as well as contemporary relevance of this issue.

3. Let me begin by focusing our attention on the assets of the State. What should the composition of these assets be? The answer to this critical question can provide an important perspective on the issue of disinvestment and privatization.

4. Very often, this question is not seen in the correct light. Many people in the policy discourse advocate State ownership of one more enterprise. Each of these proposals might appear to make sense in the small. But budget constraints are a harsh reality of life. Ultimately, there is a budget constraint in terms of the overall assets of the State. When the State chooses to own Rs.1 of something, this comes at the cost of owning Rs.1 of something else.

5. The interesting and important question that we should all be asking ourselves is: What should the portfolio composition of the government be? What assets should be held by the State? We need to think about this question, and once we have a consensus and clarity about what the portfolio composition ought to be, we should embark on a set of adjustments that take us to a different, and hopefully better, asset composition.

6. The portfolio composition of the State is not something that should remain static at all times. A few decades ago, India was in a very different setting. After independence, the Bombay Plan was drafted by the business community. It envisaged government investment in capital-intensive and technologically-complex problems of the time, such as production of steel or electricity. In the 1970s, the argument was made that if the government did not run an airline, then the private sector could not.

7. Some of the choices made in this period reflected the needs of the developmental State and this was a useful part of the early growth trajectory of a country. But those compulsions are no longer with us. The private sector is now fully able to muster the capital and technology required to produce steel or electricity. The landscape has changed and our thinking must change too.

8. So what assets should the government own and control? Most of us would agree that the airline industry works quite well as a purely private affair. All over the world, governments have got out of airlines. The decades of losses and poor performance of Alitalia is commonly held up as

an example of what goes wrong when a firm is brought under public ownership. At the opposite end, most of us would agree that rural roads have to be on the balance sheet of the State. These roads typically do not have adequate traffic, and tolling would not generate adequate revenues. If the government did not own rural roads, these roads would not exist. Similarly, the public health capital in our towns and cities will need to come from the public sector. Equally, the preservation and improvement of forest cover will have to be a new priority for the public sector assets.

9. So there is a spectrum of assets, ranging from airlines to rural roads, where government ownership is inadvisable for airlines but required for rural roads or public health infrastructure. How should we think about where each problem falls? I would like to describe two broad categories where I think the story is quite clear.

10. The first area where we have a good understanding is goods and services on ordinary competitive markets. An example is steel. Now that India has near-zero tariffs on steel, it is a globally competitive market. Many private companies produce steel. The old argument - about capital and technology required for steel companies being out of reach for the private sector - is no longer convincing. We are now seeing Indian firms exporting steel into the global market - which demonstrates that there is no gap in technology. And, we are also seeing Indian companies turning into multinationals and buying up global steel companies - which demonstrates that there is no gap in capital availability for Indian companies.

11. Under these conditions, private ownership works best. This should be seen at different levels. First, under ordinary circumstances, private ownership generates the best incentives for cost-minimisation, innovation, and dynamic adjustment of corporate strategy. This is not an ideological position. An extensive research literature has examined privatisation experiences from all across the world, and the findings suggest big gains in productivity from private ownership.

12. The second aspect of public versus private ownership concerns the issues that arise when a company approaches bankruptcy. In the private sector, bankruptcy is taken seriously. The fear of bankruptcy generates drastic responses in terms of selling off parts of the company, modifying business strategy, etc. These are healthy responses from the viewpoint of the economy. When an unhealthy company sells off a factory to a strong company, the control of assets of the economy moves into the best hands.

13. Output and employment are optimised through these adjustments. In contrast, in the public sector, managers have a tendency to be relatively relaxed about the prospect of bankruptcy. Drastic adjustments when faced with extinction do not take place, because the managers know that there is no real danger of extinction. Public sector companies are always able to access capital from the taxpayer. So there are two problems. Adjustments do not take place because of the lack of fear of extinction, and the taxpayer suffers from periodic claims on resources every time the company gets into trouble. There is also a deeper problem here. If in the market place, one of the participants like a PSU is operating under a "soft budget constraint" and that too with deep pockets, then it can adversely affect the performance and fortunes of even efficient private sector companies operating in that sector and such a market structure will systematically misallocate resources.

14. The second area where private ownership is clearly desirable is in regulated industries. In India, we are now seeing numerous regulated industries, ranging from finance to infrastructure, where a government agency performs the function of regulation and multiple competing firms are located in the private sector. Here, the simple and clean solution – government as the umpire and the private sector as the players – is what works best. This configuration is used in every advanced country, and we in India also face the challenge of setting up this architecture of government as regulator with massive investment coming in from the private sector which builds multiple competing firms.

15. In many of these industries, we have a legacy of government ownership either directly by government departments or in the form of PSUs. The problems described above are very much there: productivity tends to be lower in public sector companies, the fear of bankruptcy is absent, and the risk of asking for money from the taxpayer is ever present. There is an additional issue. This is the conflict of interest between government as an owner and government as the regulator. For instance, the formulation and implementation of competition policy will be much vigorous and fair if government companies are not out of action. Look at the recent example of government's various policy measures to support Air India. Many of these can be construed as anti-competitive as these vitiate the playing field for our private airlines.

16. India's future lies in building a new institutional architecture with government as regulator and with the private sector doing investment. There is a problem when the government is conflicted. If the private sector feels that the regulator will not be an unbiased umpire in the competitive

process, because a ward of the government is one of the players, then this makes the private sector feel uncomfortable. In the eyes of the private sector, this is a political risk. To pay for higher risk, the private sector demands a higher return. Fewer projects are implemented: the magnitude of investment goes down. With a higher rate of return on capital demanded by the private sector, user charges go up.

17. If we think of the next 25 years, a very substantial portion of the investment in all regulated industries in India is going to come from the private sector. It would be myopic for the government to have a regulator who is conflicted, which reduces the quantum of investment and drive up user charges. It makes more sense for the government to reorganise itself, shifting into the role of the umpire and away from the role of the player. We must move towards a simple and clean solution: government as an umpire and the private sector as players.

18. There are other areas where there are shades of grey or complexities. For instance, natural resource based industries such as upstream hydrocarbons sector. Here, there is a strategic issue as well as the issue of optimal appropriation of the underlying vast resources rent. Similarly, the role of government vis-à-vis universities is also complex. Barring such a few but key areas, I feel quite confident that we can confidently set about reformulating the activities of the State in the following two key areas. Firstly, the State should not be producing things which can be produced in competitive markets: this covers areas like steel or aluminium or cars. And secondly, the State should not be a player in regulated industries: this covers areas like airlines, running railway trains, shipping, telecom, banking or insurance.

19. A useful way to visualise this is essentially as a balance sheet adjustment. Suppose the government undertakes a portfolio adjustment, where Rs.10,000 crore of shares of Air India is sold and used to build 2000 kilometres of highways. Let us trace through the full implications of this. Even if Rs.10,000 crore of shares of Air India constitute a minority sale (i.e. 'disinvestment' in the Indian jargon), then certain efficiency gains are obtained. We now have our own empirical evidence which show that the mere act of listing induces improved productivity. Four channels seem to be at work: listing induces increased transparency, the stock market brings pressure on senior managers by doing daily performance evaluation, corporate governance is typically improved after listing, and to the extent that employees are given some shares, they become more aligned towards the growth and success of the organisation.

20. If Rs.10,000 crore of shares of Air India constitutes a majority sale (i.e. 'privatisation') then even bigger efficiency gains are obtained. Extensive international evidence shows that productivity goes up strongly after privatisation. The increase in India's GDP because of a better run Air India is the first gain from the proposed portfolio adjustment. The second gain from the proposed portfolio adjustment lies in obtaining an additional 2000 kilometres of highway. The benefits for India of this public asset are simply enormous. The 2000 km of highway that we do not have is the opportunity cost that we suffer every year owing to an investment of Rs.10,000 crore in Air India.

21. In short, I am proposing that it makes a lot of sense for India to undertake this portfolio adjustment of public sector assets to switch from owning Air India to owning highways or public health infrastructure or augmenting "environmental capital". I want to emphasize the full picture. The motivation for disinvestment or privatisation should not be narrowly seen as being only about maximising the proceeds from the sale of assets. The real big gains come from the full picture. We gain when the private sector obtains higher productivity (and this happens even with mere disinvestment, but it happens much more strongly with privatisation). We gain when the private sector becomes more comfortable bringing capital into investing in India in regulated industries. And, we gain when the government is able to build highways and canals, metro systems and railroad, which are crucial for India's growth and legitimately belong on the government's balance sheet.

22. We may embark on disinvestment today, but we have to think about the end-game which is privatisation, where the government fully gets out of the picture. How do we want to approach the ownership and governance of PSUs? The two broad approaches that can be adopted for privatisation are 'strategic sales' (where a controlling stake is sold to one buyer) or 'open market sales' (where shares are sold to the public at large).

23. There are three arguments which favour strategic sales:

a. In some situations, the buyer brings in essential new technology or expertise;

b. The buyer can exert sound governance inputs into the firm, and has incentives to do so owing to the large stake, and

c. The buyer can decisively displace government as the controller of the firm.

24. Other arguments in favour of strategic sales are somewhat suspect. For example, the argument that strategic sales fetch higher prices raises concerns. If the valuation of the buyer is solely driven by expectations of improved dividends from the firm, then there is no difference between his valuation of shares as compared with those of the broad public. If a buyer is willing to pay much more than the wide public, this would generally mean that the buyer plans to extract private benefits (i.e. steal) from the company, at the expense of minority shareholders. Such a transaction needs to be questioned.

25. Strategic sales of large public sector companies such as Vizag Steel or HPCL are more likely to encounter operational and political difficulties. They yield reduced competition when existing incumbents take over such large PSUs. Most importantly, strategic sales serve to increase the concentration of power and wealth in the hands of a few hundred families of the country.

26. Strategic sales are often attractive owing to the perception that they yield higher proceeds. Perhaps, in the case of smaller public sector companies operating in competitive markets, strategic sales may be an easier option. However, as emphasised earlier, the full impact of privatisation lies in its impact on GDP growth and not just on maximisation of proceeds. There are other dimensions of the privatization process in which strategic sales fare poorly.

27. Apart from strategic sales, open market sales are an important instrumentality for disinvestment, and should not be overlooked in our policy efforts. Open market sales are the path to obtaining dispersed share ownership, widely-held, professionally managed companies, and creation of widespread shareholder wealth. A disinvestment strategy based on open market sales would strengthen institutions and corporate governance in the country.

28. At the simplest, in cases where a strategic sale has been completed, and a new management team is clearly in the saddle, GOI can eliminate the residual shareholding by selling on the open market. For firms where no strategic sale has taken place, GOI can privatise through open market sales designed to deliberately disperse share ownership over a very large number of households, and create professionally managed, widely-held companies.

29. India has now growing experience of good corporate governance by professional management teams with widely dispersed shareholding,

where no one family has a controlling stake in the company. Some of the best-run and most-respected companies in India, such as HDFC, Infosys and L&T, are widely-held, professionally managed companies.

30. According to CMIE data, there are 300 companies in India today where the 'promoters' control below 10%. In each of these companies, the managing director and the rest of the top management team do not own a controlling stake in the company, yet these companies continue to function without being captured by other firms or individuals. This suggests that we do have significant skills and institutions in the country in the creation and operation of professionally-managed, widely-held firms.

31. The disinvestment or privatization program could explicitly target conversion of the larger PSUs into widely held, professionally managed companies, as an alternative to strategic sales which explicitly give over control of the company to a narrowly defined buyer. There could be provisions in the disinvestment mechanism that creeping acquisitions – which are currently regulated by SEBI – would not be permitted for a few years. For instance, there could be a rule requiring that no one individual or firm could own more than 5% of the firm for a period greater than five years. This would give time for the professional management team to develop modern corporate governance mechanisms. Such an approach, I believe, can be also applied to disinvestment in our banking sector.

32. India already knows quite a bit about having well-run widely held and professionally managed companies. PSUs which turn into private, widely-held, professionally managed companies could perform a valuable role in economic policy by strengthening this crucial part of the economy.

33. There is another dimension in which dispersed share-holding makes a lot of sense, and that is the political economy. If the disinvestment process is designed appropriately, it can lead to dispersed share ownership amongst crores of households. This could have enormous economic and political consequences. It would help in sharing the benefits of disinvestment with the people of India; it would improve support for the reforms process, and improve the stake in the functioning of the country as seen by households.

34. The significance of dispersed ownership is not limited to the economy. Dispersed ownership would also have beneficial impact upon democracy. An exclusive reliance on strategic sales would greatly increase the wealth and power of a few hundred families in the country. Dispersed

ownership, spread across crores of households, would spread wealth across a much larger slice of the country.

35. As an example of an international experience, it has been argued that the exclusive use of strategic sales in the privatisation process of some large Latin American countries was detrimental to obtaining dispersion of wealth and income in the country. We should seek to avoid such an outcome in India.

36. In the international experience, open market sales have been widely used in all major countries which have strong capital markets and democratic institutions. Among OECD countries as a whole, in the decade of the 1990s, two- thirds of privatisation proceeds were obtained using public offerings of shares in the stock market.

37. The stock market in India has made enormous progress on technology, whereby millions of investors now access the market using tens of thousands of satellite terminals and Internet trading. Mutual funds, banks and FIIs also exclusively trade through these computer screens. In the future, we could see foreign investments brought into India for FDI purposes become indirectly deployed into purchasing shares in the disinvestment process also.

38. Thus, selling shares through these screens is a powerful tool for accessing a very large investor base, which includes Indian retail households, Indian institutional investors such as banks, insurance companies and mutual funds, and foreign institutional investors. This is in contrast with the narrow group of buyers who interact with GOI on strategic sales.

39. When shares are sold in India, they are accessible to foreign buyers of shares through the FII route. This channel can be strengthened by further liberalisation of the entry rules into FII status, and increasing the fraction of shares which can be held by FIIs. In contrast, when shares are sold in London or New York through the GDR or ADR route, they are not accessible to domestic buyers. Hence, disinvestment within India is the channel through which the largest possible investor base can be accessed.

40. The primary market in India is a large conduit for selling shares and bonds. The disinvestment process could creatively exploit the sale of convertible bonds, exchangeable bonds, or exchange-traded warrants, thus better catering to the needs of retail investors, and current market conditions.

41. From an international perspective, strategic sales have been heavily used in countries which lack domestic capital markets, such as the erstwhile communist countries. This is not a constraint that India suffers from. The National Stock Exchange and the Bombay Stock Exchange are now amongst the largest exchanges in the world, measured by the number of trades per year where they occupy ranks 3 and 7 respectively. The stock market mechanism in India today – using electronic trading, clearing corporation, depository, and T+3 settlement coupled with vibrant equity derivatives markets – is now up to the best international standards.

42. The incentives of employees of PSUs could be influenced by sale of shares, and employee stock option plans (ESOPs), whereby every employee in the company would end up having a stake in obtaining a higher stock price. This would serve to align the interests of employees with the interests of owners, and encourage support for the disinvestment process on the part of employees. This is another attractive feature of the strategy of selling shares widely, instead of doing strategic sales to a few.

43. One of the important areas where the disinvestment process should seek to make continued progress lies in the domain of companies where the first listing has been achieved, and a clear secondary market benchmark price exists. For these companies, there is no impediment to establishing a *steady and ongoing* mechanism for GOI to gradually reach 0% shareholding.

44. There are concerns about the impact upon prices when GOI sells shares of (say) CMC, which is listed on the stock market today. However, it is important to see that the valuation of CMC is fundamentally driven by the growth prospects of dividends paid by CMC. When the ownership of shares changes from GOI to some other hands, it does not (in itself) alter the number of shares, and it does not alter the prospects for dividend growth. Hence, sales by GOI are fundamentally different from fresh equity issuance, which dilutes the cash flows of the company and diminishes share prices.

45. A transaction where government sells shares could have a temporary impact upon market prices. This can be contained using two tools: the call auction and a sequence of pre–announced small transactions.

a. **Call auction** The call auction is a computerised market mechanism through which buyers and sellers discover a single price which clears demand and supply. It is used, for instance, to discover the NYSE opening price. The call auction is very effective at clearing large blocks of supply and demand, while giving all transactions a single price (i.e. zero 'impact cost').

It is possible for the National Stock Exchange (NSE) to build software which runs the call auction. Once that is done, the NSE opening and closing prices would come out of call auctions. This would offer GOI a mechanism to steadily sell shares using the routine processes of the secondary market, using a market mechanism specially designed to absorb large transactions without incurring market impact cost.

b. **Pre-announcement** A key element which should play a role here is a pre–announced schedule of sales. Government can make a public announcement about a program of future sales using the call auction. For example, GOI could announce that on the 1st of every month, 100,000 shares of VSNL would be sold on the NSE pre-opening call auction. This would serve as advance notice for myriad prospective buyers of VSNL shares to flock to the NSE trading screens on the 1st, thus generating demand for those shares. These sales would realise a value which is close to prevailing market prices.

46. Through such a program of pre-announced sales, GOI can engage in steadily selling shares in a simple, depoliticised way. Markets become volatile when they are surprised; by doing full pre-announcement of all future transactions, there would be minimal disruptive effects upon the market.

47. There is yet another instrumentality, particularly for partial disinvestment and this relates to the sale of under-performing or under-utilised assets of the PSUs. A prominent example of such assets is "land". Many of our PSUs have large tracts of land which have become very valuable with creeping urbanization and with growing reluctance to make land available to new industrial units. One central PSU alone in Bangalore has as much as 2000 acres of such underutilized land. In cooperation with the State governments, such land assets can be leveraged by the PSUs by making them available to new units. This will remove one of the new constraints faced by Indian industries. When one includes such land assets of the departmental enterprises such as Railways and Port Trusts, a mind boggling amount of resources will be available for the government for restructuring its balance sheet and for further industrialisation and alleviating housing constraints. This is also true for the state level public sector enterprises.

48. There is one additional point, and this relates to the policy for deployment of resources generated through disinvestment/privatisation. According to current policy, this is to be channelized through the National Investment Fund. I would argue that this is a restrictive policy and we should liberalize this fully by allowing the government to use these resources as a part of the budgetary resources to create new public capital assets –whether in the form of better urban infrastructure by providing capital grants to our cities or for revamping country's energy base through ambitious solar energy programme or the expansion of rural road network or for recharging country's depleting water bodies and cleaning of rivers. This would require the Union government sharing the proceeds from disinvestment or privatization with the State governments on a systematic basis on the lines of the Finance Commission's devolution formula for the sharing of union taxes with the States.

49. For coming decades, water, environment and urban infrastructure are going to be the key binding constraints on India's growth ambition. To remove these binding constraints, we will require large investments to accelerate country's march towards high quality growth. I am sure you will agree with the view that disinvestment and privatisation policy has now assumed strategic importance in our country.

50. We should recognize that disinvestment is an area of economic policy with multiple objectives. The most important objective should be that of increasing the efficiency with which the labour and capital, that is in existing PSUs, is converted into GDP. In addition, other auxiliary goals include enhancing investment in the country, creating new traditions of corporate governance, catering to consumer interests by maximising competition in product markets, and reducing the stock of public debt. An important positive impact of disinvestment upon our fiscal problems would flow through a higher GDP growth.

51. Policies on disinvestment must be particularly mindful of its ramifications to the political economy. The disinvestment process can lead to dispersed share ownership amongst crores of households. This would disperse wealth in the country. It would help create a middle-class constituency which has a stake in the profits of PSUs and (more generally) in the economic well-being of the country. This could have larger ramifications for the reforms program.

52. The design of disinvestment policy needs to cater to these multiple goals. In particular, a narrow focus upon maximising proceeds is unlikely to yield sound policies on disinvestment.

53. In terms of implementation, the recent successes with strategic sales have been a very important achievement of the disinvestment program. At the same time, open market sales are also a useful instrumentality in pursuing disinvestment. Strategic sales are attractive in decisively displacing government from the driver's seat, but suffer from many other important weaknesses which I have already outlined. Dispersed public ownership of PSUs particularly of our large PSUs is attractive in many ways, but requires obtaining sound governance. Towards this, we need to guard against a risk of PSUs being captured by managers, which can happen if control is not contestable and governance is weak.

54. There is a strong role for utilising AMCs for managing the disinvestment process, and for performing corporate governance functions for PSUs pending complete disinvestment. There is also a need for building a consensus around extending the domain of disinvestment to PSUs in the financial sector. In a recent thoughtful article, Dr. Ajit Ranade has persuasively argued for such a strategy as there is a dire need to capitalize our banking sector. I agree with him that a relatively under-capitalized banking sector will considerably slow down the Indian economy.

55. To sum up, we need a bold and imaginative programme for disinvestment and privatization calling for restructuring of the portfolio of the country's "public capital assets". Clearly, I am not asking for a retreat of the State but essentially re-engineering of its portfolio of public capital assets. This will help our country meet the challenges of the first half of the 21st century just like our PSUs helped the country in the second half of the 20th century to overcome our industrial backwardness.

56. I thank you all for your attention.