Small-scale Industries in the Age of Liberalization
Sebastian Morris
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Disinvestment and Privatization in India: Assessment and Options
R. Nagaraj
Asian Development Bank
India Resident Mission (INRM)
4 San Martin Marg
Chanakyapuri
New Delhi 110021

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Sebastian Morris is Professor at the Indian Institute of Management, Ahmedabad.
Rakesh Basant is Professor at the Indian Institute of Management, Ahmedabad.
R. Nagaraj is Professor at the Indira Gandhi Institute of Development Research, Mumbai.
Foreword

The India Resident Mission (INRM) Policy Brief Series is sponsored by the Asian Development Bank (ADB) and is designed as a forum to disseminate findings from policy research work undertaken on the Indian economy. The series is primarily based on papers prepared under the Technical Assistance (TA) ‘Policy Research Networking to Strengthen Policy Reforms in India’. The main purpose of the TA was to provide assistance for developing policy research networking capacity, in order to build support for, and consolidate the reform process. The INRM Policy Briefs provide a nontechnical account of important policy issues confronting India.

Tadashi Kondo
Country Director
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Introduction

Small firms in India have a crucial and seminal role to play, which arises out of both the late industrialization context and the particular historical experience of industrialization that has contributed to the evolution of the industrial structure. Analyzing the Indian reality in the context of the experiences of Japan and East Asia and the insights of Dennis Anderson (1982), it is argued that existing macroeconomic, trade, and exchange-rate policies do not favor rapid growth and transformation of small firms, even as they do not favor manufacturing. This is worrying because today Indian manufacturing has to compete with many countries, but notably the dynamic East Asian.

Small firms’ comparative advantages lie in manufacturing especially in items that involve a greater share of value added from labor—particularly semiskilled and skilled labor—and in the Indian context even unskilled labor. Manufacturing is also the most tradable of all sectors, and especially of output that is standardized, competitive, and has a long shelf life. Successful late industrialization episodes show the crucial role of labor-intensive manufacturing in transforming the economy, especially in exports in the early phase of the transformation (Kojima and Ozawa 1985). Since small firms have a comparative advantage in labor-intensive manufacturing, and this is amplified by the schism in the labor market. Therefore voluminous exports that exploit
the country’s labor cost advantage are not possible without the small firms’ dominant and productive role. This also gives criticality to the key complementary role of larger firms—that give out subcontracts, aggregate, and trade in small-firm products. Indeed, in a micro-action sense promotion of such trading houses and integrators as also freeing small firms to perform this vital role may be crucial (Morris 1998). The key role of trading firms is amply observed in the case of East Asia, especially Japan.¹

Policy Distortions Constraining the Small-scale Sector

A variety of policy issues have been cited for the inadequate performance of the small-scale sector in India. Some of these are general while others relate to specific issues. We begin with some general concerns.

Unrecognized Macroeconomic Determinants

For most scholars, small-industry policies have typically meant narrow sector-oriented policies such as reservation, duty concessions, directed credit, and government regulation, controls, and extension. The major impact of macroeconomic policies—both monetary and fiscal—on the sector has been almost entirely missed in both government’s discussion of policies and academic debate. Similarly, infrastructural policies and development, which specially impinge on the sector—since most firms cannot develop their own infrastructure—have got inadequate systematic attention (Morris et al. 2001: Morris, ch. 1, ‘Towards a Conceptual and Analytical Framework’).

The ‘Protection’ Syndrome

The unstated but manifest assumption in policy has been that ‘small firms need essentially to be protected’. In the past this approach sought to develop small firms as an integral part of the Mahalanobis strategy. It was then believed—quite wrongly, as subsequent developments and the historical experience of Japan and elsewhere in the late industrialization context reveal—that the traditional, typically handicraft-based, industries producing a wide variety of consumer products could gradually and through continuous investments and upgrading of technology evolve into modern medium and small enterprises (SMEs). This assumption could at best have been right for a minuscule fraction of the small firms which were largely household-based. Protection from large firms was integral to the Mahalanobis strategy. Protection was sought to be built, inter alia, by the ban on capacity addition in industries like textiles in the mill sector. Such bans continued until 1984, to the great detriment of the Indian economy. This measure and overvaluation of currency negated completely the industry’s potential to ride the postwar penetration of manufactured goods markets of the advanced capitalist countries (Morris et al. 2001: Morris, ch. 6, ‘Infrastructure Constraints and Small Firms’).

Losing the Manufactured Export Boom

India among all developing countries had the best endowments and initial conditions to take advantage of falling tariffs over the various rounds of the General Agreement on Tariffs and Trade (GATT) not only in textiles but in a whole host of light engineering, electrical, ceramic, and other manufacturing industries in the medium and large sectors. But given the massive biases of the establishment against exports—compounded by economic strategy and macroeconomic policies—the only option for manufacturing industries was to resort to import substitution. Also, while the large sector was expected to focus on high-tech and long-gestation capital and basic material industries, the manufacturing and light industries were to remain small. The strict curbs on the ‘large’ consumer goods sector, however, failed to promote the expected flowering of the small firms to produce consumer goods cheaply.

Orthogonal Policy

Essentially, the policy was orthogonal to the evolving industrial structure. It is only since the mid-1960s that the modern small-firm sector could begin to emerge due to the expansion of the economy and de facto fragmentation of large firms (given the capacity curbs and the widening schism in the labor market).

In the 1980s the modern small-scale industries had come into their own, including through subcontracting and vendor relations with large

¹ In China though, given the little schism in the labor market, industry size has hardly any effect on the price paid for labor, so that exploiting labor, and the development of complementary (competitive) factors is possible within the same managerial hierarchy.
the country's labor cost advantage are not possible without the small firms' dominant and productive role. This also gives criticality to the key complementary role of larger firms—that give out subcontracts, aggregate, and trade in small-firm products. Indeed, in a micro-action sense promotion of such trading houses and integrators as also freeing small firms to perform this vital role may be crucial (Morris 1998). The key role of trading firms is amply observed in the case of East Asia, especially Japan.1

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firms (Nagaraj 1986) and exploitation of the schism in the labor market. But policy continues to assume that small firms need protection. In the process, the major distortions against the small-firm sector continued and have deepened. Even in the 1990s some of these distortions were only partially corrected while others intensified.

**Political and Social Agenda in Small-industry Policy**

In the period of redistribution (1965 to 1980) and continuing well into the 1980s, SMEs began to be promoted also to ‘diversify the social basis of capitalism’. The important measures taken in this direction were reservation, preferences in public procurement, credit and equity support, and increasing differentials in the taxes paid by small firms vis-à-vis the large (Desai and Taneja 1993; Morris et al. 2001: Morris, ch. 7, ‘Finance and Small Firms’). Many technology-based small firms did come about as a result of these policy measures and import substitution was taken deeper. But the negative aspect was that the small-firm policy continued to focus on the entrepreneur and the surpluses he could make rather than economic benefits to the country.

**The Regional Development Agenda**

Ever since the Mahalanobis Plan regional development was seen as integral to the development of small firms. Small firms were seen as locatable virtually anywhere as long as the basic physical infrastructure—water, electricity, roads, etc.—could be provided. Simplistic statements, such as ‘steel plus electricity, with a policy of regional dispersal equals regional development’ almost became dogma. The neglected truth was that small firms are greatly dependent upon agglomeration economies and access to city serving functions. The result was disastrous. Industrial estates that lacked access to reasonably sized central places failed. The survivors had to overcome and bear the high cost of inappropriate location. Many SMEs were pushed into inappropriate locations through fiscal and other concessions and administrative measures. Not given enough time to overcome location-related infirmities, as these push measures were retracted, they became unviable and closed down.\(^2\)

Current Macroeconomic Policy Distortions

Many specific macroeconomic policy-induced distortions work against the small-scale sector.

**Tariff Inversion**

Tariffs are not entirely free from inversion, that is, higher rates on inputs like steel, plastics, energy, and metals semi-manufactured than on finished products. This inversion which, since the reform was at its peak in the late 1990s, has declined but not disappeared. Inversion particularly hurts small firms since they have a comparative advantage in ‘manufacturing’ in its original sense. Additionally, the very high uncompensated costs of energy, especially electricity and petroleum-based energy, which are not vatted even for export industries, impose large costs on location of manufacturing (Morris et al. 2001: Morris, ch. 5, ‘Small Firms and Exports’).

**Conservative Monetary Policies**

Monetary policies have been unduly conservative and have typically targeted money supply rather than interest rates. This tended to arrest any potential growth impetus in the second half of the 1990s. Once inflation was in control (since 1996 inflation is almost entirely on the supply-side and caused by rising agricultural and fuel prices) the policy should have shifted to managing interest rate and supporting fiscal expenditure, especially when the fiscal expansion has been on account of (efficiently directed) infrastructural spending. In needlessly curtailling demand, therefore, the manufacturing sector has realized poor growth relative to its potential. This hurts the small-firm sector.

**Exchange Rates Not Aggressive Enough**

Exchange-rate policies have been particularly hurtful to small firms, especially in areas dominated by SMEs, like textiles. The effective exchange rate of the rupee has been higher than the value that prevailed at the end of the stabilization period. If it can move back to those values the small firms’ export can rise, as can manufactured goods production. It is worth remembering that export-led growth economies greatly undervalued their currencies for long periods to prime the export engine.

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‘Tight’ Credit

Credit is the single most important constraint for small firms. When large capital flows both on account of portfolio flows and direct investment are sought to be sterilized to hold on to monetary targets, tight credit conditions are imposed on domestic firms. Such credit tightening operates asymmetrically between firms that have access to foreign capital inflows and foreign direct investment (FDI) and domestic firms that lack such access. Small firms, being dependent upon intermediated banks for finance much more than other firms, are particularly affected.

Also, the share of bank savings in total savings has been steadily declining. The allowed high spread to banks, control over deposit rates, numerous incentives for so-called ‘small savings’, and tax deductions allowed on other bonds and funds deflect savings from fixed bank deposits, curtailing intermediation. Since SMEs have a comparative advantage in accessing bank funds (large firms can go to markets) these distortional policies implicitly discriminate against SMEs. The distortions have not reduced with ‘reform’ of the financial sector nor has the banks’ ‘need’ for large spreads declined. Structural distortions in the regulation of banks and in incentive structures within banks accentuate the SMEs’ credit difficulties. Under tight credit conditions there is a triple squeeze on them: (a) asymmetrical restrictions; (b) delayed payments; and (c) squeeze in credit lines in purchases.

Perverse Incentives in Banks

Banks have poor incentives for accounts development, both on account of restricted interbank competition as also their internal processes. Since 1995 the tendency has been to shore up banks’ profits by ‘allowing them’ a large spread between lending and deposit rates by administratively fixing deposit rates. This large and continued spread, the fact that banks earn high interest on statutory liquidity ratio (SLR) securities (risk-free rate being high due to monetary policy), accelerates disintermediation since banks have little motivation to lend out of the smaller share of savings that they collect. Small firms, inherently dependent on credit markets, suffer as a result.3

Erroneous Sickness Data

In reporting the data on lending to small firms banks include loans made out under many sop programs of the Planning Commission. Most of these are giveaways at best. Naturally, this magnifies the scenario of overall sickness of and loans outstanding against small firms. In reality, the nonperforming loans outstanding against small firms are much smaller than in lending to medium and large firms. Such erroneous data biases not only outsiders against lending to small firms but the bankers themselves.

Underdeveloped Venture Capital Industry

Compounding the problem of nonavailability and high cost of credit is the fact that venture capital institutions in the country are shy of exploiting emerging entrepreneurial opportunities for small firms. They suffer from a banking mindset, bureaucratic norms, and target orientation, and focus on the growth phase of enterprises.

Reservation

Though there is widespread recognition that reservation should go, being anathema and in complete contradiction with the tenets of a liberal economy, the problem has been viewed as being political. If the sector as a whole could have experienced high rates of growth, desreservation should have been easy enough. Rigidly and permanently defining activity distribution between small and large firms, the distortions imposed by reservation essentially hurt the dynamic development of competencies within the economy: they stifle the unfoldment of dynamic comparative advantage by checking a continual evolution and movement of the boundary between small and large and in general between markets and other modes of coordination (Desai and Taneja 1993; Morris et al. 2001: Morris, ch. 4, ‘Reservation Quality and Government Purchase’).

Looking Ahead—Policies for Energizing Small Firms

A liberalized environment cannot accommodate policy of the discretionary case-by-case variety or those that necessarily result in incom-

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petence and waste. Policies espousing entry barriers are therefore out of place. Sector- and industry-oriented policies similarly would also have to be driven by their incentive effects.

**Factories Act**

Tempered by this perspective, the Factories Act, which makes the labor market inelastic and contributes to its schism needs to be modified. In the application of the Act we suggest the following: (a) The criterion of ‘with and without the use of power’ be dispensed with. (b) The Act be applied comprehensively to all units with more than fifty employees, including the entrepreneur and family labor. (c) All other (small) units be brought under the Employees Compensation Act, to shift the focus of government to implementing the law rather than to its systematic vitiation by authorities and entrepreneurs alike.

**Credit-related Issues**

**Incentivization of Credit.** Priority sector targets must be incentivized. There needs to be a policy shift from targets or quotas (small firms as targets for priority sector lending) to incentives to banks for lending to small firms. Instead of viewing lending to small firms as a constraint, banks would then begin to see it as an opportunity. Incentivization will also reorient banks towards real assessment rather than merely going by the rulebook, as is being done now.

**Modified Regulation of Banks.** The Reserve Bank of India (RBI) would have to reorient and loosen its direction and supervision of banks, allowing them operational freedom and granting performance-based incentives. A dynamic heterogeneity would then result in the way banks manage their internal processes. Responsible risk taking in lending would have to reemerge, encouraging accounts development among small firms.

**Tax-based Incentives.** Tax-based incentives for banks and financial intermediaries are possible. Specifically, we recommend that the tax rate applicable to a bank or a financial intermediary with a portfolio of $x\%$ in small firms in its total lending portfolio be: $(1-x)^*T$, where $T$ is the normal tax rate applicable. This tax concession should be extended to all institutions whether term lending or in working capital provision, banking or otherwise, and whether in the private, cooperative, or public sectors. An additional incentive for banks, based on SLR and cash reserve ratio (CRR), can be provided as follows: If the normal statutory reserve requirement is $S$ (SLR+CRR), then actual reserve requirement on a bank lending to small firms can be made equal to $S*(1-p\times x)$ where $p$ is the benefit on $S$ in lending to small firms; $x$ is the share of small firms in the bank’s total lending portfolio. We would suggest, at this juncture, $p = 0.20$, i.e. a 20% reduction in $S$ for a bank that has its entire portfolio (highly unlikely) in small firms.

**No Concessional Interest.** Concessions on interest rates are dysfunctional, whether on term or working capital. Nevertheless, a ceiling of 4% over prime lending rate (PLR) would be called for, to avoid the problem of adverse selection. Similarly, for export-related credit to small firms, rates not more than 2% above the lowest export credit rate should apply. We see a process whereby foreign institutional investors (FIIs) and banks would, over a period, develop their sectoral and client size and type specializations, and find the right balance between diversified and specialized portfolio, optimizing between risks and returns.

**Portfolio Tradability.** Tradability of loan portfolios of small firms could be retained along with targets, during this period of transition. With the financial sector reforms well underway, the older way of targeted lending and entirely specialized financial intermediaries are dysfunctional, since portfolio freedom (arising from the need to diversify risk) would be a major element of financial reform. This necessarily means that government instead of concerning itself with whether the Small Industries Development Bank of India (SIDBI) or state finance corporations (SFCs), etc. have met their targets, should put in place incentives, as mentioned above, for SIDBI, SFCs, and other financial institutions and banks. It is natural that nationalized banks, cooperative banks, smaller private (especially domestic) banks, and so-called rural banks, would have a larger portion of their portfolio in small firms, with the proposed incentives and with their comparative advantage in having a vast network of branches.

**Reform of Development Finance Institutions.** All SFCs would have to quickly restructure and refocus on promotion of new enterprises typically in such areas, and in activities where vast positive external effects are anticipated, such as in technology-based small firms, promising industries, nodal industries, industrial estate corporations, in extending specific infrastructural support to existing clusters of small firms, etc.
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Other Credit Instruments. Small firms with subcontracting relations with large firms are squeezed by the latter, particularly during credit crunch. Acknowledging this fact, the Delayed Payments Act should be scrapped and replaced with a scheme for discounting small firms’ receivables from the large firms, by banks and financial institutions. The scheme would necessarily have to provide for some additional benefit (either higher credit limits or lower rates) for participating large firms. Such a scheme would go a long way in making timely credit available to small firms that sell to large firms of repute. The risks in such credit provision are few and the costs of intermediation very low. It can be a major window of profit for banks.

The Problem of Collateral. Banks typically hold collateral far above their exposure to small units. Little is known about the actual market value of collateral held by banks. RBI should immediately institute a study to bring to light the magnitude of the problem. The potential of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, to reduce the risks in lending, needs to be unlocked.

Venture Capital: Opportunities are Large. Venture capital can have a major role in industries with much technological change which, however, would be a tiny part of the sector. Venture capital operations remain rudimentary in India. There is a case for financial institutions to develop strong venture capital arms to finance innovative small firms.

Tax Concessions

There is a twin logic for continuing with excise duty concessions for small firms: (1) The cost of excise registration and dealing with excise authorities is too large. (2) The ‘fixed’ component of the excise cost cannot be spread over a large value of turnover. Only significantly lower excise rates for small firms could compensate them sufficiently.

Overcoming Tariff Inversion

Inversion in tariff needs to go or be neutralized by strategic undervaluation of currency. The effect of tariff structure on the competitiveness of small firms has not been adequately recognized. Despite import liberalization the tariffs on materials like steel, copper, many nonferrous metals, plastics, many chemicals, paper, etc. remain high in comparison to tariffs on manufactured goods (other than consumer goods). The resultant ‘inversion’ in the tariff structure specifically hurts small firms, since their potential to produce tradables (export- and import-competing manufactured goods) is large.

Cluster Approach

Many traditional small firms are in clusters, and a cluster-oriented approach is important for their success. Indeed, cluster orientation would be necessary for any micro-action or extension. The necessary ingredients for the success of such an approach would be (1) extension built around associations and leaders from the clusters; (2) protection to nonprivate but regionally defined collective brand names such as ‘Kanchipuram’, ‘Tangail’, ‘Aligarhi’, ‘Moradabad’, ‘Jetpuri’, ‘Kattaki’, etc.; and (3) financing of collectives via financing of cooperatives/associations.

A strategy based on leveraging on trade names/brand names, many of which could be argued to be geographic indicators, with much equity world wide, would require immediate changes in our intellectual property rights (IPR) regime. Otherwise, we would lose out significantly in many market segments. The potential of the Indian market to create its own specific products, distinct from western culture, as incomes in India rise, is high. The element of geographic indicators has now been added in the new IPR legislation. How it is to be used to our advantage has to be worked out.

For more ‘modern’ clusters interlinkages among firms in and outside the clusters are critical. Policies must facilitate these linkages. These range from IPR policies to regulation of FDI as well as the ability of large firms to hold equity in smaller firms. There is already movement in these areas and one may need to look for fine-tuning these policy instruments. Insofar as capabilities of local firms determine their ability to build linkages, support to upgrade their processes and practices would be useful.

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**Infrastructure Constraints**

Investments in infrastructure, especially general roads, power, railways, and water supply would help to improve the performance of small firms significantly. This is particularly important in clusters.

India has at the moment absolute advantages in off-shoring many activities in these industries, and with clusters like Bangalore taking root the growth prospects are immense. But infrastructural and public services constraints and poor governance remain causes for concern. Correction of municipal infrastructure in a few cities is crucial to the growth of off-shoring activities. The limitations are obvious but their solutions may require a deeper understanding of the root of failure.

**Making Way for Rapid Growth of Industries**

The opportunities provided by modern industries that have large export potential due to the unfoldment of the country’s long-term comparative advantage—technology-based and skilled-labor-using industries such as information technology (IT), biotechnology, pharmaceuticals, and automobile-oriented industries—also need to be exploited. Industrial transformation has rarely been the all-round and simultaneous growth of all industries. Some are bound to grow much faster.

The need of the hour is to optimize the growth of these industries. For example, clarity on regulations required for the emergence of clinical research organizations is a priority for the pharmaceutical industry. In automobiles, taxes are still very large and the inverted tariffs/high cost of materials and energy that are uncompensated hurt India as a base for manufactures.

**IPR Regimes**

In IT, biotechnology, pharmaceutical industries, and other related off-shoring activities the challenges lie in bringing about better IPR regimes that reduce the risk foreign firms face in their operations in India. In all these industries insightful IPR regimes would have to be worked out, balancing the interest of Indian firms and yet leading to much industrial relocation which can then bring its own spillover benefits. For example, introduction of a petty patent regime could considerably enhance the extraction of value from the many innovations that take place in the SME sector.

**Other Measures**

Many legal reforms need to be initiated immediately. One is merging the umpteen laws and regulations. There are, for example, over seven Acts/authorities that pertain to labor, ranging from the Employee Compensation Act to the Unionization Act, which could be merged into one. Governance reforms are also equally urgent. Small firms bear a very heavy burden in dealing with government. The long-pending need to get out of the inspector raj syndrome cannot be overstressed.

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Disinvestment and Privatization in India: Assessment and Options

R. Nagaraj

Introduction

The public sector contributes about a quarter of India’s measured domestic output. Administrative departments (including defense) account for about 8–9% of gross domestic product (GDP). The remaining contribution comes from a few departmental enterprises like railways and postal services, and a large number of nondepartmental enterprises. The latter include around 250 public sector enterprises (PSEs) owned and managed by the central government, mostly in industry and services (excluding commercial banks and financial institutions). At the state level production and distribution of electricity and provision of passenger road transport form the principal activities under the public sector, run mostly by autonomous boards and statutory corporations.

Poor financial return on the massive public investments has been an enduring concern. Many institutional reforms (most of them administrative) have been suggested to overcome the problems of PSEs’ autonomy and accountability. In the 1990s ownership reforms were also attempted consistent with the worldwide move in favor of private enterprise. This paper mainly addresses the issue whether Government should persist with the policy of ownership reform of PSEs.

1 The study is largely restricted to manufacturing and nonfinancial enterprises owned and managed by the central government.
Assessing the Principles, Premises, and Performance of the Disinvestment-Privatization Process

To begin with, is the disinvestment policy based on valid premises? Mainstream economics is largely ambiguous about the role of ownership in firms and focuses on how market structure affects their performance (Vickers and Yarrow 1991). Property-right theorists have emphasized the role of ownership on economic performance (Fama 1980). But in the twentieth century, with the separation of ownership from control in modern industry, there is a serious agency problem regardless of ownership. The view that the secondary capital market and the market for managers provide adequate discipline on a firm’s performance is at variance with evidence, especially from the US experience.

The Rationale for Disinvestment in India

It is widely believed that a large and growing share of fiscal deficit is on account of PSEs’ financial losses and selling them would restore fiscal discipline. Is it indeed true? While financial performance of the public sector needed improvement, the dismal performance was not, in the main, on account of the nonfinancial nondepartment enterprises. The two main reasons for growing fiscal deficit were (i) growing government expenditure and subsidies and (ii) poor return on investment in electricity, irrigation, and road transport. The real problem is, perhaps, not so much public ownership but pricing of public utilities and government’s inability to collect user charges, for a variety of political and social reasons.

Further, ownership reform as a policy measure has its limitations:

- Large-scale privatization must be ruled out considering (a) the shallow domestic stock market, (b) relatively small size of the private corporate sector, (c) the widespread political opposition to transfer of managerial control to foreign-owned firms, and (d) social costs of such transfers.

- In principle, disinvestment without a change in management is unlikely to make much difference to efficiency. It may help raise limited resources from the capital market, mainly reflecting government monopoly in the industry. But this is a costly source of finance with high transaction costs. Given excess liquidity currently in the financial system, it would be cheaper to sell bonds domestically to raise the required finances (Yarrow 1986).

If we admit that there are genuine limitations to selling off PSEs—the core of which belong to energy, infrastructure, and industries of strategic interest in national development—there is perhaps no credible alternative but to find ways to improve their functioning. But how to do it? One suggestion is to create industry-wise holding companies. For instance, the Arjun Sengupta Committee’s main suggestion (GOI 1984) was to create these as an institutional buffer between an enterprise and government. But such organizational form often implies creation of another tier of bureaucracy, undermining firm- or factory-level managers’ autonomy.

Admittedly, there are numerous PSEs with modest investments that operate in competitive markets or do not serve any strategic purpose. Loss-making units among these can be disposed of by selling their real estate by creating empowered committees of all their stakeholders. Workers are unlikely to oppose such a move if there is a reasonable and transparent sharing of proceeds of sale. The rest can be granted greater autonomy or given out to private parties on management contracts or

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2 Managers of firms tend to pursue their own goals which may conflict with those of shareholders (owners).

3 Despite considerable modernization of institutions and procedures of securities markets in the last decade, there are many shortcomings: (i) the market is still very shallow with a few scripts accounting for the bulk of the trade; (ii) volatility in the Indian market is one of the highest in the world; (iii) despite the phenomenal growth of the national stock exchange a small coterie of brokers at the Bombay stock exchange call the shots in the entire market. Thus, the India market continues to be what V. I. Joshi and I. M. D. Little (1996) aptly called the ‘snake pit’.

4 The size of India’s private corporate sector is relatively small, estimated to be between 10 and 12% of domestic output. Most private sector firms are small compared to PSEs that are targets of privatization.

5 For instance, in 1991–14 largest PSEs constituted 55% of value added and capital employed. The enterprises, in descending order in terms of gross block were: ONGC, BPC, NALCO, Rashtriya Ispat Nigam Ltd, BSR, Indian Oil, Neyvelli Lignite, MTNL, Indian Airlines, Shipping Corporation, IPCL, GAIL, Air India, and South Eastern Coal Fields.

6 PSEs need not necessarily have to be large and monolithic organizations. There is considerable scope for their rationalization.

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Lessons from International Experience

In Anglo-Saxon economies the secondary stock market acted as disciplining device on corporate performance and as market for managers. In principle, stock prices that summarize all publicly available information on the firm’s performance should provide adequate signals for managers to act optimally. The system also seems capable of providing risk capital to spur rapid technological progress, witness the role that venture capital played in promoting the Internet revolution. However, the agency problem poses enormous scope for abuse, with evidence provided by hostile takeovers and leveraged buyouts (Dore 2000), the recent implosion of some of the world’s biggest companies, astronomical rise in managerial remuneration disproportionate to performance of firms, and widespread abuse of stock options by top management in firms like Enron and Tyco at the turn of the last century (Stiglitz 2003).

To overcome some of the well-known shortcomings of the stock market—heeding Keynes’ advice and Greshenkov’s (1962) historical insights—‘follower industrializing’ economies of continental Europe and Japan evolved a bank-centric mechanism of financing of industrialization and corporate governance (Zysman 1983). In this system banks provide not only loans but equity as well, and closely monitor performance. The Japanese system of interlocking equity ownership centered around a main bank, called Keiretsu, with mutual stockholding leading to accountability and risk sharing, has overcome some of the widely observed informational deficiencies in the stock market-based system, leading to improved efficiency and growth over a sustained period (Aoki 1996).

At the same time, bank-centric systems have had their share of problems. While they were perhaps capable of engineering rapid capital accumulation and technological catch-up with the US, they were probably not nimble enough to finance risk taking to extend the technological frontier, as the experience of the 1990s demonstrates. Many blame the close and opaque nexus between firms, banks, and the bureaucracy for the Japanese debacle in the 1990s that still persists. Similarly, state-sponsored industrialization is believed to have been responsible for the East Asian crisis in 1997.

Although, learning from this experience there is rethinking in Japan and continental Europe about their institutional mechanism, bank-centric systems have been superior in promoting the postwar experience (1945–2000). Variants of the Japanese model of financing and governance have contributed in no small measure to the unprecedented success of ‘late industrializing’ economies of East Asia—as represented by the ‘rise of the rest’, to use Alice Amsden’s phrase (Amsden 2001). Thus, on balance, history and theory seem to favor a bank-centric system, at least in the early phase of industrialization.

Policy Options

From the foregoing, if we accept that the PSEs’ real problems are (i) dysfunctional political interference, (ii) constitutionally mandated procedural audit, and (iii) soft budget constraint, the following measures can be suggested:

- Reduce government holding to less than 50% by transferring share to mutually complementary firms by creating Japanese-style keiretsu, tied around a public sector bank or financial institution. For instance, interlocking of equity holding among steel, coal, and electricity firms; or petroleum exploration, refining, and petrochemical complexes. This would eliminate procedural audit and political interference in day-to-day operational matters.
- For public accountability managers may be asked to make presentations to parliamentary subcommittees on efficiency of resource use. At the same time, managers should have clearly defined security of tenure for say three or five years to ensure continuity and show measurable performance.
- Harden the budget constraint for PSEs by a clear sunset clause on budgetary support or government guarantee for loans, except for specific public purpose-oriented investments.
- Banks providing substantial equity and loans would, in principle, have an incentive to monitor PSEs’ performance. But who will monitor the banks? Given the increasing independence of the Reserve Bank, it is conceivable to devise a system where the central bank and other regulatory authorities have the mandate of appointing top managers of banks. Such delegated monitoring
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- To ensure that PSEs do not abuse their oligopolistic position in the domestic market, liberal open trade and investment regime could impart the discipline of the world market.

Conclusion

Realistic prospects for disinvestment-privatization of the public sector appear limited, since the bulk of public capital employed is in infrastructure and industries of strategic importance, where national interest demands public policy. Secondly, the argument for ownership as the principal basis for economic outcomes is not conclusive: evidence on privatization across the world fails to prove that private ownership necessarily and sustainably improves firm-level performance. History and theory also do not support stock market-based discipline, which is an inevitable result of disinvestment and privatization, to be the superior alternative.

How to design an institutional mechanism that limits the agency problem, puts hard budget constraint on firms, and reduces dysfunctional political-bureaucratic interference? The solution seems closely tied to financing of investment, with a financial system that provides resources for development and functions as a disciplining device on firms. In practice it would imply Japanese- and German-style interlocking of ownership of complementary PSEs tied together with a bank that enforces greater managerial accountability and encourages long-term outlook of output growth and acquisition of technological capabilities.

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