Inaugural address by C. Rangarajan, Governor, Reserve Bank of India at the `Conference on Disinvestment: Strategies & Issues' Organised by disinvestment commission, Delhi at Mumbai Wednesday, February 5, 1997

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Mr.Ramakrishna, Mr.Mankad and friends,

1. I am happy to be associated with this conference on Disinvestment. I believe this is part of the effort to ascertain professional opinion on the various issues posed to the Disinvestment Commission as well as to create public awareness of the various dimensions of disinvestment. Hopefully, such conferences will also lead to better appreciation on the part of the public of the need for disinvestment in certain areas.
2. Ultimately, the issues relating to disinvestment turn around three questions - why, how and how much. To some extent, these issues were addressed by the Committee on Disinvestment which submitted its report in 1993. As a background to answering these issues, we also need to look at the evolution of the role of public sector enterprise in our country as well as their performance. Much of this information is found in the discussion paper produced by the Disinvestment Commission.
3. The origins of public sector enterprises are manifold. The objectives range from building infrastructure for economic development to generating investible resources for development by earning suitable returns. Thus, the motivation extends from the theory of commanding heights to the provision of consumption goods at subsidised rates. Eventually, public sector enterprises are now spread over from coal, steel and oil at one end to hotel and breadmaking at another. The time has come to critically assess the sectors in which public enterprises must function. This is particularly important in the context that the resources available for the centre and states are limited and are needed for extending in a bigger way the social infrastructure. The Eighth Plan identified some of the principles governing public sector investments and stated:
    a. The public sector should make investment only in those areas where investment is mainly infrastructural in nature and where private sector participants are not likely to come forth to an adequate extent within a reasonable time perspective;
    b. The public sector must withdraw from the areas where no public purpose is served by its presence; and
    c. The principle of market economy should be accepted as the main operative principle by all public sector enterprises unless the commodities and services produced and distributed are specifical ly for protecting the poorest in the society. The Common Minimum Programme while emphasising the need to strengthen and reform the public sector enterprises had also commented that - "The question of withdrawing the public sector from non-core and non-strategic areas will be carefully examined."
4. The performance of public enterprises can be judged by several efficiency criteria. However, the financial performance assumes importance because one of the objectives of creating public sector enterprises was to generate investible resources for development by earning adequate returns. The picture in this regard is mixed. In the fiscal 1995, out of a total of 241 public sector undertakings in the central sector, 130

made net profits. The net profits amounted to Rs.12,120 Cr. The losses of 109 units amounted to Rs.4,910 Cr. It is also interesting to note that 10 enterprises contributed over 2/3rds of the profits.

Out of these ten, six were in the oil sector. The profits of the public sector enterprises would look less impressive if the oil sector is excluded. In fact, the contribution of the profit making public sector enterprises to the finances of central government in the form of dividends amounted only to Rs.1,440 Cr.

5. The reform of the public sector in general and that of the loss-making units in particular has assumed importance in the context of the financial strain under which all governments, both at the centre and the state, are now operating. The issue of how to handle loss making enterprise needs to be faced squarely.
6. One can move away from financial performance and judge the public sector enterprises in terms of technical efficiency, allocative efficiency and dynamic efficiency. Technical efficiency basically relates to the ratio of inputs to outputs. Allocative efficiency relates to correction of market failure leading to better allocation of resources than what will be decided by price-mechanism. Dynamic efficiency relates to innovations and technological development. Even in relation to these criteria, the results in relation to public enterprises are mixed.
7. Current profit and or current loss need not necessarily be the appropriate criterion for disinvestment. Merely because a unit is profitable, it does not qualify to continue to be public ly owned, unless it meets a well-defined felt need. Loss making units need not be excluded from disinvestment, if there are buyers who can make it profitable.
8. Before we go into the various issues relating to disin vestment, we must clear one semantic problem. Most often in India the term `disinvestment' is used rather than `privatisation'. Privatisation implies a change in ownership resulting in a change in management. Disinvestment in that sense is a wider term extending from dilution of the stake of the government to a level where there is no change in control to dilution that re sults in the transfer of management. If in fact in a particular enterprise there is dilution of government ownership beyond 51 per cent, this can result effectively in a transfer of ownership. The extent of dilution needs to be determined as part of the policy of disinvestment.

Why Disinvestment

9. Broadly speaking, there are two major reasons adduced for disinvestment. One is to provide fiscal support and the other is to improve the efficiency of the enterprise. The fiscal support argument has to be given due weightage. The demands on the governments, both at the centre and the states are increas ing. There is a compelling need to expand the activities of the state in areas such as education, health and medicine. It is therefore legitimate that a part of the additional resources needed for supporting these activities comes out of the sale of shares built up earlier by the government out of its resources.

It is sometimes argued that the resources raised through disinvestment must be utilised for retiring past debts and thereby bringing down the interest burden of the government. So long as government is a net borrower of a fairly large magnitude year after year, it does not make any material difference whether the resources are utilised to retire past debts or simply utilised as part of the receipts. In the latter case, it only results in a lower borrowing requirement. The second important argument in favour of disinvestment is the contribution that it can make to improving the efficiency of the working of the enterprise. Leaving aside the extreme case where the dilution results in the transfer of ownership, even in the case of disinvestment where the dilution is of lesser order and where the government control is still retained, the induction of public ownership can have a salutory effect on the functioning of an enterprise. It in creases the accountability of those in charge of the enterprise.

The shareholders would require to be compensated and this will in turn compel the enterprise to run more efficiently and earn more profits. This must be regarded as part of the reform and restructuring of public enterprise. Flexibility in ownership can in effect impart efficiency. In fact, the induction of the public into the ownership structure can also create conditions in which there could be greater autonomy for the functioning of the public sector enterprise. Disinvestment can therefore be regarded as a tool for enhancing economic efficiency.

How much of disinvestment

10. The second important issue with respect to disinvestment relates to the extent of disinvestment to be made in an enterprise. Obviously the level of disinvestment in an enterprise in any year should be derived from the target level of government ownership in that enterprise over the medium term. The target levels of ownership could be 0; 26 per cent to ensure limited control over special resolutions brought in in the general body meetings of the enterprise; 51 per cent to have effective control and 100 per cent for full ownership. The target level of disinvestment should be derived from the desirable level of public ownership in an activity or unit consistent with Industrial Policy.
11. The Discussion Paper quotes from a government document that the extent of disinvestment in strategic, core and non-core non-strategic sectors could be `Nil', 49 percent and 74 per cent or more, respectively. As quoted earlier, the Common Minimum Programe has also indicated the possibility of withdrawing PSUs from non-core and non-strategic sectors.
12. The Approach Paper of the Ninth Plan also states that ...`disinvestments will be considered upto 51 per cent and beyond in the case of PSUs operating in a non-strategic and non-core sectors'. The time has come now to define very clearly what enterprise falls into what category. There is a general degree of consensus that in non-strategic and non-core sectors disinvestment can be beyond 51 per cent. For the rest of the sectors, the criterion of disinvestment can be the extent of improvement and efficiency that can be brought about as well as the need to take care of the financial requirements of the government.

How to disinvest

13. The last issue that arises with respect to disinvest ment relates to the process to be adopted for disinvestment. This in turn revolves around appropriate valuation of the shares and the modalities to be adopted for sale. In general, three methods for valuation of shares are adopted - net asset value method, profit earning capacity value method and discounted cash flow method. While the NAV would indicate the value of the asset, it would not be in a position to indicate the profitability or income to the investors. The profit earning capacity is generally based on the profit actually earned or anticipated. The discounted cash flow is a far more comprehensive method of reflecting the expected income flows to the investors. Of these three methods, the discounted cash flow method has the greatest relevance though it is the most difficult. Valuation is a difficult exercise whether in the private or public sectors - in India or elsewhere. This is all the more so when the different valuation methods give different results. It has also to be noted that while the different valuation methods can provide a bench mark for the price, the price at which a share can be sold is determined more by investor perception rather than any mechanical measure of intrinsic worth. There is therefore the need for full disclosure to generate credibility and investor interest. Rise or fall in share value of an enterprise soon after disinvestment does not by itself indicate that shares were underpriced or overpriced at the time of disinvestment.

14. On the modalities of disinvestment, there are two acceptable and transparent processes available.
    a. Offering shares of public sector enterprises at a fixed price through a general prospectus. The offer is made to the general public through the medium of recognised market intermediaries.
    b. Sale of equity through auction of shares amongst predetermined clientele whose number can be as large as necessary or practicable. The reserve price for the public sector enterprises' equity can be determined with the assistance of merchant bankers.
15. Both these methods have their own merits and demerits. In the first alternative of `offer for sale', difficulties may be encountered in estimating and determining the `fixed' price if it is offered for the first time and the shares have not actually been trading in the stock exchange. On the other hand, this method has the advantage of spreading the ownership widely amongst the general public and in a transparent manner. In the case of those PEs for which the first sale of equity is yet to be made, or those where the track record of trading in shares is yet to be established, the tender system would be advantageous. Once a reasonable market price is established in a normal trading atmosphere over a reasonable period of time and a public enterprise completes the preparatory work, the fixed price method would be appropriate.
16. Yet another issue in relation to modalities is with respect to restructuring. In the case of some enterprises, some restructuring can result in increasing the proceeds of disinvestment. However, whether the shares should be sold as-is-where-is or whether some restructuring should be undertaken before sale should depend upon the time, energy and resources to be devoted for such restructuring. There has to be a balance of costs and benefits.
17. Disinvestment does not necessarily benefit the enterprises in terms of immediate accrual of resources. The proceeds of disinvestment goes to government. In order to sustain the interest of the enterprises in the process of disinvestment, it may be useful to set aside a certain percentage of the profits - say 10 percent as recommended by the Committee on Disinvestments, to be given to the enterprises themselves for their own expansion.
18. The process of disinvestment has also to take into account the conditions in the capital market. Disinvestment should not result in `crowding out' resources available for the private sector. In order to avoid the situation many countries have also chosen to sell a part of the shares set aside for disinvestment abroad.
19. Disinvestments need not and should not be regarded as a case of selling family silver. The original investments where made by the government out of its receipts. If some part of this investment has to be sold and realised for the purpose of expanding the activities of the state in certain other areas which are considered to be urgent now, it should not be regarded as some thing undesirable. Disinvestments even where it does not lead to transfer of ownership can have a salutary effect on management. There will be a new sense of accountability which goes beyond being responsible only to the government. Reform of the public sector enterprises is in some ways related to the process of disinvestments but has a distinct importance by itself. There will be a very large number of public enterprises still operating in the core and strategic sectors where the control will be with the government. To make them more efficient, productive and financially strong is a task that must be addressed independent of the exercise relating to disinvestment.
20. Disinvestment is a process. We can learn from experience. We can modify the modalities as we go along. I believe that there is a general consensus on the basic parameters of disinvestment. The only concern is that the process is fair and just. I do hope that these delibrations will lead to Disinvestment Commission setting the ground rules soon so that the process of disinvestment can begin.