LIMITS OF PUBLIC SECTOR IN INDIA

PROF. GANGADHAR GADGIL

FORUM OF FREE ENTERPRISE
PIRAMAL MANSION, 235 DR. D. N. ROAD,
BOMBAY 400 001.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good."

—EUGENE BLACK

LIMITS OF PUBLIC SECTOR IN INDIA*

PROF. GANGADHAR GADGIL

The case for the Public Sector was summarised by Mr. George Fernandes, Union Industry Minister, in a recent Memorial Lecture. It is as follows :

1. The public sector should not be judged primarily or exclusively in terms of profits, productivity and employment. In any case, if the public sector were to have the pricing policy of the private sector, the prices of public sector products like coal would have been 30 to 40 per cent higher and the public sector too would have shown profits.

2. Without the public sector, India would not be among the front rankers in the world in industry or technology. The public sector has made a tremendous contribution to national development in such varied fields as nuclear or space technology, heavy engineering, aeronautics, ship building, steel, energy, machine tools or such essential consumer goods as pharmaceuticals, textiles or even bread.

3. The public sector has taken over sick units and stepped in where private sector has sought to escape social responsibility. The public sector has saved the workers from starvation, when the private sector has failed to protect them. It is unfair to expect such sick units taken over by the public sector to make profits.

---

* This text is based on a public lecture delivered in Bombay on March 20, 1979, under the auspices of the Forum of Free Enterprise. Prof. Gadgil is an eminent economist.

4. While the failures of the public sector are publicised, those of the private sector are not highlighted. Numerous units in the private sector have performed poorly, failed to make profits and even turned sick as a result of heavy losses. About Rs. 900 crores of the banks are tied up in such sick units. In other words, the performance of the public sector, if poor, is no worse than that of the private sector.

5. Public sector has achieved various social goals. It has established effective public control over the commanding heights of the economy by socialising the means of production in strategic areas.

6. It has created a countervailing force against the growth of large houses and large enterprises in the private sector and the consequent concentration of economic power in private hands.

7. It has located industries in backward areas and thereby decentralised economic development.

8. It has encouraged the development of ancillaries.

9. It has provided housing and other facilities to workers and looked after their welfare.

These arguments should be scrutinised. It is particularly necessary to take a close look at the performance of the public sector.

The performance of the public sector is being judged in terms of profitability, efficiency and production not because they happen to be the norms of the private sector. These norms are being applied because they have been prescribed in the statement on Economic Policy of the Janata Party and also in the Sixth Five Year Plan, as can be seen from the following quotations:

"...... In order to do this, the public sector will have to improve greatly the efficiency of public enterprises and their managerial capabilities. ...... In view of the present needs of investible resources for agricultural and rural development, both the public sector and the organised private sector must generate surpluses and use their own internal resources for growth and expansion. This would imply that their productive efficiencies must improve and their pricing and output policies must be so adjusted as to generate surpluses. These surpluses should not be thrown away by way of indiscriminate distribution of dividends and bonus and increasing the perks and amenities of the top people. These surpluses must be saved and invested for growth and expansion thus relieving the public exchequer and the banking system of the need for continuously channelising further investible funds, which can then be directed towards agricultural development and building up of cottage and decentralised industries."

Thus the Janata Party, to which Mr. Fernandes belongs, very clearly expects the public sector enterprises to improve their productive efficiency and generate surpluses which are to be invested for growth and expansion. This would enable the public exchequer and the banking system to utilise the funds at their disposal for development of agriculture and small as well as cottage industries.

The Planning Commission has similar expectations. It expects the public enterprises to contribute for financing the plan of Rs. 10,296 crores at 1977-78 fares, freights, tariffs and rates. In other words, this contribution is expected without raising prices above 1977-78 level. This contribution is to consist of depreciation provisions, retained profits and accrual of deferred expenditure to current revenue. In other words, the taxes, both direct and indirect, paid by these enterprises, payments of interest, and loan instalments are not to be treated as contributions by these enterprises to plan resources. This point has been explicitly brought out here because many overenthusiastic defenders of the public sector include all these payments in their estimates of the contribution of public sector enterprises to the national economy.

The Planning Commission is not satisfied with the present performance of the public sector enterprises. It has observed: "The Central Government's non-departmental enterprises, which now earn a post-tax rate of return of 4.8 **per cent** on investment, should aim at earning 10 **per cent per annum.** In determining administered prices in important sectors, Government has already accepted 10-15 per cent (net of taxes) as a fair return. Therefore, a return of 10 **per cent** in public enterprises would seem to be a reasonable expectation. Some price adjustments will have to be allowed and it would be necessary for the enterprises to improve their inventory levels and improve their operational efficiency through introduction of modern management (operations research) techniques. These developments would require further professionalisation of management and the grant of greater autonomy to managers." (Draft Five Year Plan 1978-83 P. 59)

These excerpts make it quite clear that, contrary to what Mr. Fernandes says, both the Janata Party and the Planning Commission expect the public sector enterprises to earn post-tax profits on investment, to increase production and improve efficiency. These are, according to both, major criteria in terms of which the performance of public sector enterprises should be assessed. This is precisely what the public and the press are doing. The annual report of the Bureau of Public Enterprises on the working of the "Industrial and Commercial Undertakings of the Central Government 1977-78" has now been published. The report shows that the performance of these enterprises under the stewardship of Mr. Fernandes has been quite poor.

Mr. Satish Agarwal, the Union Minister of State for Finance, stated in the Rajya Sabha, that the return on the total investment made in the Union Government industrial and commercial undertakings in 1977-78 was 8.3 **per cent** as against 9.7 **per cent** in the previous year. These figures, however, would be misleading unless they are properly understood. The figures he mentioned indicate the percentage of gross profit to total capital employed. The gross profit is arrived at after providing for all the working expenses including depreciation and deferred revenue expenditure, but before interest on loans and before payment of tax. This gross profit is related to the total capital employed inclusive of loans. This is not the return the Planning Commission has in mind when it calls for an increase in post-tax rate of return on investment from 4.8 **per cent** to 10 **per cent.** The net profit after tax of these enterprises which was Rs. 239.59 crores in 1976-77 turned into a loss of Rs. 14.72 crores in 1977-78. This is obviously totally unsatisfactory in relation to the expectations of the Janata Party and the Planning Commission.

It is claimed by some that the losses of the public sector are not real but are only an accountant's illusion. Even these people do not deny that the "investible surplus (revenue — direct cost), which includes depreciation, interest and corporate taxes, declined from Rs. 944 crores to Rs. 852 crores. But they contend that the net profit after tax declined sharply from Rs. 239.59 crores in 1976-77 to Rs. 14.42 crores (loss) in 1977-78 only because of the larger amounts deducted towards depreciation. While it was deducted at a rate of 4.88 **per cent** in 1976-77, it was deducted at a higher rate of 6.06 **per cent** in 1977-78. Further, interest payments rose from 4.19 **per cent** of capital employed to 4.73 **per cent.** These figures do indicate that the performance of public sector enterprises in 1977-78 was not much worse than that in 1976-77. But they also indicate that their performance in 1976-77 was really much poorer than what it appears to be. They further indicate that their performance in 1977-78 also was much poorer than is indicated by the figures. To calculate depreciation at the rate of 4.88 **per cent** on capital employed is no doubt a shockingly bad accounting procedure. But to raise the rate to 6.06 **per cent** is not exactly a sound accounting practice. This data presented by the apologists of the public sector confirms the suspicion in the public mind that the public sector enterprises are pampered babies and that all kinds of unusual gimmicks are used to make it appear that they are performing well.

Let us take a closer look at the rate of interest paid by public sector enterprises. This rate, which varied between 7 and 8 **per cent** (depending on period of loan) up to 31st July, 1974, was raised from 1st August 1974 and since then varies between $9\frac{1}{2}$ to $10\frac{1}{2}$ **per cent.** (Incidentally, public sector financial institutions are given funds at rates ranging from $6\frac{1}{4}$ **per cent** to 8 **per cent).** No private sector enterprise gets loans at these attractively low rates of interest. This shows that the public sector enterprises get a favoured treatment as compared with their private sector cousins and yet their performance is so poor.

Incidentally, these basic rates of interest have not been raised since August 1974. What then is the reason for the rise in interest payments as percentage of capital employed? The public sector enterprises are notorious for running into deficits and also for being unable to pay interest and loan instalments. When this happens to a private sector enterprise it runs into serious trouble and even becomes sick. But the public sector enterprises are baled out of such predicament by the Government, which advances them further loans. This tendency to borrow more in order to cover deficits grew and acquired such alarming dimensions that the Government had to do something to discourage it. The Government, therefore, raised the rate of interest on such non-plan loans to $12\frac{1}{2}$ **per cent** in September 1976. This rate was also applied to non-Plan loans for meeting working capital requirements from that date. Incidentally, even this punitive rate was lower than the rate normally paid by private sector enterprises. This rate was further raised from 16th September, 1978 to 14 **per cent.** Even this cannot be considered a particularly punitive rate of interest. In any case, this was the only increase in the rate of interest which was made in 1978 and it became effective only in the month of September. There is, therefore, no reason why it should have affected interest charges for the period ending 31st March 1978. Thus there is absolutely no substance in the claim that interest rates for public enterprises were raised by the Govt. in 1977-78. If the reference is not to Government loans but loans from banks and financial institutions, the rates on these too were not raised in 1977-78. In fact, they were brought down in March 1978. Thus the interest burden of public sector enterprises increased only because they borrowed more at punitive rates to cover their losses. Incidentally, this untenable defence of the losses of public sector enterprises has done one service. It has pointedly drawn attention to the large amounts borrowed by public sector enterprises to cover their deficits and the favoured treatment they receive as borrowers.

It remains to be seen how far the pricing policies of public enterprises have been responsible for their poor financial performance. In the first place, it should be clearly understood that not all prices of products of public sector enterprises are subject to statutory price control. Further, where statutory price control exists, it applies both to the public sector and the private sector. Thus the private sector operates under the same handicap as the public sector when prices are statutorily controlled. Generally, under a system of price control, there is a distinction between the market price, which the buyer pays and the retention price which the productive enterprise gets. The retention price is fixed with due regard to cost of production. Thus public sector steel plants, which were established later and had a higher capital cost, were given a higher retention price as compared with the retention price for, say, TISCO. Except in certain special cases, a fair retention price was so fixed as to yield a post-tax return of 12 **per cent** of net worth. ("Report on Working of Industrial and Commercial Undertakings of the Central Government". P. 195). In practice, the controlled price did not generally yield a 12 **per cent** post-tax return on net worth. Various factors, which are quite well known, were responsible for this. In any case, the point to be noted is that under a system of price control, public sector units did not and do not get a treatment more unfair than that meted out to private sector enterprises.

Some of the public sector enterprises sell in world markets either under competitive conditions or at prices fixed by international agencies. Thus Air India, Shipping Corporation of India etc., sell at prices fixed by IATA and Shipping conferences. The State Trading Corporation sells in world markets under competitive conditions. In these cases, there is no occasion for the Government to fix prices at unremunerative levels. Some public sector enterprises sell in domesttic markets products or services which are not subject to statutory control. In such cases, the enterprises are either left free to fix prices in the light of market conditions or the prices are so fixed as to give a post-tax return of 12 **per cent** on net worth. A number of these enterprises are monopolies and use their monopoly position to charge high prices.

It is no doubt true that in some cases the Government for political considerations or in public interest brings down to an unreasonably low level the price of a public sector product or service. In other cases, it compels public sector enterprises to make purchases at unreasonably high prices. But this is done only in respect of sensitive commodities like coal, cotton etc. It is also true that public sector prices are not by and large raised as easily or as frequently as private sector prices. In some cases like coal and steel, Government has either refused to grant price increases or has only granted them partially and after delay.

As against these disadvantages, we must also consider the advantages enjoyed by the public sector enterprises. They get public funds at significantly lower rates of interest. Moreover, they get loans relatively easily as compared with private sector enterprises, particularly when they are making losses. This relatively easy access to funds is a great advantage. The public sector enterprises also enjoyed for a long time a price preference of 10 **per cent,** when they bid for public tenders. Later on this preference was withdrawn. But they continued to enjoy a purchase preference until July 1978. In a number of cases, the imports of commodities produced by public sector enterprises are canalised through those enterprises. Thus imports of watches are canalised through HMT and those of steel through SAIL. This gives them additional income, which in some cases can be substantial. Similarly, canalisation of exports of sugar through the STC, when the exports were highly remunerative, earned substantial profits for that organisation. The public sector enterprises are also subsidised in some cases. Thus the State Trading Corporation is subsidised when it exports sugar at a loss. Incidentally, private exporters of sugar are not given the subsidy, although they too have to export at a loss.

Apart from these visible advantages, there are a number of invisible advantages which the public sector enterprises enjoy. They often get public land at favourable prices. They get a favoured treatment in supply of scarce inputs like power, coal etc., which are produced in the public sector. Sometimes fiscal policies are framed with a view to benefiting them. Thus concessions in income tax are so designed as to benefit the L.I.C. and U.T.I. In other cases, decisions in respect of purchases are taken with a view to bestowing advantages on a public sector project. Thus a Defence Ministry decision regarding purchase of machine tools greatly benefited HMT and enabled it to grow, diversify and make profits.

After taking all these factors into account, one can conclude that public sector enterprises are not put at a serious disadvantage due to the pricing policies they are required to follow.

Even if we leave aside the criterion of post-tax profit, and consider their contribution for financing the plan, it is obvious that the performance of public sector enterprises falls far short of what is expected of them in the Sixth Plan.

The Sixth Plan, like the previous plans, has fixed a number of production and investment targets. The targets in terms of financial investment have been by and large fulfilled in the past. But as regards production, the public sector has fallen short of targets in many vital areas like power, steel, coal etc. The latest available data indicates that steel production declined in 1978-79 as compared with the previous year. The target of coal production was twice revised downwards in 1978-79 in the light of the poor performance of Coal India Ltd. Shortage of electricity and railway transport are also seriously hampering the growth of the economy. The position so far is that shortfalls in production of basic inputs by the public sector have acted as bottlenecks hampering the growth of the economy.

Considering the paucity of investible resources and shortages by which the economy is plagued, capacity utilisation becomes an important criterion for judging performance of public sector enterprises. Here again the data for 1977-78 is disappointing. As against 76 units utilising 75 **per cent** or more capacity in 1976-77, only 71 units fall in that category in 1977-78. The number of units recording less than 50 **per cent** capacity utilisation increased from 17 in 1976-77 to 27 in 1977-78. In this category fall a number of fertiliser units, plants of Heavy Engineering Corporation, plants of HMT etc. Thus a number of key enterprises, on which economic progress depends, have had a very poor record of capacity utilisation. Two major steel plants at Bokaro and Durgapur utilised less than 75 **per cent** capacity in 1977-78. The production of private sector TISCO was, as stated by Mr. J.R.D. Tata, in excess of the rated capacity. The public sector coal fields show a high capacity utilisation in excess of 100 per cent. This is quite deceptive, because capacity utilisation is measured in terms of targeted capacity, which is based on actual performance.

Poor capacity utilisation was not entirely the consequence of factors beyond the control of managements of public sector enterprises. Of the seven factors responsible for poor capacity utilisation, four were controllable. They were (1) Industrial unrest; (2) Lack of Balancing Equipment; (3) Equipment Breakdown, and (4) Design Deficiencies.

High inventories increase costs, add to scarcities of material and lock up funds that can be usefully employed elsewhere. The public sector enterprises carried notoriously large inventories for a number of years. In 1967-78, their inventories represented 6.7 months' output. This percentage has been brought down to 3.4 months' output in 1977-78. This is no doubt a welcome improvement. Yet, the inventories are still high as compared with Tandon Committee norms. Moreover, most of the public sector units have non-moving items of considerable value in their inventories. Incidentally, inventory norms have not been worked out in a number of these units.

The data presented so far reveals that the performance falls far short of what is expected of them by the Planning Commission. Nor does it indicate the superiority of public sector enterprises particularly in comparison with enterprises run by big business houses. The Prime Minister was, therefore, quite justified in admonishing the executives of public sector enterprises and the Industry Minister, Mr. George Fernandes, was on very slippery ground when he claimed that those enterprises need not be ashamed of their performance.

The country has certainly a number of creditable achievements in the field of industry and the public sector has contributed to them. But to reserve a number of important fields of industry only for public sector enterprises and then to claim that they have made India a frontranker in industry and technology is not a proper way of argument. Wherever they had the opportunities, the private sector enterprises too have made commendable achievements. Incidentally, both the public sector and private sector have so far only assimilated imported technologies. Even this has not been done fully. Both still lag considerably behind the industries in advanced countries in the technologies they use and both have very little to show by way of technological innovations. The public sector steel, fertiliser, pharmaceutical, electronic, and engineering industries still depend heavily on imported knowhow for uptodating their technologies. Nor have they attained high technological standards in the quality of their products. According to a recent report from Patna, the Bihar Government has under consideration a proposal to claim damages from BHEL for the thoroughly unsatisfactory performance of Patratu's seventh unit of 110 mw. In fact, at least a part of the responsibility for the poor performance of our power generating units rests on the shoulders of BHEL. How the public sector plant at Pimpri has made a mess of pencillin production is quite well known. It is fatuous, therefore, to claim that the public sector has placed India in the front-rank in the sphere of industry and technology.

Equally untenable is Mr. Fernandes' contention that public sector has taken over the sick units in the private sector, while the private sector has evaded the social responsibility to keep them running. It is not really in social interest to take over and keep them going at a loss. If funds so lost over a period of time are invested in new projects, they may generate far more employment than is offered by the sick unit.

Assuming that it is proper to take over and sustain sick units, it is most unreasonable to expect the private sector to do so. The private sector does not have unlimited powers of taxation and captive lenders as the Government has. It cannot compel the people to bear the losses of these sick units. Under these conditions, it is unrealistic to expect private sector enterprises to sustain sick units, as it is to expect trade unions to do so. Incidentally, a number of big business houses have sustained sick units belonging to them at considerable cost. Further, many of them are coming forward to do so after the announcement of the scheme for amalgamation of sick units with healthy ones in the private sector. The trouble is that the Government is not quickly approving these amalgamation proposals, simply because they come from the big business houses.

Incidentally, it is not true that sickness occurs only in the private sector. The Bureau of Public Enterprises has a very liberal definition of sickness. Those units which continuously sustain losses for five years are declared sick according to this definition. This is obviously a definition without any financial justification. According to this definition, an enterprise, which more than wipes out its capital in three years, would still be not considered sick, if it suffers further heavy losses in the fourth year, but manages to break even in the fifth year. A number of textile mills taken over by the public sector National Textile Corporation were not sick according to this definition, when they were taken over. Even on the basis of this definition. the Bureau of Public Enterprises has branded 13 public sector units as sick. By more ordinary standards, many more public sector units will have to be declared sick. But they continue to exist at great cost to the country simply because the Industry Minister can dip into public funds to sustain them. The economic damage inflicted in this manner on this poor country is colossal.

The public sector enterprises have no doubt, as claimed by Mr. Fernandes, established effective public control over the commanding heights of the economy. This was done by the simple expedient of nationalisation and reservation of various fields of industry for the public sector. It was a simple case of exercise of political power.

The question is whether this public control has been used for public good. If public good is defined in terms of the expectations of the Janata Party and the Planning Commission, the answer is an unqualified "No". Nor are there any prospects of an early improvement in this state of affairs. While the economic goals have not been attained by the public sector, it has done a lot of damage to the country in other ways. It has led to enormous concentration of economic power in the hands of the bureaucracy and the politicians in power. It has created monopolies in vital sectors of the economy. There are numerous instances of misuse of monopoly power by these public sector Leviathans. Worst of all the enormously powerful public sector was used for creating dictatorship in this country.

In view of all this, the people in this country have started wondering whether it is really desirable to have such a large and powerful public sector in our economy.

That big business in the private sector poses certain dangers to society has been acknowledged for more than a century. Various devices have been evolved over the years to regulate and tame big business and make it serve public good. Mr. Fernandes would be on solid ground and well within the limits of the mandate given to him if he advocates effective steps to regulate the big business houses. In doing so, however, he should recognise that modern economies require big business. The problem of bigness cannot, therefore, be solved by destroying big business houses. Nor can it be solved through nationalisation. For, the business of the public sector also poses great dangers to society. Unless, the Government can effectively fashion instruments and techniques for taming the public sector and making it effectively serve public interest, none can legitimately advocate its expansion.

Mr. Fernandes claims that the public sector has contributed to development of backward areas, small industries and agriculture. If one takes merely a micro view, it has certainly done so to a certain degree. Incidentally, so also has the private sector. But if one takes a macro view, one has to conclude that the public sector has signally failed to serve these social purposes. The Planning Commission rightly points out that the public sector can best contribute to development of agriculture, small industries etc., by generating surpluses that would release public resources for these purposes. The Janata Party has expressed the same view in its Statement on Economic Policy. But this is the one thing that the public sector enterprises have not done and do not show any prospect of doing. The public sector, therefore, is proving to be a major obstacle in the attainment of social and economic goals set before itself by the Janata Party. Nor has it created any new industrial culture as claimed by Mr. Fernandes. One has only to scan the reports of the Commitee on Public Undertakings to find out how public funds are being wasted on entertainment, luxuriously furnished guest houses, interior decoration of cabins of executives, foreign tours undertaken on flimsy grounds and questionable deals. To plead for the expansion of the public sector through further nationalisation is neither in public interest nor is it consistent with the philosophy and goals of the Government.

"Free Enterprise was born with man and shall survive as long as man survives."

—A. D. SHROFF
(1899-1965)
Founder-President,
Forum of Free Enterprise.

HAVE YOU JOINED THE FORUM?

392

The Forum of Free Enterprise is a non-political and non-partisan organisation, started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets and leaflets, meetings, essay competitions, and other means as befit a democratic society.

Membership is open to all who agree with the Manifesto of the Forum. Annual membership fee is Rs. 15/- (entrance fee Rs. 10/-) and Associate membership fee Rs. 7/- only (entrance fee Rs. 5/-). Graduate course students can get our booklets and leaflets by becoming Student Associates on payment of Rs. 3/- only. (No entrance fee).

Write for further particulars (state whether Membership or Student Associateship) to the Secretary, Forum of Free Enterprise, 235 Dr. Dadabhai Naoroji Road, Post Box No. 48-A, Bombay-400 001.

Published by M. R. Pai for the Forum of Free Enterprise, 235 Dr. Dadabhai Naoroji Road, Bombay-400 001, and Printed by H. Narayan Rao at H. R. Mohan & Co., 9-B Cawasji Patel Street, Bombay-400 001.

18/July/1979