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Public sector enterprise disinvestment in India: Efficiency gains in a political context

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ABSTRACT

India instituted a program of state enterprise disinvestment in 1991 as part of a sweeping reform initiative. This study analyses the effect of disinvestment on enterprise performance, conditioned on political context as characterized by the ideological leanings of the parties in power at state and central levels. Using stochastic frontier analysis, measures of firm efficiency are generated for 238 central public sector enterprises for the period 1991–1992 to 2010–2011. The relationship between efficiency so measured and disinvestment is then estimated using a two-stage instrumental variables approach to control for endogeneity between firm efficiency and selection for disinvestment. Initial disinvestment is associated with substantial efficiency gains, but subsequent disinvestment much less so and the proportion of shares disinvested only loosely so. This may be explained by the transformative effect of initial stock market listing on accountability and profit orientation that is not repeated with further rounds of disinvestment. The effect of disinvestment on performance is stronger if the enterprise is located in a state governed by a right leaning party or one that is ideologically aligned with the party in power at the centre.

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1. Introduction

It is commonly thought that privately owned and managed firms operate more efficiently than public sector firms. The crux of the argument, at least in developing economies like India, is that state owned enterprises (SOEs) are used as instruments to achieve social and developmental goals. Further, more often than not, public sector firms are free of competitive pressure. This privileged position when combined with an indistinct mandate of serving social interests is presumed to lead to operational inefficiencies. Yet the drivers of enterprise performance are complex. The Indian case in particular calls for a more nuanced understanding given a policy pursued since 1991 of gradual state disinvestment that has resulted in mixed and evolving ownership structures. How enterprises perform under these circumstances must certainly depend on a host of factors both internal and external to the firm.

In the late 1980s, the performance of enterprises owned by the Indian central government (central public enterprises, CPSEs) was notably below par, mainly due to lack of competition and the need to serve multiple objectives (Ahuja & Majumdar, 1998; Ghosh, 2009). Burgeoning losses made these enterprises a burden on the exchequer. Disinvestment was therefore begun under the *New Economic Policy* instituted in 1991. However, over two and a half decades, the pace of implementation has been slow. Kapur and Ramamurti (2002) argue that political instability, poor financial market performance, weak judiciary institutions, and CPSE structure are factors responsible for this slow pace.

The main rationale for disinvestment, as documented in the international literature (Matsumura, 1998), is that private enterprises perform better than public enterprises. With disinvestment, public enterprises are presumed to benefit from

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better management and more focused objectives. Against this background, the current study aims to evaluate the performance of CPSEs in India since the adoption of the disinvestment policy. Specifically, the study investigates the following two relationships:

1. efficacy of disinvestment as a policy option to improve CPSE performance;
2. influence of state specific political factors (ideology) on CPSE performance.

The disinvestment policy in India began with an announcement by the Chandrashekhar government on March 4, 1991 stating a goal to privatize up to 20% of state equity in selected CPSEs. Since its inception, the policy of disinvestment has evolved over time. The period from 1991–1992 to 1995–1996, wherein partial disinvestment was attempted by fits and starts, marked the first phase. In the second phase from 1996–1997 to 1997–1998, the disinvestment commission was constituted in an effort to institutionalize the process. From 1998–1999 to 2007–2008, the third phase demonstrated a paradigm shift towards disinvestment. The final ongoing phase dates to 2008–2009.

A number of studies have addressed the impact of disinvestment on firm performance in India. The most common refrains have lamented the absence of a focused objective and well-defined policy options (Chari & Gupta, 2008; Gouri, 1997). These studies suggest that due to political factors, disinvestment was pursued less aggressively than efforts to reinvent PSEs and introduce competition. Sarkar, Sarkar, and Bhaumik (1998) and Ghosh (2009) explore the relationship between public ownership and firm performance, finding that a key driver of performance was stock market listing. For banks in particular, Sarkar et al. (1998) deduce that whereas traded private banks performed better than public banks, non-traded private banks did not differ significantly in performance from public banks. Ghosh (2008), Majumdar (2008) and Gupta (2005) find that disinvestment has had a positive impact on CPSE performance. Gupta (2005) suggests the when shares of divested firms are traded on the stock market there is an increase in productivity without layoffs. Gupta (2010) finds that performance improvements for divested CPSEs are positively and significantly related to the fraction of equity sold.

Existing literature on disinvestment in India suffers from a number of limitations. First, most studies assess performance of public sector enterprises using standard accounting measures better suited to private enterprises. These measures fail to capture the performance features particular to public enterprises with respect to objectives, organization, and structure. Second, performance does not depend solely on resources consumed directly by firms, but also on local political conditions, institutional characteristics, and government policies. Previous studies have ignored this. Finally, previous studies have typically treated disinvestment as a dichotomous variable. The present study overcomes these limitations by taking a broader approach to assessing performance and measuring both disinvestment and local government ideological stance with more nuance.

The study employs panel data instrumental variable techniques, drawing on official data from the Public Enterprise Survey (PES) for the period 1991–2010. It uses firm efficiency as a measure of performance. Disinvestment decisions are captured by three variables: initial disinvestment; any occurrence of disinvestment (initial or subsequent); and extent of disinvestment defined as the cumulative proportion of shares in a CPSE transferred from the government to the private sector.

Performance of public sector enterprises is found to be driven by a combination of internal and external factors. Key internal factors include firm age, size, and leverage. Further, initial disinvestment, any occurrence of disinvestment, and extent of disinvestment are all found to improve performance. Ideology at state level per se is not found to affect firm performance, although ideological difference between state and central levels is shown to have negative ramifications for performance. Moreover, the effect of disinvestment on firm performance is strongly conditioned on both state level ideology and ideological similarity with the centre. The positive impact of disinvestment is stronger in right leaning states due to policies that support disinvestment and create a better environment for business. Moreover, the impact of disinvestment on performance is better if the enterprise is in a state that shares a similar ideological stance to the centre.

2. Influence of disinvestment and ideology on CPSE performance

2.1. Disinvestment and firm performance

Boycko, Shleifer, and Vishny (1996) posits that PSEs are not as efficient as their private counterparts for two reasons. First, government owners have a multidimensional objective function and hence pursue goals other than profit maximization, for example, employment growth, investment in certain regions or products, or high but unsustainable dividend payouts. The lack of a clearly defined objective function affects the performance and outcome of public sector enterprises adversely. Hence, transferring ownership to private investors can focus management on achieving more standardized performance outcomes.

Second, PSEs suffer from a lack of transparency in management decision making. Listing on a stock market introduces outside monitoring and control mechanisms (Gebka, 2008). Information about management decisions is delivered to overseers, who exercise control over managerial salaries, and to the marketplace more generally with its ultimate disciplining device of takeover threats. Hence, disinvestment may improve performance by introducing private mechanisms of monitoring and control: a legal framework for accountability; actions of analysts and shareholders; and a market for managerial talent. Gupta (2005) concludes that on these grounds even partial privatization has had a positive impact on firm

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