

Sengupta Report on Public Enterprises

Eloquent Fuzziness at Its Best

Prajapati Trivedi

A number of major policy initiatives toward public enterprises are being pushed vigorously by the government. Phrases like "MOUs" "holding companies" and "privatisation" have become a part of the current economic jargon. A closer examination reveals that they have spawned out of a common source—the Arjun Sengupta Report on Public Enterprises. Yet, this Report has never been subjected to any debate. Primarily, because it has not yet been made public by the government. The present critique is based on an unauthorised publication of this Report. The author finds that it contains some excellent ideas; however, (hey are too few in number and the manner of presentation obscures their importance. This paper analyses each section of the Report to see the contradictions involved and the linkages between various issues. It singles out two recommendations for immediate implementation. First, the information base regarding public enterprises should be strengthened by installing an information system. Second, a system of performance evaluation, based on clear targets and linked to an incentive system should be implemented.

IN the recently concluded International Congress of Public Enterprises (January 20-22),¹ it was apparent that neither the public enterprise (PE) managers nor the government policy makers had a clear picture of the government's policy towards this crucial sector of our economy. Consequently, the debates had no focus and the participants simply made speeches on a variety of topics such as the memorandum of understanding (MOU), the number of government directors on the board of public enterprises, etc. If there was a common bond linking these topics, it was provided by the fact that they had all spawned from the same source: the report of the Arjun Sengupta Committee to Review Policy for Public Enterprises.

Realising the critical role assigned to the public sector in the mobilisation of resources for the Seventh Plan,² the government of India decided to set up a high-level committee to review and suggest policies for improving the performance of public enterprises. This Committee, headed by Arjun Sengupta, then special secretary to the prime minister, was set up in September 1984, just six months before the start of the Seventh Plan. It is to the credit of this Committee that they finished their work on time by the end of December 1984. It is to the discredit of the government that this report was neither placed before the parliament nor released directly for public debate. It was eventually made public by *Mainstream* (June 21, 1986) after a period of a year and a half. One of the cardinal principles of policy-making is that unless a public policy is publicly debated, public interest is likely to suffer. The Sengupta Report is a classic example of this principle in action.

The purpose of this paper is to provide a comprehensive critique of this Report. There are two ways of organising an analysis of this sort. Either, one can divide the discussion under various conceptual categories, or, use the same categories found in the original document. In this paper, we have opted for the latter approach.

Such a discussion, however, could easily

suffer from the same major problem associated with the original Sengupta Report—lack of prioritisation. If one were responsible for implementing the recommendations of the Sengupta Committee, it would be difficult to know where to begin. Therefore, it comes as no surprise that two years after the submission of the Report, there has been 'hardly any action taken on its recommendations.'³ To avoid similar problems, we will begin by providing a central focus around which our arguments will be organised.

It I had to summarise my evaluation of this Report, I would argue that in general, the Sengupta Committee failed to distinguish *causes* from *effects* of the fundamental problems of contemporary public enterprises in India. Further, it also failed to prioritise causes. Consequently, they emerged with a long list of sixty-nine recommendations to cure both causes as well as effects. It is little wonder, then, that public enterprise reform has proved to be such an overwhelming task.

In this paper, we will show that the two most important recommendations of the Sengupta Report are as follows:

a) The performance of a chief executive of a public enterprise should be evaluated on the basis of an agreed set of clear targets (Recommendation number 10.34; see also, para 4.39).

b) An appropriate information system capable of monitoring public enterprise performance in terms of these targets should be developed (Recommendation number 10.48; see also, para 5.17).

All other recommendations are linked in one way or another to the above. Some of them follow logically as obvious corollaries, while others represent prerequisites for implementing the above-mentioned recommendations. In other words, these recommendations represent the heart of the Report; all other recommendations represent either forward or backward linkages. The failure to recognise these conceptual relationships leads to much fuzziness in the body of the Report. However, let us begin from the beginning.

The Sengupta Report starts with the usual mandatory letter of submission and acknowledgements. The most curious aspect of this section is the conspicuous absence of academics from the list of persons consulted for this Report. There are two possibilities. Either academicians were too busy to spare their time for this committee or the committee could not find any qualified academicians. Unfortunately, I am unable to accept either of these reasons and the Report does not provide clarification on this matter.

The introductory section has the objective of establishing the importance of this Report or justifying this exercise. It tries to do so by attempting to establish two facts. First, it tries to show the importance of the role played by public enterprises in the Indian economy. Second, it attempts to show that the performance of the public enterprises has been very poor.

Roth of these issues are widely believed to be true, and hardly require a major effort. However, if a high-level committee such as this one decides to address them, one expects a much higher level of introspection and analysis of these popular perceptions. Unfortunately, the Committee disappoints us even in this introductory section, which should have been rather straightforward.⁴

This section starts by tracing the very familiar story of the growth of public enterprises in India by reproducing well known data on the subject. However, the story ends abruptly in 1983-84, when the capital employed in public enterprises stood at Rs. 32,202 crore, with a turnover of Rs 46,777 crore and employment exceeding 2 million workers. The real challenge was to predict the future of this sector. Will it continue to play a similar role or will it be phased out? Or, perhaps, *can* it be phased out? Should it be phased out?

These are not rhetorical questions designed for promoting a polemical debate. Public policies have to be structured very differently if the thrust of the government is towards "privatisation" (euphemistically referred to as "rationalisation" by international agen-

cies). The Committee deals with this issue in a cowardly fashion by hiding it in an obscure corner of the Report (para 7.4). A less timid stance in this section would have gone a long way in clearing the current doubts about the government's intentions towards the issue of privatisation. Since the prime minister has mentioned the Report approvingly more than once in the course of his interviews, these questions have acquired real significance.

The assertion of the poor performance of public enterprises also betrays a carelessness in developing the argument. The only evidence cited is in terms of the financial profitability of public enterprises. The Report argues that the Sixth Plan target of 10 per cent profitability ratio in constant prices was not met by the public sector.

This reasoning is surprising in view of the fact that because the Committee quotes the Industrial Policy Resolution of 1956 to suggest that public enterprises should be judged by their "total results", and yet the Committee goes on to ignore this aspect of public enterprise performance. At one point (para 1.2), it commends the achievement of public enterprises, "in terms of their contribution to the quantitative targets of production, to the establishment of a modern industrial structure, to balanced regional development and to the formation of technological skills". Surely, these must be considered when passing any judgment on public enterprise performance. Unless, of course, these goals were given a small weight in the aggregate index of targets. If so, who decided to give them these small weights? The above-mentioned tasks are absolutely critical for a developing nation in its initial stages of growth. If anything, they should be given greater weight than financial profitability.

I am not trying to defend or condone the poor financial profitability of public enterprises. Rather, I am merely highlighting a typical problem with such analyses of public enterprises, often found in popular journalism. Instead of rising above this trap, the Committee succumbed to it. Curiously, the Committee criticises the government for a similar failure. "While public enterprises were to be judged by their 'total results' the monitoring and evaluation system of the government has not been adequate to the task" (para 1.5).

The Report claims that the financial profitability of public enterprises has declined continuously in constant prices. This goes against its own indictment of the government for the failure to have an adequate information or evaluation system. Who is responsible for these constant price calculations? Proper constant price procedures require information on the price-quantity break down of value figures in the financial statements. Any other method has to be a very crude alternative.

Why should the fact that public enterprises failed to meet the target of 10 per cent

profitability during the Sixth Plan be considered an indictment of their performance? Rather, it could be a reflection of the naivete of the planners. Did the Committee examine the assumptions and procedures for setting such targets in the Sixth Plan? It is entirely possible that even if our public enterprises were doing infinitely better than the situation today, some enthusiastic planner might set an unrealistically high target and make the public sector look bad. An equal amount of attention should be given to this target-setting procedure in the Planning Commission.

Those who have studied the literature on public enterprise performance evaluation, consider it to be self evident that "financial profits" do not have a one-to-one relationship with "managerial performance". This topic has been dealt with extensively in several places [Sen, 1971; Jones, 1979; Trivedi, 1986b]. Hence, I will merely give a quick example to illustrate one class of problems with financial profitability as a measure of public enterprise performance. Financial profitability looks at costs and benefits from a private individual's point of view. Therefore, an increase in taxes leads to lower profits and a lower level of individual welfare. However, an increase in taxes does not change the total welfare of society. From society's point of view, this is simply a transfer of welfare from one party to another. It is a re-distribution of welfare, not a reduction of welfare. It is quite possible that the decline in profits of public enterprises may have resulted from an increase in the tax burden. Similarly, there are many other instances where "public" and "private" costs and benefits differ. Unless the Committee has already examined all such factors, its assertions about public enterprise performances should be treated as very tenuous at best.

Finally, the failure to meet plan targets is hardly the crime of the century. All sectors habitually and regularly fail to meet various plan targets: The private sector, for instance, has been criticised for its lack of import substitution and employment generation. The point is not that it is alright to ignore plan targets; however, failure to meet these targets, in itself, does not necessarily make one sector worse than all others as suggested by the Committee. In fact, the Planning Commission does not meet its own targets sometimes. Remember the days of "Rolling Plans" and "Plan Holidays" when the concept of five-year plans was itself in jeopardy for a while.

It is clear that the various points discussed thus far lead us to a common source of troubles regarding the above confusion: lack of clarity of and the goals of public enterprises as well as inadequate information and monitoring capabilities of the government. While the Committee staggers its way through the issues discussed above, it is to its credit that it recognises the need for

reform in these areas (as mentioned at the beginning of the paper).

PUBLIC ENTERPRISE AND NATIONAL PLANNING

In the next section of the Report following the introduction, the relationship between public enterprises and national planning is highlighted. One can hardly argue with axiomatic statements like the following: "public enterprises in India have to function within the framework of planning and, in many areas, they are in effect the principal instruments for the realisation of plan objectives" (para 2.1). I must object however, to harping on the time worn cliches like "the central issue is to find the right balance between autonomy and accountability" (para 2.6). This is a dead issue in the literature on the subject. This trade-off between autonomy and accountability haunts us only as long as we talk about the "quantity of controls" and not the "quality of controls".

To see this we have to realise that, broadly speaking, there are basically two ways of controlling an enterprise. One can, either, hold an enterprise responsible for results (also known as Management by Objectives). Or, where goals are difficult to specify, one can control the enterprise by controlling procedures and processes.

The latter is achieved by laying down detailed rules and procedures for monitoring. This requires a great deal of intervention in the operations of the enterprise and, hence, leads to allegations of lack of autonomy. However, when autonomy is granted it is often abused as the goals are not clear. That is, accountability suffers. Which, in turn, invites a cut-back in autonomy and takes the enterprise to "square one", i.e., less autonomy but more accountability. This classic "autonomy pendulum" can be observed in public sectors all over the world since most governments find it hard to specify goals. The situation in India is, therefore, not unique.

However, one need not be trapped, *ad infinitum*, in this pendulum. If one can improve the "quality of control" by specifying goals and objectives clearly and developing performance information and evaluation systems to monitor public enterprises, this dilemma would disappear.

Another example of the Committee's obsession with secondary issues is its attempt to produce yet another classification of public enterprises. The Committee claims that from the point of view of *planning* and *budgetary management*, public enterprises may be grouped as follows (para 2.5);

- (a) Enterprises operating in the core sector.⁵
- (b) Financially viable enterprises in the non-core sector, and
- (c) Enterprises in the non-core sector incurring losses.

It is easy to see that this classification can-

not be justified on the basis of either the planning or budget management compulsions. In para 2.1, the Committee argues that "public enterprises are not islands unto themselves and the decision taken by one enterprise affects the fortunes of others". Therefore, while the core sector is certainly critical for other sectors, it is equally true that other sectors may also be critical for the core sector. For example, coal in the core sector is absolutely critical for cement in the non-core sector (these categories are based on the Report, para 2.3). Cement bottle-necks, however, can be devastating for most core sector industries including coal. That is, a non-core sector product that affects a core sector product can acquire an equal status and thus blur the distinction proposed by the Committee.

Similarly, from the point of view of budget management, the distinction between viable and loss-making non-core sector enterprises is equally spurious. Why should this distinction be *confined* to the non-core sector? From the budgetary management point-of-view, profits and losses in all sectors are of interest. Further, there is no financial caste system operating in the public sector. In other words, it is not divinely ordained that certain enterprises once born in the loss making sub-caste of the non-core sector will be branded as such for, at least, this life on earth. Financial viability is not an absolute concept. Today's loss makers may be tomorrow's success stones and vice versa. This is true regardless of the sector to which one belongs.

Another major source of confusion and contradiction is presented in para 2.1 of the Report. It is argued that the relationship between the government and public enterprises cannot be reduced to the usual annual interaction between shareholders and corporate management. A more active interaction between them is unavoidable in the critical areas like investment priorities and formulation of large projects.

This argument exemplifies a conceptual confusion spread, throughout the Report. The study of public enterprises can be divided for analytic purposes into three areas: a) Investment decision, b) Pricing policy, c) Performance Evaluation.⁶ Investment decision deals with whether or not to set up a given enterprise or undertake a given project. However, once an enterprise is created, the next issue becomes what price to charge for its products and services. Finally, performance evaluation tries to judge the performance of a public enterprise manager with a given stock of capital (investment decision) and a given set of prices (pricing decision).⁷

The most common source of confusion arises when commentators mix these three areas. In para 2.1, also, investment decision has been dragged in while discussing performance evaluation. A great deal of interaction may be required before an enterprise or pro-

ject is set up. Once it comes into existence, though, there is no reason why the "usual annual interaction" cannot be a feasible policy. That is, there is no reason why the government can specify goals of the enterprise at the beginning of the year and hold it responsible by evaluating enterprise performance at the end of the year.

Indeed, para 2.1 contradicts another part of the Report—para 3.10. Since the latter is, in my view, the very heart of any prospective solution that is likely to emerge, I would like to quote it at length:

In our approach government should be primarily concerned with overall strategic planning and policy rather than with day-to-day functioning of the public enterprises. Once the goals have been mutually agreed to, the enterprises should be allowed to operate without further interventions by the government in day-to-day functioning. The enterprises should, however, be held strictly accountable for their performance in relation to the goals set and there should be an appropriate mechanism for evaluation of their performance.

This para clearly reiterates many of the points we have already made. In particular, it argues for a "management by objective" type approach, which is to be accomplished by increasing the quality of controls and reducing the quantity. The trouble is, paragraphs containing such bright gems are scattered sparsely in the marshlands of the eternal conceptual fog of the Report. As a result, only a determined adventurer can retrieve them.

ORGANISATIONAL STRUCTURE OF PUBLIC ENTERPRISES

The Report, also, fails to capitalise on certain useful ideas within its pages by failing to relate them to other aspects discussed in the Report. Section III is a good case in point. It starts by arguing that because of the parliamentary form of government, our public enterprises cannot be free from governmental scrutiny of their general policies as well as some aspects of their day-to-day operations. It goes on to suggest that since Parliament's authority in such matters is supreme, it may be necessary to evolve a convention by which members of parliament accept some self-imposed restraints on the nature of the questions they ask.

Instead of taking the parliamentary intervention as a given fact, if the Committee had explored the reasons for it, this recommendation would not have been necessary. In my view, the main reason everyone feels free to interfere with public enterprises is because their goals are not clear, nor is it clear who is their real master—enterprises are known to have multiple goals, which are often contradictory, and multiple principals with different and often conflicting perspectives. As a result, each principal, parliament being one of them, feels entitled to push its own favourite goals for a public enterprise. However once the management by objective

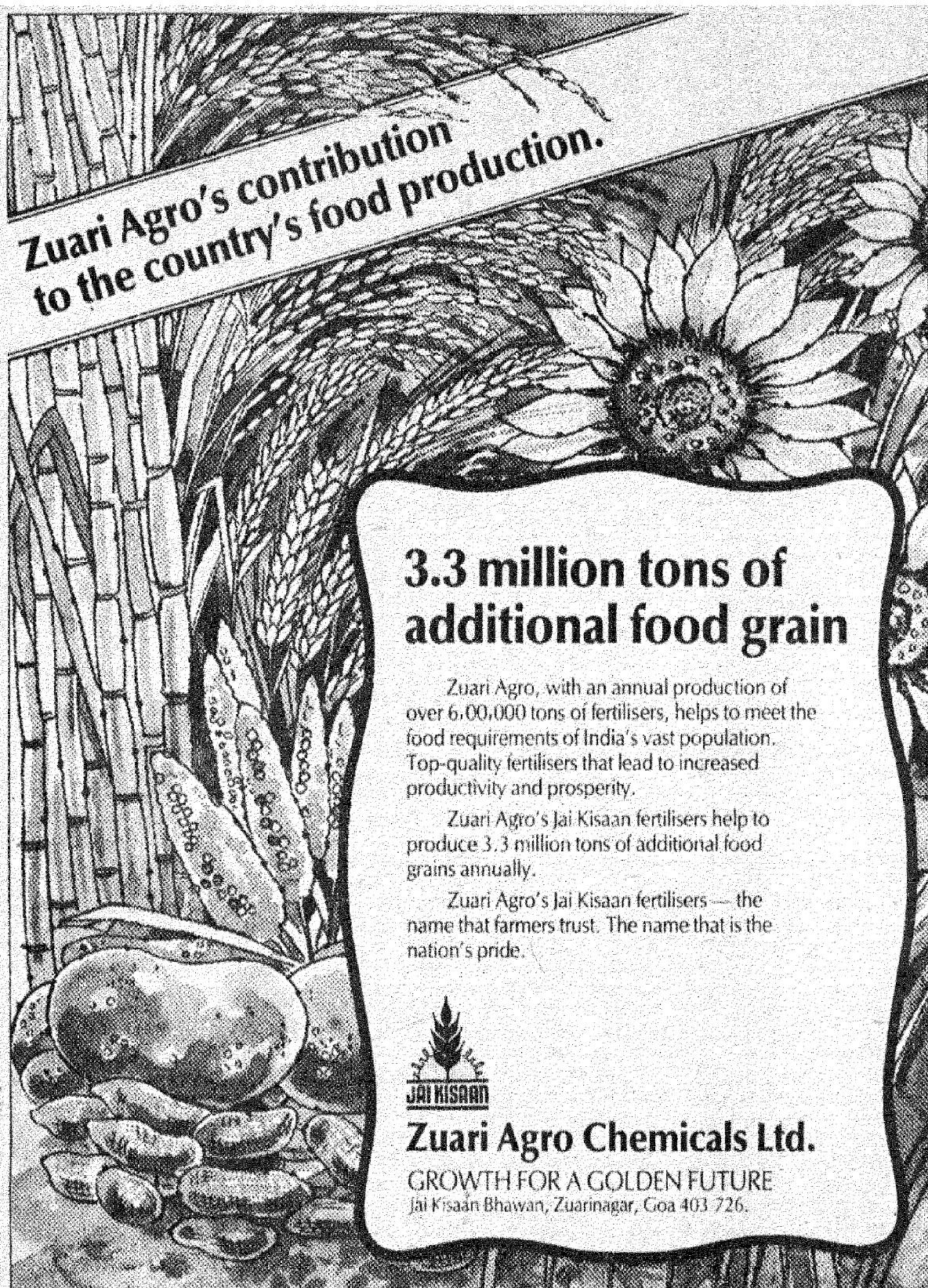
(MBO) type approach with clear targets is accepted, the scope for unwarranted intervention will be greatly reduced, if not eliminated altogether.

The Committee's suggestion of "evolving" a parliamentary convention for non-intervention is far-fetched and appears to be politically naive. How do you "evolve" conventions? By definition, the term "evolve" implies an automic and gradual self-development. It could take ages for the complete realisation of this pipe-dream. The reason why this is a non-starter is the same reason why, we have opted for a planned economic development rather than let the free market take its time to bring about the same results.

Even in a politically mature parliamentary democracy like the United Kingdom (were they do not even have a written constitution and conventions rule the roost), they found it necessary to pass the "Self-Denying Ordinance" which limits governmental meddling by law and not by conventions. The absence of politicians on the Sengupta Committee as well as the list of people interviewed, may, perhaps, explain why such recommendations managed to slip into the Report.

All of this confusion pales in comparison to the problems associated with the Committee's proposal to form holding companies. The committee argues that the only way to reduce governmental intervention in the day-to-day operations of the enterprises is to create a holding company in between these two groups. Thus, the administrative responsibility in respect of individual companies will be that of the holding company and, thereby, eliminating government's day-to-day contact with the enterprise.

It is surprising that the Committee makes only a passing reference to the fact that this concept has been tried in many European countries. Further, it does not say whether these experiments have been successful or not. The most widely cited example of the holding company concept is that of the IRI in Italy. To the best of my knowledge the Italian public enterprises are not considered to be examples of excellence. Why did not the Committee look for examples from developing nations, where circumstances are closer to the prevailing conditions in India? It would not have had to look very far. Our neighbour to the west, Pakistan, tried the "holding company" experiment by forming the "Bureau of Industrial Management" and, subsequently, abandoned it. Why go even that far? The Committee's total omission of our not so successful attempts at holding companies in India in the steel and coal sectors are also inexplicable. At the very minimum, by discussing the reasons for the troubles with these holding companies and the Committee's suggestions to overcome them would have shown that the Committee had given adequate thought to this matter.



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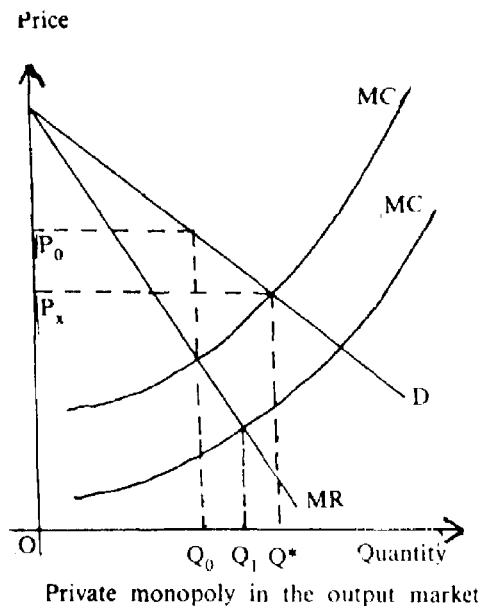
Any serious report would have also discussed the pros and cons of their models of managing the government-public enterprise interface. The onus of burden lies with the Committee to explain why the concept of "holding company" has not caught on like wild fire among the nations of the world, in spite of such a sound theoretical basis claimed by them on behalf of this concept.

Attempts to form holding companies by merging public enterprises in the same sector, tends to also contradict another major policy thrust of the government—industrial liberalisation. These monstrous giants would gang up on whatever competition there might be from the private sector. Further, the "healthy" effects of competition between public enterprises would also be lost. The above statement derives its legitimacy from research findings that efficiency is promoted not by having a particular type of ownership—public or private—but by the existence of competition [Jones and Vogelsang, 1982; Butterworth, 1987]. Private monopolies can be as inefficient as public ones. However, the situation of most developing nations like India is that in many of our crucial sectors only public enterprise will or can exist. Hence, they only feasible source of competitive pressure is inter-public enterprise competition. The sectoral holding company concept seems to undermine this possibility.

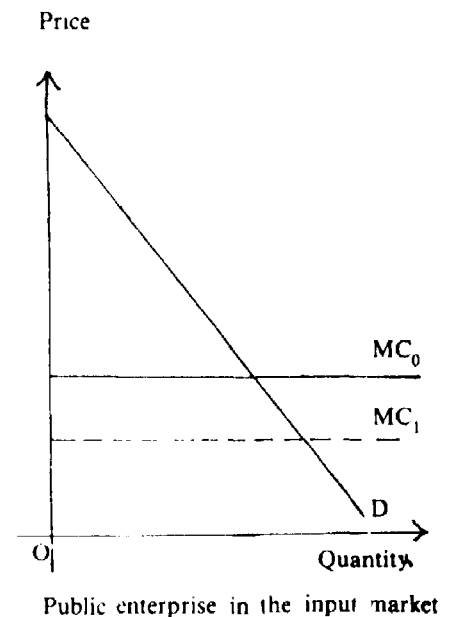
The mega-conglomerates created by merging huge public enterprises would pose another problem. It would promote excessive autonomy since the enterprises would be very powerful in comparison to controlling authorities. Any country that ignores the lessons from the experience of Pertamina in Indonesia, is likely to have serious regrets. This mega-company became a nation within a nation and went into an uncontrollable binge of expansion and acquisitions. Through unwise investment decisions, it held the destiny of the entire nation at ransom. There are numerous examples, such as these, from all around the world, where the chief executives of such huge enterprises have eventually become more powerful than the ministers above him. At one point (para 3.20), the Report does point out the possibility of having "too large" a holding company. However, it does not tell us how large is too large.

In fact, by putting loss making units under the profitable ones one may jeopardise the performance of the latter in two ways. One is, of course, the genuine burden of supporting a loss maker. Second, by providing a convenient excuse or scapegoat, the government may tempt the successful enterprises into complacency. If things go wrong in the future, the profitable enterprise has a readily available excuse to shirk its responsibility.

In short, the Committee's advocacy of this concept of the holding company, again, betrays the confusion between cause and effect.



Private monopoly in the output market



Public enterprise in the input market

feet. All of these changes suggested by the Committee address only the effect, leaving the cause untouched. The problem of governmental intervention arises because there is a non-congruence of goals. The chief executives of public enterprises have one notion of the mission of their enterprises, the government, another. Thus, even when both parties are well-meaning, there is bound to be friction which, of course, becomes worse when one of the parties becomes tainted with lack of sincerity. Having a holding company will not eliminate the divergence between the perspectives of the two parties. Hence, intervention by the government in the day-to-day affairs of the enterprise will continue. Once clear-cut goals are set and agreed upon by all parties, however, much of this friction will disappear.

The Committee recommends (para 3.24) that the concerned ministries should evaluate the performance of holding companies under them. There is convincing evidence that such a model of performance evaluation does not work very well [Young, 1986; Mehdi, 1985]. Serious and credible performance evaluation is a difficult job and has substantial economics of scale associated with it. It is much better to have it centralised than decentralised.

Further, as I have argued elsewhere [Trivedi, 1985a], ultimately it is the prime minister who is accountable to the people for his government's performance. There is often a frequent shifting of ministers from one department to another under the same prime minister. Therefore, the minister in-charge of a technical ministry will never quite reveal to the prime minister the seriousness of failure on the part of a public enterprise under him, even if he is fully aware of it. To do so would also reflect on his own performance. His attempt will be to,

somehow, push the unpleasant facts under the rug and stall. In time, a new minister will come and expose the mess and call for the setting up of yet another committee. This scenario will not materialise, if the dirt under the carpet becomes unmanageable and is exposed willy-nilly. By the time this happens, one can be rest assured that the mess will be of scandalous proportions and, perhaps, only divine intervention could save the situation.

Finally, given the limited availability of technical manpower required for public policy formulation and implementation, the choice is quite clear. Either one can utilise scarce resources for the cosmetic exercise of merging and de-merging enterprises to form holding companies and weather the storms created in the process of upsetting the given structures. Or, one can use them for setting appropriate goals for public enterprises in the existing structure and develop a reliable information system to monitor and evaluate their performance. In my opinion, the real battles have to be fought and won on the latter front.

Section III of the Report contains two more controversial recommendations—one regarding the government directors on the boards of public enterprises and the other, regarding the memorandum of understanding. The common problem in both instances relates to what the Report does not say about these issues rather than what it does.

For example, if one reads para 3.19 of the Report, one gets the impression that the issue of government directors is fairly straightforward and not very contentious. The Committee takes note of the suggestion made by some groups that there is no need for representation of the government on the board of directors of public enterprises, but,

recommends that this practice should continue nevertheless. They argue that government directors are generally a positive source of help and mediation between the government and the enterprises. However, if one had listened to the four to five hundred top managers and chief executives gathered for the International Congress of Public Enterprises in Delhi, one would get a very different picture.

There were three categories of opinions expressed at this conference. The overwhelming sentiment seemed to be that government directors were a definite source of nuisance and obstruction in the conduct of business and ought to be done away with. The second group argued that while government directors may be a potential source of conflict, they can be taken care of, if handled with tact. Some chief executives even bragged about their ability to manipulate and control government directors. Finally, there were some who argued for the presence of at least one government director since the government as the owner had the right to have its representative on the board of directors. In any event, it is clear that no one was arguing for the Committee's position that government directors were a source of positive help. The closest they came to the Committee's position was in implying that government directors are a necessary evil that can be manipulated by a skilled chief executive.

The Report does not help in building the Committee's case. Later in the same para (3.9), they recommend that the subsidiaries of the holding company need not have government directors on the boards. This seems to contradict their own line of reasoning. If government directors are a positive source of help and mediation, what is the harm in also having them on the boards of subsidiaries as well? They should not be there only if the committee felt that they are a problem. If so, why was that issue brushed aside.

In my view, however, the conflict with government directors is merely a symptom, not the cause of public sector woes. The problem, again, is the non-congruence of goals of government directors and chief executives. It is fair to say that most government directors are well meaning individuals trying to do their job as best as they can. That is, to protect and promote the interest of the government as the shareholder. Similarly, most of the chief executives are honourable and able people trying to promote the interests of their respective companies. Most problems arise because, often, these two viewpoints do not coincide. This is, then, the real problem. Once goals are clearly determined and agreed upon by the government and the enterprise, these conflicts are likely to become a non-issue. Conversely, so long as the fundamental problem of non-convergence of goals remains unsolved, all other changes will be tantamount to cosmetic surgery to hide systemic problems.

The final controversy in section III of the Report relates to the proposals for the "Memorandum of Understanding (MOU)". The MOUs are the latest buzz-word in policy making circles. The prime minister has put the weight of his personality and office behind it. The impression is being created that they will, finally, salvage the public sector in India. Most reports implicate the Sengupta Committee for spawning this "brilliant" idea. Therefore, it is truly surprising to find that in the Report there is only one substantive para (3.23) on the topic of the MOUs.

The cavalier fashion in which the Committee has dealt with this issue would tend to suggest that this concept is both sound and widely known to everyone. However, even a cursory survey of public enterprise chiefs, BPE officials and technical ministries, reveals that practically everyone is in the dark about the concept, rationale and the *modus operandi* of the MOUs.

As a matter of fact, the concept of MOUs is a very simple one and the Report does an adequate job of describing them (para 3.23):

The Holding Company would also specify its plans for investments, production, capacity utilisation, dividends, etc., for a 5 year period and, therefore, enter into the memorandum of understanding with the government on mutually agreed basis. Certain obligations would also be cast on the ministry or department regarding provisions of equity, price level, etc. This memorandum of understanding would be reviewed each year and updated and the performance of the holding company judged on this basis, making due allowance for the failure or otherwise of the ministry or department to fulfil its part of the understanding.

It is, indeed, quite unfortunate that the Committee should choose the easiest and least controversial aspect of MOUs for inclusion in its Report and duck the major issues in this connection. For example, it is not clear why MOUs cannot be implemented between the ministries (administrative as well as technical) and public enterprises within the present structure. Is the formation of holding companies a necessary condition for the implementation of MOUs?

The problem here is similar to that encountered with respect to other recommendations made by the Sengupta Committee. No rationale is provided for preferring this particular approach. One possible reason could be the success of the MOU type approach elsewhere in the world. As always the Committee does not seem to have carefully (if at all) considered the international experience in this regard.

All such contractual approaches are copies of the famous French contracts between the government and public enterprises in France. Instead of the word "copies", I was thinking of saying that such notions derive their "inspiration" from French contracts. Unfortunately, there is nothing inspir-

ing about the French experience. After twenty years of experimentation with this system, the French public sector had incurred a record deficit around the same time that Sengupta and his associates were recommending this system to us in India. Therefore, it is completely understandable that they did not want to make a reference to the European experience as they did in the case of the holding company concept.

There is a saying that goes: "If it ain't broke, don't fix it." By this criterion too, the French contract system was a failure. In the span of twenty years, they went through four phases of such contracts: (a) Contrats de Stabilité (b) Contrats de Programme, (c) Contrats de Entreprise, and (d) Contrats du Plan. These contracts were abandoned for one reason or the other [Green, 1982]. The jury is still out for the last phase of these contracts—Contrats du Plan.

All of the above is still not enough to suggest that the French system of "contracts" should not be given a chance. So long as their experiences have been carefully analysed and lessons learned from their failures, we are on a solid ground. I am merely concerned with an attempt to re-invent the "square" wheel and the potential costs associated with such experimentation. The Committee gives us no reasons to help us allay our concerns in this matter.

Further, the French experience with the contractual approach is not the only one available to help us in designing our policies for India. Perhaps for us, the more relevant experiences are those of Senegal, Gambia, Pakistan, Korea and Bangladesh. All of these countries have adopted similar contractual approaches with varying degrees of success.

The Indian government's experience with MOUs thus far shows that adequate framework was not done by the government in this regard. It has taken the government more than two years to come up with two complete MOUs. This information is, by necessity, based on rumours as nothing has been made public. While the government is dragging its feet in signing MOUs, the public sector has already fallen way behind the targets for the current plan. At this rate, by the time the MOUs do arrive, it may be too late for any enterprises.

Moreover, the two existing MOUs have been reportedly signed with chief executives, who, perhaps, require it the least—V Krishnamurthy of SAIL and S P Wahi of ONGC. These managers are reputed to be achievers and are cited as success stories. Let the government try negotiating with some known losers.

If this is such a major policy thrust of the government, why has there been no public discussion on it. Perhaps the government has figured it all out and needs no input from anyone. The anxiety this is creating among chief executives is most undesirable. No one knows what this animal called "MOU"

really looks like, or, who will be negotiating on behalf of the government. Some reports have created the impression that the prime minister is directly involved in this process. One would also like to know, what the sanctions for non-fulfillment of the contractual terms are? Who will arbitrate in case of contractual disputes?

Some would argue that a similar system, though a less formal one, is already in operation. The technical ministries regularly meet with public enterprises under them and try to reach an agreement on their goals. The ministry of programme implementation has acquired similar experience in monitoring project implementation. The government should carefully examine these experiences before plunging ahead with half-baked ideas.

In particular, two issues come to mind. First, how can the government insure that public enterprises are not negotiating for deliberately low targets so that they can look good without much effort. This is particularly true in the absence of a good information system with the government. This is the reason why the Korean government decided to have a computer based information system before negotiating detailed targets. Their experience warrants close scrutiny, particularly because they are being marketed as a success story in the business of MOUs.

Finally, one would have to be careful that powerful chief executives do not "get off easily" by using their clout to negotiate low target. This is the kind of trade-off that the Committee should have examined, i.e., the advantages of a large holding company and the disadvantage of concentrating too much power in the chief executives of these enterprises.

AUTONOMY OF PUBLIC ENTERPRISES

Section IV of the Report with the autonomy of public enterprises, conceptualised as the "quantity of controls". It argues that the original objective of providing maximum autonomy in the day-to-day management of public enterprise has not been met. The main culprits, according to the Report, are the specific clauses in the Articles of Associations; Bureau of Public Enterprises; government guidelines and directions; the procedures followed for scrutinising investment funding, etc.

In bringing up these issues, the Committee is not breaking any new ground. Endless committees before this one have already made similar comments.⁸ This is not to belittle their recommendations in these areas however. In fact, some of their suggestions are good and should be implemented immediately, if they have not already been implemented. An example of this class of recommendations relates to the length of the tenure of the chief executives and full-time directors. The Committee recommends that the tenure of chief executives and full-time

directors should be five years subject to a probationary period of one year and removal at three months notice for unsatisfactory performance. The Committee is absolutely correct that the present practice of giving a tenure of two years is undesirable; two years is too short a time to bring about any substantial changes or improvements in large organisations (para 4.31).

In the same section discussed above, the Committee spends a lot of space on peripheral issues. For instance, it recommends that disciplinary proceedings against board-level appointees is the responsibility of the government. Also, it states that the government should consult the chief executive in appointing part-time directors. These comments are reasonable, except that they detract from the larger issues by cluttering the pages of the Report.

The Committee also suggests many changes which may be categorised as "cosmic" because adequate justification is not provided. For example, para 4.1 suggests that various limits relating to the size of projects going to the Expenditure Finance Committee and the Public Investment Board should be raised. They may reduce the quantity of control marginally, but do not increase the quality of control.

Further, there are recommendations that can only be called platitudes. For instance, para 4.40 urges the need for training and retraining of workers. It goes on to say: "Further it is desirable that each enterprise management must submit to its board of directors, once a year, a manpower budget, the training or retraining plans for all categories of employees, particularly the managerial cadres." It is difficult to disagree with such banal recommendations. The trouble is that it does not tell us the consequences of non-compliance. Moreover, it seems ironic that while the Committee argues against guidelines, and yet, it goes on to prescribe some fresh ones.

Finally, there are recommendations in Section IV which are simply off the mark, pure and simple. For example, para 4.6 recommends that in the case of a financially viable non-core sector, there is no need for detailed scrutiny of investment proposals. This equates financial viability with superior performance. As we know, however, that financial viability can also be due to favourable pricing policies, among other things. In the absence of a strong performance information system which can calculate the trend in constant prices, this recommendation could be very misplaced, to say the least.

Interestingly, in other parts of the Report, the Committee shows that it is aware of the issue of constant prices. In para 4.27, it clearly states that the bonus should be linked to an increase in productivity at constant prices, not to financial profits and losses. This brings us to another general problem with the Sengupta Report. There are so many inconsistencies between various parts

of the Report that an impression is created that it was created by slapping together pieces written by several people who did not even bother to eliminate such gaping gaps. For example, the argument regarding a five year tenure for a chief executive and full-time directors (para 4.31) could have been tied to the MOU requirement for a five-year plan in para 3.23. Similarly, there are innumerable instances in which the MOUs would make some of the recommendations redundant. In para 4.14, the Committee says that a mechanism has to be found to compensate the enterprise for the non-commercial burdens imposed by the government. The Committee overlooked the fact that the MOU is one such instrument for explicitly dealing with precisely these types of problems.

ACCOUNTABILITY OF ENTERPRISES

As mentioned earlier, there are two ways of controlling an enterprise. One is by specifying targets at the beginning of the year and leaving the enterprise free to pursue these objectives in their own way. Only at the end of the year they are to be evaluated on the basis of the agreed parameters. However, as indicated earlier, most governments find it difficult to specify such concrete goals for public enterprises since these enterprises are expected to achieve multiple goals that are often conflicting. The situation is made worse by the existence of multiple principles, with varied perspectives, trying to push their own particular goals. Therefore, most governments settle for a policy of controlling enterprises by stipulating operating procedures through a myriad of rules. This is viewed by most public enterprises on a "lack of autonomy".

The situation in India is similar to the stylised scenario depicted above. It follows from this, if we are to increase operating autonomy for public enterprises, *accountability* needs to be strengthened. Thus, Section V, which discussed these issues, is perhaps the most important section of the entire Report. For this reason it was also a major disappointment.

This portion of the Report suffers from every class of problem mentioned earlier in connection with other sections. First of all, it contradicts other sections of the Report. Para 5.3 suggests that the memorandum of understanding should be arrived at between the government in the administrative ministry and the public enterprise management. On the other hand, para 2.3 clearly states that it is the holding company that should enter into a memorandum of understanding with the government. It is as if the person writing Section V did not read Section III, where the main recommendations was to create a buffer between the government and the enterprises in the shape of a holding company to minimise government intervention in the affairs of the enterprises under its control.

The author of this section of the Report also ignores much of the recent progress made in the field of performance evaluation of public enterprises. No new ideas are presented and much of the recent literature on the topic is not utilised. In fact, once again, some of the oldest and most hackneyed themes are repeated. For example, para 5.4 states, "Public enterprises pursue a number of objectives simultaneously and a single measure of performance is difficult to specify." No one would, or could, argue with this statement; however, it does not address the more substantive issues: What are the various measures of performance for a public enterprise? How does one combine them to get a true picture of the overall performance of the enterprise? Unfortunately, on both fronts the answers in the Report are very unsatisfactory, to put it mildly.

In regard to the first question mentioned above, the Committee suggests, "there are certain objectives that are common and these should form the basis for general performance criteria. These general criteria may fall into four groups: (1) Financial performance, (2) Productivity and cost reduction, (3) Technical dynamism, (4) Effectiveness of project implementation" (para 5.4). There are numerous problems with both the individual categories of these criteria as well as the group as a whole.

For example, no rationale is given for the choice of these particular criteria. It seems that "repair and maintenance", "corporate planning," etc, are equally important for all public enterprises and should qualify to be included in this list of general criteria. Perhaps, if the Committee had explained its choices, one could better understand their reason for excluding other equally valid criteria.

Further, no indication is given as to the course of action to be undertaken when some of these criteria are mutually conflicting. For example, "technical dynamism" involves costs in the present and may result in lower financial profits in the current year. As a matter of fact, this problem of conflicting goals has been overlooked altogether in the Report.

This contradiction extends to various individual categories of criteria as well. The Committee suggests the following three criteria to evaluate financial performance of public enterprises;

- a) *Gross margin on assets* (for all enterprises), where:

$$\text{Gross margin} = \text{Sales} - \text{operating costs (excluding interest)}$$

$$\text{Assets} = \text{Gross fixed assets plus inventories}$$
- b) *Met profit on net worth* (for core sector and profit making enterprises), where:

$$\text{Net profit} = \text{Gross Margin} - \text{depreciation} - \text{interest}$$

$$\text{Net worth} = \text{Equity plus reserves}$$
- c) *Gross margin on sales* (for service enterprises), defined as: Gross margin divided by sales

To see the nature of problems associated with this recommendation, consider the following example. Imagine, that a public enterprise in a particular year, compared to the previous year, increases its sales by Rs 100 and also its consumption of intermediate inputs by Rs 100. From the point of view of society as a whole, therefore, this transaction is a neutral one. It does not lead to value added or surplus welfare—the society gains exactly what it sacrifices. However, if one looks at criteria (a) and (c) above, one gets a contradictory and confusing message. Criterion (a) remains unaffected, while criterion (c) decreases. Now, if we were using these criteria for controlling public enterprises, it is not clear what we should make of this dilemma. Should we penalise the manager or leave him alone? The Committee does not provide any clarifications.

Consider another example. Suppose there are two public enterprises, similar in every respect, except that one was set up in year V and the other one in year 't + 1'. Let us also assume that the prices of everything in these two years remain the same, except for fixed assets. Naturally, if we were to compare these two enterprises, we would find that the one set up in year 't + 1' has a larger denominator as per criterion (a), and, hence, appears to have a lower gross margin to asset ratio. This is obviously unfair to the manager of this enterprise as he is producing the same surplus from the same physical amount of productive capacity.

Similar problems relate to the Committee's recommendations regarding the monitoring of productivity and cost reduction. These recommendations are preceded by a platitudinous assertion reminding us that: "Monitoring performance in terms of financial profitability has to be supplemented by some simple monitoring of productivity and costs." However, the indicators suggested are neither *simple* nor *supplementary*. The Committee recommends that capacity utilisation, raw material costs (at constant prices) per unit of output, etc, should be used to monitor productivity and costs. This is surprising as it goes against one of the most fundamental principles of economics - the law of diminishing returns. According to the latter, when a variable factor (say, raw material) is added to a fixed factor (say, plant capacity), beyond a certain point, each additional unit of the variable input leads to successively smaller outputs. Therefore, in most cases, an a priori case can be made for a conflict between capacity utilisation and raw material costs (at constant prices) per unit of output.

In addition, calculation of raw material costs per unit of output at constant prices is no simple matter, either. To do an acceptable job, one needs prices and quantities of all raw materials as well as outputs. This information is not reported in the conventional, audited account of enterprises (except for a selected few industries, like cement).

Therefore, unless a sophisticated information system is in existence, the government will have little success in their constant price calculations.

Para 5.11 also argues, "it is particularly important to undertake such monitoring of costs and productivity in the core sector enterprises-." It is these kind of statements which show the lack of determination to undertake real reforms. As already mentioned, such distinctions between core and non-core sectors in our inter-dependent world appear to be artificial and unjustifiable.

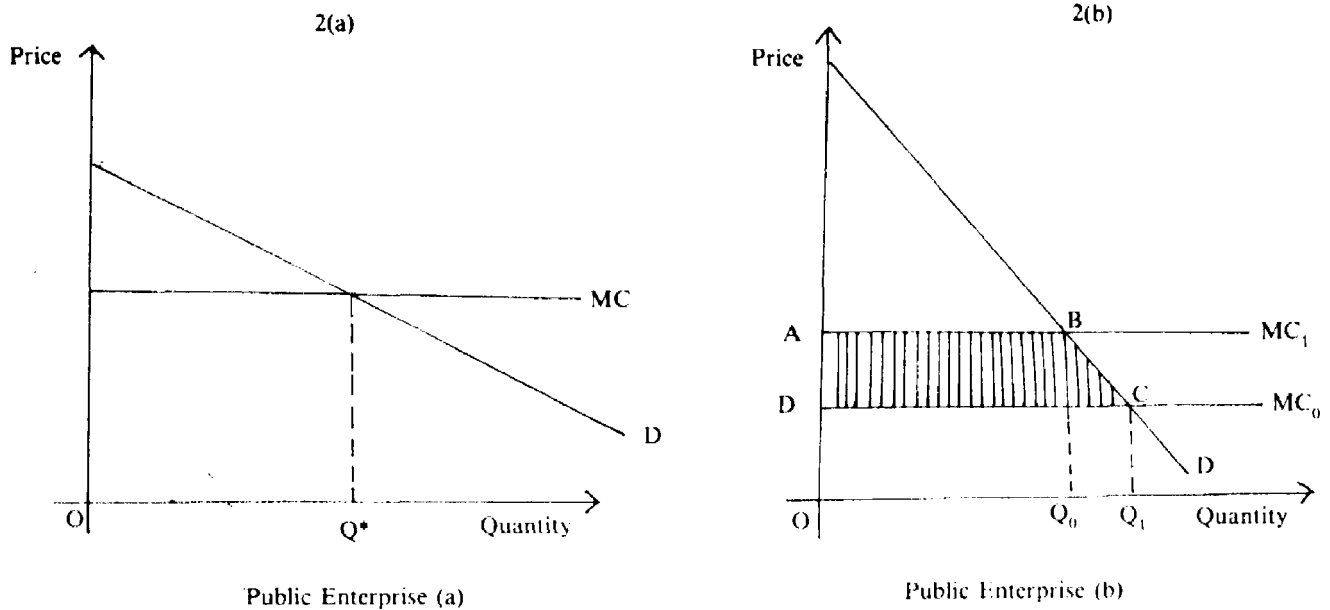
The recommendations regarding the monitoring of "technical dynamism" and "project implementation" are also written in a hurried manner. For the former, a quantitative indicator (number of product and process innovations introduced) and a qualitative assessment are suggested. No concrete steps are proposed, however, to combine the qualitative and quantitative aspects to come to a composite evaluation.

One could go on with these problems for some time. The danger is that it may start to look like nit-picking. Therefore, let us summarise the main points. There is clearly a danger in using partial indicators like labour productivity, capacity utilisation, raw material efficiency, etc. They only capture a limited aspect of the total reality. To overcome this, the most common mistake made is to opt for a multiple indicator which is simply a weighted average of a number of partial indicators. The Committee, too, fell for this age-old trap. This oversight is hard to understand since there existed sufficient literature [Sen, 1971; Jones, 1979; Jones and Trivedi, 1983; Nawab, 1984; Trivedi, 1985a and 1986b] at the time of writing this report, to caution them against these dangers and suggest feasible solutions. Unfortunately, one cannot go into the details of these solutions within the confines of this article.

Similarly, in making its recommendations regarding information systems, the Committee appears to be oblivious of the existing body of knowledge and collective experience of the developing nations in this regard. Currently, a distinction is made between a *performance information system* (PIS) and a *management information system* (MIS). The former system is meant for use by government bodies in monitoring the socio-economically relevant behaviour of its public enterprises. It is intended as a part of a larger signalling system which guides managers to make decisions in the national interest and rewards them for doing so. The purpose of this kind of information system is not to make a final arbitrary decision as to how well managers have done. Rather, it is to provide the information upon which such a decision can be based.

Since a PIS is at the apex of a large pyramidal decision-making hierarchy, it is as important to exclude irrelevant information as it is to include necessary information. To maintain the advantages of hierarchy and

FIGURE 2



decentralisation of decision-making, and to avoid swamping the top levels with extraneous data, it is necessary to filter information as it moves upwards through the hierarchy. The top needs the broad summary variables, not all the details. For example, a conventional MIS provides managers with a wealth of details on standard costs, inventory levels and a multitude of other factors which help him to control costs. The PIS, on the other hand, contains much less details in this area, being concerned only with whether costs are rising or falling (and whether it is due to price or quantity effects).

The two information systems are not substitutes but complements. The PIS at the ministry level motivates the use of, and in part measures the success of the MIS at the enterprise or the holding company level. The Sengupta Committee only emphasises the MIS and ignores the PIS altogether. In fact, it recommends dismantling even the rudimentary PIS that already exists in the Planning Commission. One would have expected them to suggest strengthening this system along with the installation of a compatible MIS in various public enterprises.

One of the reasons given for abandoning this information system contradicts some of the recommendations made earlier in this Report. The Committee argues that a performance information system is not necessary because the government can obtain specific information, when the need arises, from public enterprises. Those who know our public sector will agree that government requests for information of all types at odd times is a major source of irritation, if not disguised harassment, for enterprises. Further, in the absence of a system of checks and cross-checks, there is no guarantee that public enterprises will always supply reliable data. Some of these

mistakes may be intentional and some otherwise. However, the government would not know the difference in any case.

ROLE OF THE COMPTROLLER AND AUDITOR CENTRAL

In this section too, the now familiar pattern of the report is faithfully repeated. That is, correct facts are stated but analysis and policy recommendations somehow go awry in the transformation process from facts to recommendations. For example, the Committee correctly reports that public enterprises are subject to "two audits" regularly. One by the chartered accountants deals mainly with questions of "regularity," i.e., whether accounts are correctly maintained, expenditures and receipts accurately recorded. The supplementary audit by the Comptroller and Auditor General (C and AG) checks mainly the "propriety" of the transactions. C and AG also conducts a "performance audit" from time to time.

However, the Committee recommends that the "performance audit" should be continued and supplementary audit is not necessary for profitable non-core companies, once common accounting policies are evolved. This is exactly the opposite of what the logic dictates. As mentioned earlier, one of the main reasons for poor performance of public enterprises is the lack of clarity of goals. The latter being a result of multiple principals emphasising multiple goals, which are often conflicting. The solution is, therefore, reducing multiplicity of principals and the conflicting nature of goals. Having a performance audit in addition to a memorandum of understanding will be terribly confusing for public managers. They would not know who they should please. If experience is any guide, they will please neither.

However, they will escape penalties by blaming the other principal in justifying their failure to each principal separately.

The recommendation that profit making non-core companies need not care about the propriety of their transactions is extremely puzzling. Propriety of transactions is one aspect which makes a public enterprise truly different from a private one [Nitish De, 3987]. The distinction between core, non-core and profit and loss making is meaningless in this context. Public enterprise must care about the propriety of their transactions, period.

RELATION WITH PARLIAMENT

This section (5.14-5.26) of the Report repeats much of what has been said earlier. Therefore, much of it does not require further comments. For example, we have already commented on its recommendation to evolve a parliamentary convention of not asking questions on day to day operations of the public enterprise.

The recommendation which does require some thought concerns the role of the Committee on Public Undertaking (COPU) of the Indian Parliament. The Sengupta Committee endorses the occasional "post-mortem", "ex-post" studies of the working of public enterprises by the COPU. This addition of yet another "principal" in the monitoring game can only confuse and confound the public enterprise managers.

I can understand the Committee's reluctance to appear "undemocratic" by suggesting the potential dangers of still another performance evaluation exercise. The Committee failed miserably, however, in not even trying to raise the quality of this parliamentary interface by asking some relevant questions.

There is a widespread perception that COPU enquiries are often used as witch-hunts by interested parties. The Committees should have examined how many recommendations of the COPU have actually been implemented. Who are the people in the COPU staff who do these studies? What relevant experience do they have to question the working of multi-crore mega enterprises? Only after these and other questions have been answered can one take the recommendation on COPU reports seriously.

The Report seems to get more muddled as one progresses through its pages. In Section VI, a very sketchy discussion of technology upgradation is undertaken. It quotes a study that suggests that "a number of public enterprises have not made sufficient efforts to absorb imported technology or in some cases adaptation to the Indian environment." The Report then goes on immediately to discuss cures for this problem. However, all its recommendations are too general in their prescriptions and vague with regard to implementation. For example it recommends, "All major projects should include technology adaptation programmes and for this purpose the government should consider providing part of this expenditure as grant (para 6.3)". It is not clear what is meant by "technology adaptation." Where will the money for this come from?

Ideally, one would have expected the Committee to first discuss the causes for the lack of technology upgradation and, then, systematically discuss the cures in view of the particular causes. Khanna (1984) has shown that this is as much of a problem in the private sector and there are very valid economic reasons for it. On the one hand, the committee wants public enterprises to act like private ones and generate financial surpluses. On the other, it wants them to behave differently. In the short run, at least, there may be a trade-off between these two objectives. Since public managers typically have a short tenure, these considerations will bear heavily on their decisions. The Committee fails to enlighten us on how to resolve this conflict. In my view, an MOU would be a useful vehicle to carry out this policy goal; however, no such linkages are provided in the Report to guide policy makers.

Furthermore, the Committee overlooks the distinction between *investment decision* and *performance evaluation*, mentioned earlier. For most public enterprises, the technological choices are already predetermined at the investment decision stage. They do not have too many options. One has to separate the "efficiency in investment decisions" from the "efficiency in operational decisions".

FINANCIAL VIABILITY OF LOSS MAKING UNITS

The most conspicuous thing about Section VII is the quick connection made between

financial losses and efficiency. The indictment of loss makers is alarming. "Loss-making enterprises are a burden on the public exchequer and, therefore, they cannot expect the same degree of autonomy as financially viable units." I wonder if it occurred to the Committee that lack of autonomy may be the very cause for losses to start with. Therefore, to restrict autonomy further may trap these enterprises in an eternal vicious cycle.

In addition, losses could be due to several non-commercial goals that the government may have imposed on public enterprises, including lower output prices. Therefore, at the very minimum, one would have expected the Committee to tell us the performance of these loss makers in constant prices.

The Committee recommends capital restructuring by converting debt into equity. This tantamounts to putting powder on one's face to hide pimples. Generating profits in this manner does not increase the overall welfare of society. It is a transfer payment which leads to money being transferred from one party to another, leaving the overall surplus at the same level. Since most of the interest would have probably gone to the government in any case, this restructuring does not increase the resources available to the government. How does it matter whether government takes their money as interest or profit?

PRICING IN PUBLIC ENTERPRISES

Pricing policies of public enterprises are discussed at several places in the body of the

Report. Section VIII, however, is devoted exclusively to pricing issues. The problem with this section is its purely administrative approach toward these issues. One expected better from a Committee headed by an economist.

In para 8.3, the Committee recommends: "Unless the public sector share of the market is such that the concerned public enterprise is the price leader, there is no point in the public sector alone charging a price lower than those of other producers!" The first thing to note is that the Committee (implicitly) ignores the distinction between output and inputs markets. Public enterprises produce both final outputs as well as intermediate inputs. There are different considerations in deciding on pricing policies in these two types of markets. Second, the Committee never quite specifies what is the main objective of pricing policies. Is it purely "financial" (i.e., to generate profits alone) or one also wants to use them for improving resource allocation?

Even if the objective is purely financial, this recommendation is too general to be useful. In many situations, such a policy may be justified precisely because the concerned public enterprise is trying to capture a large share of the market to become a market leader and curb the monopolistic exploitation of consumers by the current market leaders from the private sector. Therefore, the resultant poor financial performance in the short run will be more than compensated by the enhanced social welfare in the long run.

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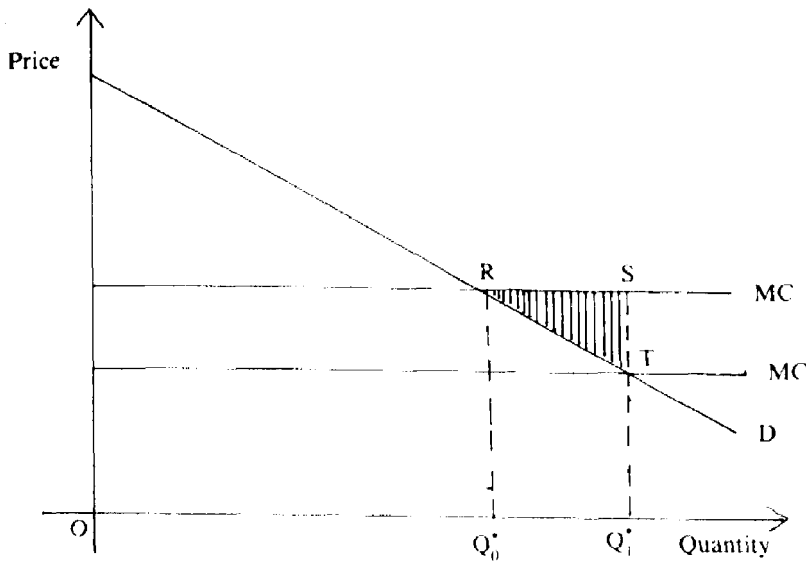
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FIGURE 3



Further, if the concerned public enterprise is a small part of the market and we force it to behave like a purely private enterprise, then one has to ask a very basic question: what is the point in having that enterprise in the public sector? Would it not be preferable to use the scarce public resources elsewhere and simply collect taxes on the profits of the private enterprise? When I talk about scarce resources, I am referring both to resources invested in the enterprise as well as resources required to monitor and control it.

More puzzling than all of this is the total neglect of the allocative role of public enterprise pricing policies by the Committee. Public enterprises are an instrument of public policy and, as such, their pricing policies are supposed to promote public interest. Financial surplus is one element of overall social welfare. Another important factor affecting social welfare is the allocative efficiency of resources. The starting point of all discussions on "allocative efficiency" is the concept of "marginal cost pricing." It is curious that this concept was not mentioned even once in the Report. There are, admittedly, conceptual and practical difficulties associated with this concept, but that is not an adequate justification for ignoring it altogether. Had the Committee cared to think about this aspect of pricing, it would have not written Section VIII in this cavalier fashion.

For example, let us consider a case where underpricing is justified in terms of allocative efficiency. Suppose that a public enterprise is supplying intermediate inputs to a private enterprise which has a monopoly in the product market. As a result of this monopoly power, the private enterprise is charging a higher price P_0 and producing a lower output, Q_0 , compared to what it would do if the market were competitive

(Figure 1). The government wants to correct this distortion and has several choices. It could either nationalise the private firm, control its prices, break it up or use public enterprise pricing policy to achieve the same objective. Each policy has its pros and cons, too numerous to discuss here.

However, let us further suppose that the government decides (after considering other options) to use public enterprise prices for achieving this objective. The argument, from what is walled the "theory of second best pricing", is that the public enterprise should set a price lower than its marginal cost of production. This will lower the cost of production for the private enterprise and move it closer toward the point of optimum allocation as shown in Figure 1. How much should the enterprise reduce the price of its products? The answer, in theory, is simple. One should continue to depart from marginal cost so long as the benefit of doing so is more than the cost of doing so. When these two become equal, one should stop. Notice that this may involve increasing the profits of a private monopoly. This is the classic trade-off between equity and efficiency.

The point is that there are several theoretically sound reasons for lowering public enterprise prices even when it may lead to some financial losses. The preceding is but one example of the innumerable cases one could cite.

The treatment of the important issue of the existing price preference system for public enterprises also smacks of *ad hoc* reasoning. According to this system, a 10 per cent price preference is to be given to public enterprises *vis-a-vis* the private sector. That is, if a product similar to that from the private sector can be supplied by a public enterprise for a price difference of not more than 10 per cent, then other public enterprises are obliged to purchase this product

from the public enterprise. (This preference is equal to 15 per cent where imports are involved.)

The Committee recommends that this system be abolished over 4 or 5 years and be substituted by an explicit subsidy equal to 10 per cent of the tender price. As usual, the Committee gives no reason for these recommendations.

One is left in the dark as to why a period of 4 to 5 years has been chosen. What is meant by "phased out"? Does it mean abolished for some immediately and later for others? Or, reduce the percentage gradually from ten to zero? Which enterprises should be chosen for this phasing out?

Similarly, what is the relative advantage of having subsidies rather than price preferences? In terms of resource mobilisation both have the same effect on the exchequer. To see other effects of this policy, let us consider a simple example. Suppose there are two public enterprises (a) and (b). Enterprise (a) sells its output to (b). In the absence of any constraints, the ideal pricing policy for (a) would involve fixing the price equal to its marginal cost (MC) as shown in Figure 2(a).

Let us now suppose that the government enforces the price preference system. This causes the marginal cost of production for (b) to increase from MC_0 to MC_1 , as shown in Figure 2(b). Comparing the two situations we find the net loss to society is equal to the area A BCD. If this loss is less than the benefits to society of maintaining employment and operating public enterprise (a), then price preference is justified. One of the reasons for the higher costs of public enterprise (a) may be due to its location in a backward area. An economist's job is to point out this trade-off and whether it is "worth it" or not, is a normal live judgment for decision makers.

Let us now consider the option of giving a subsidy and scrapping the price preference system. The result will be a lower MC facing firm (a) and, hence, an expansion of production beyond the optimum quantity of Q_0^* in Figure 3. The net loss of this policy would equal area RST.

Therefore, the choice between a subsidy and price preference will depend on whether RST in Figure 3 is greater or smaller than ABCD in Figure 2(b). Admittedly, this is a very simplified picture. It is not intended to depict reality in its entirety, only to address the issues involved. From that point of view, it is clear that generalisations made by the Committee are clearly too strong.

The last section of the Report discusses a few odds and ends. However a very disturbing comment is stuck in one of the recommendations: "Even though on paper the enterprises do enjoy complete autonomy in these areas, in practice, however, interference from the ministry or department of the government does take place. We suggest that suitable convention be evolved to ensure such

interferences are avoided." If this is true, then what is the point of so many recommendations the Committee has made to ensure more autonomy, including the formation of holding companies and MOUs? All these may be fine on paper, but as the Committee admits, in reality the interference may continue unabated. Perhaps, the Committee should have spent more time on outlining a strategy to evolve these conventions for non-interference. It is truly depressing to think that, along with the Committee, we may have been barking up the wrong tree.

Notes

[An earlier version of this paper was presented at the National Seminar on the Management of State Level Public Enterprises, Osmania University, Hyderabad, March 5-6, 1987. I would like to thank the participants of this seminar and the seminars at the Centre for Policy Research and the National Council for Applied Economic Research for their comments. Thanks are also due to K C Sethi and Bagaram Tulpule for helpful comments. Part of the research for this paper was supported by the Centre for Studies in Public Enterprise Management, Indian Institute of Management, Calcutta.]

- 1 Organised jointly by the standing Conference of Public Enterprises (Scope) and the Department of Public Enterprises.
- 2 Every third Rupee for the total investment in this plan is expected to come from the public sector.
- 3 A survey of a number of questions asked in parliament regarding the Sengupta Report suggests the following. It appears that except for three recommendations, all others have been accepted. However, implementation of these recommendations is a different story altogether. None appear to have been fully implemented. For details, see: Lok Sabha (Unstarred question No 8202, April 29, 1986; Starred question No 207, November 18, 1986), Rajya Sabha (Unstarred Question No 1251, November 17, 1986).
- 4 Careful analysis of this issue often reveals a surprisingly large divergence between perception and reality of public enterprise performance. For details, see: Trivedi (1986).
- 5 Defined by the Committee in Para 2.3 of the Report.
- 6 One can also add management of public enterprise as a fourth category, though management is subsumed under each of these three categories.
- 7 Of course, where the government does not administer prices, performance evaluation should examine the pricing policy itself.
- 8 It would be an interesting research topic to compare and contrast the recommendations of the L K Jha Committee. Why is it that two eminent policy makers examining the same issue come up with such divergent recommendations as these did in many cases? This paper is not the right forum to answer that question.

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