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The Impact of Privatization on Economic Growth of India

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I. Introduction

We all know Economic Growth is one of the most important goal for every nation in the present times. In 1960s and 1970s Academicians, Politician and Economists favoured State ownership over private ownership. This was also visible in Indian economic policies and we can see that Industrial policy of 1948,1956, 1970 advocated state ownership and there was not much space for Private sector as far as economic activities are concerned. By the end of 1980 we can clearly see a policy departure at global level. In case of India we witnessed it after introduction of New Economic Policy in 1991

The paper examines the relationship between Privatization and economic growth it also examines the good and bad effects of Privatisation on growth and development of Indian Economy. The paper looks in details why state ownership failed. According to World Bank report it was the failure of state which prompted many countries to change public policies in the favour of Privatisation. The paper looks at the various aspects where public sector and state owned enterprises failed to deliver. It highlights the problem of state ownership in the form of 1. Unprofitable S.O.Es,2. High government debts, 3. Inefficient service delivery 4. Stagnant Growth rate. We know that Privatisation became the policy tool for many countries to foster economic efficiency and for achieving higher rate of growth. The paper stresses all the points mentioned above which promote Privatisation.

The paper also emphasizes the defects of Privatisation. The policy of Privatisation has came under attack due to growing income inequality in the society and abuse of market power by few big business houses for satisfaction of their own selfish interest. Moreover the policy of Privatisation was also critised for the loss of welfare objective and for distributive injustice. The people of developing nations claim that Privatisation benefits rich on the cost of poor. There are also large number of Privatisation supporters who claim that Privatisation is the need of hour to foster efficiency and economic growth. These aspects will be analysed during the course of paper. The paper also suggests a perfect mix of Privatisation and State for achieving the twin objective of growth efficiency and equality.

II. Review of Literature

This section presents an overview of the theories of privatization, the link between privatization and economic growth and income inequality, and finally discusses theempirical literature on privatization.

Theories of Privatization

Though many theories have been used to support the privatization agenda, three theories have stood out over the past several years. These are: Property Rights theory, Public Choice theory, and Principal Agent theory. The basic assumption of the privatization theories is that free market forces enhance efficiency in organizations. Henig (1989),

Property Rights Theory-The property rights literature is quite diverse, but it is characterized by a common emphasis on the interconnectedness of ownership rights, incentives, and economic behaviour (Commander and Killick (1988). Property rights theory is therefore concerned with maximizing the utility function of managers subject to the limits established by the existing organization. Property rights have been defined in a variety of ways. Allchin (1965) defines property rightsas having three characteristics: exclusivity of rights to the choice of use of a resource; exclusivity of rights to the services of a resource; and the rights to exchange the resource at mutually aggreable terms

Principal-Agent Theory- fundamental argument for the superiority of the private enterprise in terms of its efficiency is based on the fact that as residual claimants to a firm's revenues, the owners are motivated to behave efficiently.separation of ownership from control can be an efficient form of organization relative to organizations in which the risk-bearing and decision-making functions are combined. Fama (1980) observes that a firm is usually disciplined by competitionfrom other firms will only make it more efficient.

Public Choice Theory- Underlying the case for privatization is the view that there is government failure, in the sense that public policy is likely to operate in ways that impede the efficient functioning of markets (Yarrow, 1999). Government failure or the public choice argument, according to Ghosh (2001) is the main pillar of the neoclassical counter-revolution to the interventionist state with unlimited power. Government failure refers to the failure of government policies to allocate resources efficiently, to redistribute them in a well-targeted manner, and to stabilize the economy in the period of stagflation (Tanzi and Schuknecht, 2000). The basic assumption of public choice theory is that humans are egoistic, rational, utility maximizers (Buchanan and Tullock, 1962).

The principle of utility maximization according to the public choice perspective dominates human behavior both in the marketplace and in politics (Abu Shair, 1997;). Buchanan (1972) asserts that politicians in interfering in the economic activity are more interested in winning votes than promoting efficiency in SOEs. This is due to the fact that the policy environments in which firms operate are functions of the incentive structures faced by policy makers, which depend on a range of political factors including interest group pressure and public opinion. Thismeans that an increasingly larger share of government output is designed to benefitsubgroups of the populace at the expense of the general public.

Privatization, Economic Growth, and Income Inequality

Finally, the privatization process may lead to increased investment and stimulation of economic growth for the entire economy (Berg and Berg, 1997). Davis et al. (2000) indicate that markets and investors regard privatization as a positive signal of the political likelihood that a government will stick with its overall reform program, and therefore privatization may be associated with high rates of foreign direct investment (FDI). The FDI literature indicate that developing countriesexperienced a sharp increase in the average ratio of FDI to total investment during the 1990s, which was due mainly to large scale privatization programs especially in infrastructure (Kirkpatrick, Parker, and Zhang, 2006; Palmade and Anayiolas, 2004).Foreign investment has positive spillovers to the entire economy in terms of improved technology, superior marketing and management skills, and access to international production networks (Kobrin, 2005; Kumar and Pradhan, 2002; Narula and Portelli, 2004; Sylwester, 2005). People in developing countries like India alsowitnessed widespread inequalities due to concentration of wealth and resources in few hands.

Objective of study

The objective of this study is to examine the impact of privatization on economic performance in developing countries between 1991 and 2002. The goal is to examinethe impact of privatization on two economic development indicators: economic growth and income inequality. The study therefore seeks to examine whether the privatization programs implemented by most developing countries between 1991 and 2002 had a positive effect on both output growth and distributional equity as suggested by the advocates of privatization . The dependent variables employed in this study are the economic growth rates and income inequality. The economic growth rates is represented by the Gross Domestic Product.(GDP) per capita growthrates and income inequality is represented by the ratio of the share of going to the richest in the population and the share of income going to the poorest in the population. The main independent variable of interest is the privatization variable which is represented by the privatization revenues as a percentage of Gross Domestic Product (GDP). The study will also control for other variables that are known to affect growth (e.g., the degree of openness, fiscal and monetary policy, governanceinfrastructure, and the initial level of development.

The basic Phenomenon of Privatization and Economic Growth Privatization, described as the transfer of state owned enterprises (SOEs) to theprivate owners, has become a common economic policy tool around the globe. The trend toward privatization is debatable issue. Indeed, the debate between the superiority of the private and public sectors has been going on for the past four to five decades. The discussion initially focused on how the size of public sector measured by the size of government consumption affected economic growth(Rubinson, 1977).

Findings of many studies demonstrated that privatization did not contribute to growth but helped to reduce income inequality, inflation contributed negatively to both economic growth and income equalization. On the other hand, several economists stated that Privatization, a method of reallocating assets and functions from the public sector to the private sector play vital role for economic growth. Recently, privatization has been adopted by many different political systems and has spread to every region of the world. The process of privatization can be successful way to bring about fundamental structural change by formalizing and establishing property rights, which directly creates strong individual incentives. A free market economy mainly depends on well-defined property rights in which people make individual decisions in their own interests. According to experts, privatization may improve efficiency, provide financial relief, boost wider ownership, and increase theavailability of credit for the private sector.

Major advantages of Privatization

- To reduce the burden on Government
- To strengthen competition
- To improve Public finances
- To fund infrastructure growth
- Accountability to shareholders
- To reduce unnecessary interference
- More disciplined labour force.

Privatization can be categorized into three parts:-

1. Delegation: Government keeps hold of responsibility and private enterprise handles fully or partly the delivery of product and services.

2. Disinvestment: Government surrenders the responsibility.

3. Displacement: The private enterprise expands and gradually displaces the government entity.The advantages of privatization can be apparent from both microeconomic and macroeconomic advantages and impact of Privatization.

Micro Economic Advantages

State owned enterprises generally are outdone by the private enterprises competitively. When compared the latter, it shows better results in terms of profits and efficiency and productivity. Therefore, privatization can provide the necessary push to the underperforming PSUs. Privatization brings about fundamental structural changes providing momentum in the competitive sectors. Privatization leads to implementation of the global best practices along with management and motivation of the best human talent to foster sustainable competitive advantage andquality.

Macro Economic Advantages

Privatization has a positive impact on the financial growth of the sector which was previously state dominated by way of decreasing the deficits and debts. The net transfer to the State owned Enterprises is lowered through privatization.

It helps in escalating the performance benchmarks of the industry in general.

It can initially have an undesirable impact on the employees but progressively in the long term, shall prove advantageous for the growth and prosperity of the employees. Privatized enterprises provide better and quick services to the clients and help in improving the overall infrastructure of the country.

Disadvantages of Privatization

Though privatization offers numerous advantages, it has many disadvantages; Private sector mainly focuses more on profit maximization andless on social objectives dissimilar to public sector that initiates socially viable adjustments in case of emergencies and criticalities.There is lack of clearness in private sector and stakeholders do not get the complete information about the functionality of the enterprise.

1. Privatization has provided the unnecessary support to the corruption and unlawful ways of accomplishments of licenses and business deals amongst the government and private bidders. Lobbying and bribery are the common issuescorrupting the practical applicability of privatization.
2. Privatization loses the mission with which the enterprise was established and profit maximization programme encourages malpractices like production of lower quality products, elevating the hidden indirect costs, price escalation etc.
3. Privatization results in high employee turnover and a lot of investment is required to train staff and even making the existing manpower of PSU abreastwith the latest business practices.

4. There can be a conflict of interest amongst stakeholders and the management of the buyer private company and initial resistance to change can impede theperformance of the enterprise.
5. Privatization intensifies price inflation in general as privatized enterprises do not get government subsidies after the deal and the burden of this inflation affects the common man

Major causes of privatization are:-

- To reduce the burden on Government
- To strengthen competition
- To improve Public finances
- To fund infrastructure growth
- Accountability to shareholders
- To reduce unnecessary interference
- More disciplined labour force.

The private sector have effective policies in solving the problem of externalities, through costless bargaining, driven by individual incentives. According to the Coase Theorem, individual parties will directly or indirectly take part in a cost-benefit analysis, which will eventually result in the most efficient solution (Mankiw, 2001). When comparing with public sector, the private sector responds to incentives in the market. On the other hand, public sector often has non-economic goals. The public sector is not highly driven to maximize production and allocate resources effectively, causing the government to run high cost, low-income enterprises. Privatization directly shifts the focus from political goals to economic goals, which leads to development of the market economy (Poole, 1996). The downscaling aspect of privatization is an important one since bad government policies and government corruption can play a large, negative role in economic growth (Easterly, 2001). Through privatizing, the role of the government in the economy is condensed, thus there is less chance for the government to negatively impact the economy (Poole, 1996). Privatization may have a positive impact on a country's economic situation. Privatization should not be used to finance new government expenditures and pay off future debts. Instead, privatization enables countries to pay a portion of their existing debt, thus reducing interest rates and raising the level of investment. By reducing the size of the public sector, the government reduces total expenditure and begins collecting taxes on all the businesses that are now privatized. This process can help bring an end to a vicious cycle of over-borrowing and continuous increase of the national debt (Poole, 1996). Nations around the world have adopted different methods of privatizing state assets depending on the initial conditions of the country's economy and the economic principles of the political party in charge.

Major method of privatization is the sale of state-owned enterprises to private investors. The state would simply decide which institutions should be privatized and through the use of market mechanism, private investors are able to buy shares of each organization. Advantage of this method of privatization is that it creates badlyneeded revenues for the state while putting privatized firms in the hands of investorswho have the incentives and the means of investing and reformation. Other method of privatization is called voucher privatization. The government universally distributes vouchers to its eligible citizens, which can be sold to other investors or exchanged for shares in other institutions being privatized. Although this method does not create profits for the state, it does privatize state-owned firms in a short period of time.

Next method of privation is called internal privatization, also known as "employee or management buyout". State-owned enterprises are sold to managers (for an extremely low price) who are already familiar with the particular firm and its structure, but there are minimal revenues created for the state. This method creates some incentives but the incentives are much stronger when firms are sold to strategic investors. Furthermore, new owners often do not have the resources to invest and restructure, which is badly needed in a large percentage of state-owned firms in underdeveloped countries (Stirbock, 2001).

One of the noticeable feature of privatization is the improved competitive characteristics it provides to the enterprises which prove to be fruitful for the business as well as the country. Nonetheless, privatization contracts are greatly influenced by merger variables and even global issues and are structured on the basis of manipulation of the government and the private actors along with the administering jurisdiction.

Critical Analysis of Privatization results with Reference to Indian Economy

Government of India chose for a mixed economy in which both public and private sectors were permitted to operate. The private sector had to operate within the provisions of the Industries (Development and Regulation) Act. 1951 and other relevant legislations. In this framework, the Industrial Policy Resolution 1956 stated, Industrial undertakings in the private sector have necessarily to fit into the framework of the social and economic policy of the State and will subject to control and guideline in terms of the Industries (Development and Regulation) Act and other relevant legislation. The Government of India recognizes that it would be desirable to allow such undertakings to develop with as much freedom as possible, consistent with the targets and objectives of the national plan.

Reports indicated that in spite of speedy progress of the public sector in the period of planning, private sector is the principal sector in the Indian economy 1956Since many decades, numerous modern industries have been established in the private sector. Important consumer goods industries were set up in the pre-Independence period itself. Examples include cotton textile industry, sugar industry, paper industry and edible oil industry. These industries were set up in response to the opportunities offered by the market forces. They were highly suitable for private sector since they ensured good returns and required less capital for establishment. Though the engineering industries were not established in the pre-Independence period, yet Tata had initiated in the field of iron and steel industry at Jamshedpur. After Independence, a number of consumer goods industries were set up in the private sector. Presently, India is practically self-reliant in its requirements for consumer goods. According to the 1956 resolution, "industries producing intermediate goods and machines can be set up in the private sector." As a result, chemical industries like paints, varnishes, plastics etc. and industries manufacturing machine tools, machinery and plants, ferrous and non-ferrous metals, rubber, paper, etc. have been set up in the private sector.In India, there is a need of privatization of companies to enhance economic status. Though the PSUs have contributed a lot to develop the industrial base of the country, they continue to suffer from a number of inadequacies such as; Many PSUs have been incurring and reporting losses on a continual basis. Consequently, a large number of PSUs have already been referred of loss giving units. Multiplicity of authorities to whom the PSUs are accountable. Delay in implementation of projects leading to cost escalation and other consequences.
Management There is Ineffective and extensive inefficiency on management. Many PSUs are over-staffed resulting in lower labour productivity, bad industrialrelations.
There are many examples of privatization of companies in India such as:

- Lagan Jute Machinery Company Limited (LJMC)
- Videsh Sanchar Nigam Limited (VSNL)
- Hindustan Zinc Limited (HZL)
- Hotel Corporation Limited of India (HCL)
- Bharat Aluminium Company limited (BALCO)

Major impact of Privatisation on Indian Economy are as under: Private concerns tend to be profit oriented and transparent in their functioning as private owners are always oriented towards making profits and get rid of sacred cowsand hitches in conventional bureaucratic management.

- Since the system becomes more transparent all fundamental corruption are minimised and owners have a free reign and incentive for profit maximisation so they tend to get rid of all free loaders and vices that are inherent in government functions.

- Gets rid of employment inconsistencies like free loaders or over employed departments reducing the strain on resources.

- Lessen the government's financial and administrative load.

- Effectively minimises corruption and optimises output and functions.

- Private firms are less tolerant towards capitulation and appendages in government departments and hence

tend to right size the human resource potential befitting the organisations needs and may cause resfew limitations of the study are worth noting.
First, the lack of consistent data limited
the analysis to a maximum of 75 countries in the growth regressions and 60 countries in the income inequality regressions out of the 80 countries studied. Second, the study examined the impact of total privatization and did not address the impact of different methods of privatization on economic development. A few studies have reported differential effects of the various methods of privatization on economic growth (Bennett et al., 2004; Earle, 2002). Third, the type of industries privatized may also have an effect on economic performance. Many studies on privatization of infrastructure, finance, and manufacturing firms indicate differences in the industry effect of privatization. The lack of consistent data on the revenues generated from the various methods of privatization and industries did not allow us to control for these factors. The World Bank's privatization database reports the types of industries privatized, but not the amount generated from each sector, consequently, we are unable to control for any bias thatdisgruntled employees who are accustomed to the benefits as government functionaries.

- Permit the private sector to contribute to economic development.

Limitations of the Study

A few limitations of the study are worth noting. First, the lack of consistent data limited the analysis to a maximum of 75 countries in the growth regressions and 60 countries in the income inequality regressions out of the 80 countries studied. Second, the study examined the impact of total privatization and did not address the impact of different methods of privatization on economic development. A few studies have reported differential effects of the various methods of privatization on economic growth (Bennett et al., 2004; Earle, 2002). Third, the type of industries privatized may also have an effect on economic performance. Many studies on privatization of infrastructure, finance, and manufacturing firms indicate differences in the industry effect of privatization. The lack of consistent data on the revenues generated from the various methods of privatization and industries did not allow us to control for these factors. The World Bank's privatization database reports the types of industries privatized, but not the amount generated from each sector, consequently, we are unable to control for any bias thamight be due to differences in the type of industry privatized. Finally, the effect of privatization is dependent on what the privatization proceeds are used for; it may be used to retire debt, saved, transferred to budget or used in capital expenditures. The validity of the findings of the study is therefore limited to the extent that the aforementioned factors impact thegrowth process.

III. Conclusion

In short, privatization is the process of transfer of ownership, can be of both permanent or long term lease in nature, of a once upon a time state-owned or public owned property to individuals or groups that intend to utilize it for private benefits and run the entity to generate revenues. Privatization is overriding process to enhance productivity and competitiveness, as well as attracting foreign direct investment.

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