

*The Mahbub ul Haq Memorial Lecture*

## **Privatisation, Regulation, and Competition in South Asia**

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Privatisation has begun to accelerate in India and Pakistan. However, it is not clear that a change in ownership *per se* will contribute significantly to a more rapid, efficient, and equitable growth unless policies that ensure competition for these enterprises and remove distortions in factor markets also are undertaken at the same time or prior to privatisation. After a brief discussion of the transition from state-led development to more market-oriented policies and gradual opening to world markets, this paper reviews some of the analytical literature on privatisation and regulation. The translation of these theories into concrete policy suggestions is difficult for countries such as Pakistan and India, where many of the assumptions behind the theories do not hold. However, the results of empirical studies on past privatisations around the world do hold lessons for South Asia. Similarly, theories of regulation offer only broad recommendations, most notably (for South Asia) that regulation is not the best way to redistribute resources. The final section of the paper reviews India's and Pakistan's experience with privatisation thus far. Attempted privatisation of electricity in India serves as an example of the need for more attention to regulation, while the transfer of ownership has led to better service at lower cost in the telecommunications sector. Pakistan's privatisation programme appears to have had similarly mixed results, though it is difficult to come to firm conclusions with the evidence at hand.

### **1. INTRODUCTION**

It is a great honour to be invited to deliver the Mahbub ul Haq Memorial Lecture. Mahbub finished his graduate studies in economics and left Yale in 1956, a year before I began my own graduate studies there. He had set an exemplary record that those of us from South Asia who followed him at Yale, such as Bashir Karamali, Parvez Hasan, Syed Nawab Hyder Naqvi, Syed Naseem, and myself included, could only envy. In the late seventies, I interacted with Mahbub at the World Bank, where

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*Author's Note:* I thank Jessica Wallack for her research assistance and valuable comments. A. R. Kemal, Mohsin Khan, Nicholas Hope, and Ijaz Nabi also provided helpful comments. This is a longer and revised version of my Mahbub ul Haq Memorial Lecture.

I spent three years at the Development Research Centre. I still recall our discussions at the Bank about the Basic Needs Approach to economic development. As the Special Adviser to the UNDP Administrator, he pioneered the concept of Human Development and developed the Human Development Index (HDI). We resumed our discussions, this time on the conceptual and measurement issues related to HDI. Our debates were always friendly, and even though we strongly differed on development strategies, we were united in our belief that eradication of abject poverty and enabling each individual to achieve a fuller and richer life according to his or her own lights have to be the overarching objectives of any development strategy. The world of economics, and we in South Asia, lost a beacon of light, and a source of fresh ideas and innovations, when he was snatched away from us. Let me take this opportunity to pay tribute to his wife Bani, who is not only valiantly and successfully carrying on his legacy, but also contributing in her own right to furthering economic and social development of South Asia.

### **1.1 Economic Reforms: Background**

When countries of South Asia became independent after the end of the Second World War, to varying degrees they adopted an inward-oriented development strategy that emphasised import-substituting industrialisation and accorded a dominant role to the state in the articulation and implementation of the strategy. This was natural, given that leaders of the independence movement identified the colonial regime of economic management with laissez-faire capitalism, and viewed its liberal foreign trade policy as driven primarily by considerations of generating exportable surpluses of primary commodities and ensuring that the markets in the colonies were accessible without significant barriers to imports of manufacturing from metropolitan countries. They believed that investment by the colonial regime, in what used to be called social overhead capital, namely in transportation and communication networks, was essentially driven by considerations of reducing costs of exports. Above all, they faulted the colonial regime for not investing adequately in social sectors of education and health. The fact that many of the leaders of India and Pakistan after independence were Fabian socialists contributed in no small measure to their distrust of markets and emphasis on a dominant role for the state in the economy.

It is nevertheless a fact that, even without significant tariff or non-tariff barriers to protect them, substantial industrial capacity was created in pre-partition India in the late 19th century and between the two World Wars. A number of indigenous, family-based and fairly large-sized, industrial conglomerates had emerged and controlled a large share of domestic industrial output. In other words, an entrepreneurial class existed at the time of independence which could have spearheaded development. Still the then prevailing basic distrust of the market, and a view of foreign trade as a web of economic imperialism, supplemented by the

belief that the massive task of economic development was beyond the capacity of private entrepreneurs, led to the state assuming a dominant role in the economy. However, the extent of insulation from foreign trade and the dominance of the state varied across South Asia, these being the highest in India followed by Pakistan.

The performance of this development strategy, until it came to be significantly modified by a wave of economic liberalisation and reduction of trade barriers in the late eighties and nineties, is decidedly mixed. In India, the overall average annual rate of real GDP growth from the 1950s to the beginning of 1980s was an extremely modest 3.75 percent, famously described as the “Hindu” rate of growth by the distinguished economist, the late Raj Krishna. In Pakistan, in part because the industrial base was small at independence, growth was faster. Starting from a slow 3.3 percent per annum in the 1950s as in India, it accelerated to 6.7 percent in the 1960s and remained generally close to 6 percent until the early 1990s [Hasan (1998), p. 24]. In both economies a diversified, though internationally uncompetitive, industrial structure developed, much more so in India than in Pakistan. Apart from the state establishing new enterprises, privately owned industrial enterprises, and also financial institutions, were nationalised, earlier in India and during Zulfikar Ali Bhutto’s “experiment with socialism,” as Hasan (p. 187) puts it, during his regime of 1971–77 in Pakistan. It is well known that in the era of public sector dominance, the state entered into many economic activities for which there was no conceivable social rationale for it to do so, such as for example, owning and operating luxury hotels or producing bread. Needless to say, many of the state owned enterprises (SOEs) ran at a loss (even when due allowance was made for any uncompensated social services, if any provided, by them), and the profit-making enterprises were mostly state monopolies. Thus, the fiscal burden of SOEs was significant.

Although economic liberalisation began hesitantly in the mid-eighties, a rethinking of the state-led, inward-oriented development strategy in India came about only after the macro-economic and balance of payments crisis in 1991.<sup>1</sup> The hesitant liberalisation of the 1980s, coupled with fiscal expansion, financed by domestic and external borrowing at non-concessional terms, led to a sharp acceleration in growth to 5.8 percent per year on the average. However, it was unsustainable, given the growing fiscal and current account deficits. The rising political uncertainty, with three changes in the Prime Ministership during 1980-91, and the pressure on balance of payments following the steep rise in oil imports with the onset of the Gulf War, triggered the crisis of 1991. As is to be expected, India had to seek the assistance of the

<sup>1</sup>The ascendance to power of conservatives, Margaret Thatcher in Britain and Ronald Reagan in the United States, gave a strong impetus to economic liberalisation in the West. Apparently, even President Mitterand of France, whose regime had nationalised major industries during 1979–83, reversed himself later and emphasised market mechanisms and Privatisation [APFOL (2002), p. 4]. The sovereign debt crisis in Latin America of the early 1980s also contributed to a climate of withdrawal of the state from economic activity.

International Monetary Fund and the World Bank in meeting the crisis. However, I believe that once the immediate crisis management had been completed, a rethinking of development strategy would not have followed but for two critical events. The first was the economic and political collapse of the Soviet Union whose Central Planning and state control of the economy were the models for India. The second was the spectacular economic growth of China since its economic liberalisation and opening to foreign trade and investment in 1978. The fear of being left behind by China, with whom India had fought and lost a border war in 1962, motivated a re-evaluation of India's development strategy and the initiation of system's reforms in 1991. After a drastic fall in GDP growth in the crisis year, the economy recovered. The average rate of growth of the decade of the 1990s after the reforms was around 6 percent per year. In fact, in the last two decades of the twentieth century, India was among the top ten fastest growing economies of the world.

### **1.2 Economic Reforms: Liberalisation of Foreign Trade and Investment, Privatisation, and Regulation**

The systemic economic reforms undertaken in 1991 included the dismantling of a whole host of controls on foreign trade and investment. The rethinking also involved the role of the state in the economy—in particular, its ownership and operation of enterprises producing goods and services for which there was social rationale. The aggregate losses of non-financial public enterprises added to the overall fiscal deficit by about 2 percent to 3 percent of GDP in 1991. A policy of divestment of part of public ownership, without transfer of managerial control, was initiated. It took several years before the word "Privatisation" was no longer politically incorrect. First a department, and later a ministry, were created and a minister with cabinet rank appointed to carry forward the process of disinvestment. However, until about 12-18 months ago, the extent of disinvestment in India as a proportion of the value of the assets of the public sector was extremely modest, with essentially one enterprise, a public sector bakery, having been fully privatised. Since then the pace accelerated, with major disinvestments in telecommunications, but only to be stalled in the final months of 2002 when the proposal to sell two public sector oil companies was temporarily postponed.<sup>2</sup> Even including the successful telecom Privatisation, some estimates suggest that India has been able to achieve only 40 percent of the targeted privatisation with last two years.

<sup>2</sup>As is apparently the case in Pakistan, opposition to Privatisation was led by the Minister and senior bureaucrats of the concerned ministry, as well as by the management and employees of the enterprises proposed to be sold. On January 26, 2003, a final decision to carry out a strategic sale of one of the two oil companies and reduction of public equity in the other was announced. Two days later, the Oil Sector Officers' Association, a representative body of managerial and administrative staff of public sector oil companies, served notice for an indefinite strike from the day bids are invited for sale of the companies.

Pakistan was clearly ahead of India in initiating the process of privatisation. According to Kemal (2000), the process started during the mid-eighties, and several public enterprises were identified for partial disinvestment of their shares. However, no concrete progress was made except for the sale of 10 percent of shares in Pakistan International Airlines by guaranteeing a 12.5 percent rate of profit to buyers. Dissatisfaction with its slow pace and failure to divest some profit as well as some loss making enterprises led to the establishment of a Privatisation Commission in 1991 by the Nawaz Sharif government, which came to power in November 1990. It identified 112 units to privatise in the initial phase and succeeded in privatising 68 units. But after it went out of power in 1993, the pace slowed down and resumed only after 2000 [APFOL (2002), Chapter III]. Although a much larger share of public assets have been divested in Pakistan compared to India, some observers, including Kemal, view the outcomes of privatisations as ambiguous at best.

The governments in India and Pakistan are clearly committed to accelerating the pace of disinvestment, although in India it is open to doubt whether this commitment is shared by all members of the multiparty coalition cabinet or confined only to the Prime Minister and the Disinvestment Minister. However, it is also clear that a convincing case is yet to be made in either country, based on actual experience with privatisation thus far, that it has by and large achieved its objectives and that further privatisation is essential for achieving more rapid, efficient, and better distributed growth. In the rest of my talk, I will begin with the analytics of privatisation, in particular, whether or not a change in ownership per se from public to private hands would lead to beneficial outcomes. My discussion will highlight the distinction between activities or sectors in which significant competition to a privatised enterprise could be reasonably assured, either because it already exists or could be brought about through policy. In an activity which happens to be a natural monopoly, clearly competition is ruled out. In other activities, scale economies together with market size could sustain only a few firms. In either case, a regulatory framework has to be established to ensure that privatised firms make pricing and output decisions that are socially optimal. I will briefly touch on what economic theory has to say on regulatory frameworks.

Much of the large literature on regulation presumes that regulated activities operate in an otherwise competitive economy in which governance problems are absent. Put another way, the literature mostly deals with issues of competition, privatisation and regulation in an economy with no significant distortions. Also, the literature by and large implicitly assumes a closed economy. I need hardly remind this audience that distortions are rampant, and problems of governance are extremely serious in the economies of South Asia. Among the distortions of major significance, one has to include labour and bankruptcy laws. Also our process of privatisation is part of a broader programme of economic liberalisation, including most importantly, integration with the world economy. One well-established result from

the general theory of distortions, and of the second best policies, is that reforms which would have led to greater efficiency and welfare in a distortion free economy, need not do so, as long as some distortions remain even after reforms. My point is that privatisation need not lead to the beneficial outcomes in our context, if it accentuates the effects of the continuing distortions. I will illustrate this with some example later on. After my brief review of theory, I will return to the very interesting discussion of Pakistani privatisation by my friend A. R. Kemal, and also Parvez Hasan, with whom I have interacted and been friends with since the days long ago when we were both graduate students at Yale. I will then conclude.

## 2. PRIVATISATION—SOME ANALYTICAL AND POLICY ISSUES<sup>3</sup>

Since privatisation by definition involves transferring from public to private hands a part or whole of the ownership and control of an enterprise or activity producing goods and services, it is useful to remind ourselves of the rationale for such enterprises to be publicly owned in the first place. It is well understood that extending the role of government beyond strict governance (maintenance of law and order, defense and civil administration, control of currency and money supply, enforcement of contracts and property rights) requires justification. Such a justification often is based on some form of market failure, including coordination failure. Again, conventional economic reasoning suggests that market failure is very likely if the commodity or service involved has the characteristics of a public good or its production technology is subject to significant scale economies. Coordination failure was the basis of the big-push development strategies of Rosenstein-Rodan (1970). He argued that investment in any of one of several activities in isolation would not be profitable, but simultaneous and coordinated investment in all of them would make each profitable. Both because the scale of such a coordinated investment package was deemed beyond the capacity of the private sector to mobilise, and even if it was within the capacity, because coordination would not materialise on its own, he suggested that the state had to undertake at least a coordinating role, if not undertake the investment by itself.

This is not the occasion to revisit the debate and vast literature on the role of the state in development. Let me first mention a few points relevant to the present discussion, starting with Dixit's (1996) characterisation of the state implicit in the early development literature. First it was deemed *omniscient*: it had all the information needed to fulfil its assigned role. Second, it was *omnipotent*: it had the capability to enforce its chosen actions fully and effectively. Above all, it was *benevolent*: in choosing its actions its objective was to further social welfare. Needless to say, few states in the world, let alone states in South Asia, would satisfy Dixit's description! If the state is not omniscient, problems of lack of, and

<sup>3</sup>Chaudhri (2000) succinctly describes these issues.

asymmetric, information arise in designing policy. If it is not omnipotent, it cannot ensure that any socially optimal or first best policy can in fact be fully implemented. Lastly, if the state is not benevolent, its choosing and implementing a socially optimal policy becomes moot. Nonetheless, development theory and analysis proceeded in the early days (and still do, though less so) as if the state were Dixitian.

In many developing countries, including India and Pakistan, whether or not the state had the information, capacity and desire to promote social welfare, it has extended its control over the economy far beyond what would be justified under conventional theories of market failure. This avoidable extension and its deleterious consequences are in part a motivation for privatisation. Further, technological change has made considerations of scale economies (e.g. in electricity generation) less important than earlier, and the information technology revolution has made possible private delivery of some type of educational and health services, bypassing conventional public-sector-based modes of delivery. Lastly, in the context of globalisation, competitiveness in world markets, and the ability to attract foreign direct investment (FDI), depend on the quality and adequacy of physical infrastructure and human capital. The inadequacy and poor quality of largely state-run infrastructure in South Asia are well known. Already in both our countries private sector has been invited to invest in physical infrastructure. However, a rethinking of the roles of different levels (federal, state and provincial, and local) of government and that of the private sector in education and health is overdue. The failure of the state run schools and its tragic consequences in Pakistan and in some parts of India are well known.

I have said enough to suggest that the state in South Asia is overextended. Besides, for the reason in part that the state is not a Dixitian development state, the performance of state enterprises could hardly be described as economically efficient and socially welfare enhancing. *Prima facie*, this would be a motivation, as I said a moment ago, for the state to contract, and whatever activities that are retained in state hands should be restructured as to improve economic efficiency. However at a deeper level, one has to ask whether given the political economy of South Asia how realistic it is to expect that state would contract enough (put another way, privatisation would go far enough), the processes of privatisation would be such as to ensure that the state gets adequately compensated for the assets it sells to the private sector, and above all, the privatised enterprise would perform more efficiently. The analyses of Kemal (2002) and APFOL (2002) of Pakistan's privatisation experience is sobering in this regard. Ishrat Husain, before he assumed governorship of the State Bank of Pakistan, has described the political economy of Pakistan as capture of the economy by an elitist class of civil servants, landlords, merchant capitalists of big industry and big business, military officers and elected politicians [Husain (1999, 1999a)]. This class, in Husain's view, pursued a model of growth with three ingredients: a succession of strong leaders who exercised almost dictatorial powers,

a powerful bureaucracy that implemented the leader's dictates, regardless of their legality or relevance to larger public interest, and a supine population that meekly submitted to the demands of leaders and their bureaucratic henchmen. It would be foolish of me to speculate whether Governor Husain's analysis still holds in large measure—but if it does, the prospects of successfully reforming Pakistan's economy would be considerably diminished.

Before discussing the alternative methods of privatisation, let me draw an important distinction between enterprises that produce goods and services that are sold in a potentially competitive market, and public goods and services produced under significant scale economies so that sale in a truly competitive market is infeasible. In such a situation, privatising a public monopoly has to be accompanied, if not preceded by the creation of a regulatory framework. In the case of the first category of enterprises, issues of privatisation are relatively straightforward. Although the domestic market could be potentially competitive, it might not be in reality. For example, in the hey days of the licence-permit-raj in India there were significant entry barriers. Aggregate capacity to be created in any industry was determined by the target set in each five-year plan, and this capacity was allocated (in a discretionary and nontransparent manner) through industrial licensing among applicants. In such a system, there were obvious incentives for producers already in the industry to secure a licence for additional capacity merely to prevent someone else from getting it and competing with him. Sometimes the licenced capacity was not installed by the licensee due to his fear that doing so and adding to output would erode his monopoly or oligopoly rents. In any case, with relatively few enterprises accounting for the bulk of the licenced capacity (and in the case of traded goods, imports being restricted through import licensing), competition was severely constrained in such industries.

Of course, once capacity and import licensing are abolished, as they have been, in principle significant competition would ensue, although tariff barriers could protect some inefficiency. In India, competitive pressures from imports from China led Indian producers to ask for and receive additional protection in the form of anti-dumping duties on Chinese imports. I happen to believe that whether it is U.S. steel producers or Indian producers of substitutes for imports from China, the charge of dumping by external competitors is just a means for getting a protective shelter for their own lack of competitiveness.<sup>4</sup> Be that as it may, for most internationally traded goods, each of which has many substitutes, opening the economy to trade, with very modest tariffs, if necessary, ought to be adequate to ensure competition, provided users are well-informed of characteristics and costs of alternative products. Information issue is salient for differentiated products, particularly consumer

<sup>4</sup>It is a sad fact that India has taken the dubious distinction of having initiated the largest number of anti-dumping measures in 2001 and 2002 away from the United States and the European Union [WTO (2002, 2003a)].



durables and also for drugs and pharmaceuticals. Information asymmetries could be a source of serious market failure if consumers have to rely on physicians (who in turn depend on salesmen) for information on medicines. For all these reasons, consumer protection laws and competition laws relating to restrictive trade practices also have a role to play in ensuring competition along with trade liberalisation.

Public production and provision of goods and services which generate externalities or have the characteristics of public goods is a common practice. The fact that in a competitive equilibrium, goods that generate positive (negative) externalities would be under (over) provided is not in itself a justification for their production in the public sector, since there is the alternative of optimally subsidising (taxing) private production or consumption. The real issue is whether the fiscal system is less efficient or cost-effective compared to public production and provision of such goods. Clearly, there are well understood information problems, but these arise in either case.

Turning now to objectives of privatisation, the mission statement of the Privatisation Commission in Pakistan, as quoted by Kemal (2000), expresses them well:

“Privatisation is envisaged to foster competition, ensuring greater capital investment, competitiveness, and modernisation, resulting in enhancement of employment and provision of improved quality of products and services to the consumers and reduction in the fiscal burden” (144).

Kemal’s paper also discusses various modes of privatisation adopted in Pakistan and elsewhere, varying from outright liquidation, sale of assets through various means such as sale of equity in stock markets, through financial institutions, auctions (sealed and open bid), private placement and strategic sales. In discussing provision of public goods, I have already alluded to allowing the private sector to supply such goods while ensuring that efficiency and distributional objectives are achieved through the fiscal system of appropriate taxes and subsidies to the relevant producers and consumers or through price controls and cross-subsidisation. Other alternatives to sale of public assets to the private sector are franchising and leasing.

In comparing alternative modes, one has to keep in mind that the basic objective is to realise the maximum value or return from the assets being sold or leased. Here again it matters a great deal whether there would be adequate competition among potential purchasers and whether informational asymmetries are present. For example, there is a very well-developed theory of auctions, and its insights have in fact been used in the design of spectrum auctions, for example in the United States. However, even in industrialised countries in telecommunications auctions overbidding, based on what turned to be unrealistic expectations *ex post* of the size and profitability of the market, has been observed. Overbidding might also be strategic and could lead to a hold up problem.

The intended sale of two publicly-owned petroleum companies in India was postponed for a time, in part because it was feared that the successful purchaser would turn out to be one who already has a major stake in the industry, and this would enhance his market power. Incidentally, one of the foremost auction theorists, Robert Weber, recently suggested at a conference on Game Theory in Mumbai, that an appropriately designed simultaneous auction of the two companies would raise the maximum revenue without the winner running into the winner's curse. Interestingly, the Nobel Laureate John Nash raised doubts about the efficacy of the procedure suggested by Weber for the reason that there could be a non-serious bidder whose main job is raising the cost for other bidders in such simultaneous auctions and the seller has licensure that there is no such bidder (*Economic Times*, January 6, 2003). Turning insights from theories developed for advanced countries into practical proposals for poor countries such as ours with serious problems of corruption is not simple. Determining a fair value of public assets offered for sale, designing a transparent, fair and manipulation-free sale process, ensuring that hold ups and ex post renegotiations do not occur, are difficult issues conceptually and practically. Conceptual difficulties arise from the fact that developing economies are hardly ones with complete markets with players who have rational expectations and in which informational asymmetries are absent. Given that privatisation is relatively recent in our region, it is but natural that mistakes occurred though hopefully learning from mistakes has occurred as well.

Let me cite a very interesting and instructive analysis by Lopez-de-Silanes (1997) of the auction prices realised from privatisation using firm-level data for all 236 Mexican companies privatised between 1983 and 1992. He found that on an average, net prices (net of any cost of restructuring incurred prior to auction) were only 54 percent of the value of the public assets auctioned. He attributes the low realisation to three factors: restrictions limiting participation, and hence competition, in auctions; excessively long process of privatisation that allowed deterioration of incentives and performance of firms between the time of announcement of intention to privatise and of actual sale; and finally restructuring measures that merely delayed privatisation without increasing realised prices. His estimates suggest that realised prices would have risen to 71 percent of the value of assets had the government emphasised speed, succeeded in divesting assets one year less on the average and fired the Chief Executive Officer as the only restructuring measure.

It is often argued in both India and Pakistan that first, profit making public enterprises should not be privatised, and second, realised sale value of such an enterprise in competitive markets with players with perfect foresight will yield no surplus for the state over discounted present value of future profits. This argument is not so sound. Unless the publicly owned enterprise is already earning maximum profits so that no private entrepreneur bidding for it could possibly earn more, which is unlikely, the second argument is not valid. The first is based on an invalid

premise. The issue is not whether or not an enterprise is making profits and earning the market rate of return, but whether there is any social rationale for it to be in the public sector. If there is none, it should be privatised. If it is profitable, but earns less than the social cost of capital, it should be privatised. More generally, it is not so much the actual loss or profits at often distorted prices that should determine the decision to privatise. Simply put, if there is no sound social rationale for an enterprise to continue to be in the public sector, such as for example, the lack of an environment in which the privatised enterprise would operate efficiently, it should be privatised.

Before turning to creation of regulatory frameworks for privatised monopolies, quasi-monopolies, and the financial sector, let me raise some issues regarding privatisation that are peculiar to India and Pakistan. Our public enterprises are over-manned, and the workforce is overpaid relative to productivity. They provide subsidised housing, health care, and other benefits to workers, and saddled with ostensibly social responsibilities for which they are inadequately compensated. It is no surprise that employees of such enterprises fear being let go and losing some benefits were the enterprise to be privatised. But benefits expected from privatisation would obviously not be realised if the privatised enterprise is constrained from rationalising its labour force or, in effect, have to buy workers off with expensive separation payments. In fact, anticipating such problems, potential buyers would either not bid or bid less than what the enterprise would be worth had the constraints not been present, as the analysis of Lopez-de-Silanes demonstrates. There is no doubt labour laws, which have remained out of touch with realities of labour markets, have raised the costs of hiring and firing workers. Indeed, the use of casual substitute labour hired on a short-term basis, and of contract labour are responses to the dysfunctional labour laws. Ironically, while private enterprises often get around the labour laws through such practices at some cost that adversely affects their competitiveness, public enterprises are unable to get around them. This not only affects their performance but reduces the chances of their realising their value if they are successfully privatised. This being the case, it is not surprising that public enterprises often do not perform much better after their privatisation than before.

Another issue that needs some analysis is whether public enterprises should be restructured before they are put up for sale, instead of on an as is where is basis. It is argued that such restructuring would raise their sale value. Needless to say that restructuring would cost resources and a private buyer would offer no more to a restructured enterprise than it would have cost him to do it himself were he to buy it on an as is where is basis, and he would spend just as much on restructuring as would be justified by the discounted stream of additional returns from restructuring. Under the circumstances, unless there are reasons to believe that the cost to the government of restructuring is less than what the buyer would have spent,

restructuring prior to sale is a money-losing proposition. Once again, the analysis of Lopez-de-Silanes (1997) confirms this expectation.

Finally, there is the issue of whether amounts realised from sales of public assets should be used to pay off public debt or be treated as current revenues and, in effect, used to reduce the level of fiscal deficit from what it would otherwise have been. At one level, the first option seems eminently reasonable—the revenues from sales of *assets* should be used to reduce *liabilities*. But on reflection, it is not that obvious: after all, if the government were to use its revenues optimally, then the marginal value (in terms of the government's objective) of a rupee of revenue in any of its uses, whether for reducing debt or deficits, would be the same. Put another way, paying down debt by a rupee saves future flows of servicing a rupee of debt. On the other hand, using it to reduce an exogenous fiscal deficit by a rupee means that a rupee of debt, which otherwise would have been created with its own future debt-service obligations in financing the deficit, would not be created. Thus there is essentially no difference from this perspective between the two alternative uses of privatisation revenue. However, there is a political economy argument in favour of using it to pay down debt, namely, it would put greater pressure on bringing down the fiscal deficit. Whether this is a persuasive argument in the political economy of India and Pakistan, in which only a crisis seems to motivate reform of any kind, is arguable.

### 3. REGULATION

The economic theory of regulation, which was initiated by the late Nobel Laureate Stigler (1971) and Posner (1971) more than three decades ago has attracted many theorists to contribute to it. Peltzman (1989) reviewed the state of theory following a decade of deregulation in the United States. The French economists Laffont and Tirole (1986, 1986a, 1990, 1990a, 1991, 1993) have written extensively on various aspects of regulation, including a very recent (2001) volume on telecommunications. Their work on network pricing jointly with P. Rey is also relevant [Laffont, Rey and Tirole (1996, 1996a)]. Other major contributors include Joskow (1989, 2000), Schmalensee (1989), and many others. Judge Richard Posner pointed out that one of the functions of regulation is to redistribute and allocate resources, functions that are normally in the domain of fiscal authorities. Posner's recognition of this function arose from the failure of the two traditional views of regulation, either that it is primarily to protect the public (at least large subclasses of the public) against monopoly or that it is procured for their own protection by politically effective groups, assumed to be the members of the regulated industry itself, to explain why in many regulated industries many services continue to be provided at lower rates and in larger quantities than would be offered in an unregulated competitive market or, a fortiori, an unregulated monopoly. Given the limited experience with regulation in South Asia, it is unclear whether regulatory

agencies are performing fiscal functions. For the same reason, it is too soon to tell whether the theory of regulatory capture analysed, for example, by Laffont and Tirole (1991), is of relevance.

One of the main points emerging from the vast literature is that many of the goals of privatisation could be achieved, sometimes at lower cost, through other policies [Yarrow (1986)]. Simply privatising a firm, that is changing its ownership, will not guarantee any significant efficiency improvements. Caves and Christiansen (1980) studied privately and publicly owned Canadian railroads and found no evidence that public ownership is inherently less productive than private ownership. The more important issue is how privatisation changes the incentives of those who would be managing the enterprise. Thus privatisation is just one means to this end, and in the case of natural monopolies, must be accompanied by regulation to ensure incentives for efficient, low-cost service provision. An early study by Davies (1971) showed that a regulated private airline in Australia was much more economically efficient than the public one. The notion that privatised public monopoly would maximise profits at the cost of social welfare is not supported in theory. The reason is that public monopolies do not always maximise welfare, and a regulated private monopoly cannot ignore social welfare impacts of its actions. Thus in a well-regulated private monopoly, considerations of efficiency on profit and social welfare would be balanced in an appropriate fashion.

The literature on alternative modes of regulation such as rate of return regulation, price regulation, particularly pricing of access to telecommunications networks and power grids, cost plus contracts and so on is again rich and vast. The literature also brings into the analysis in an essential way issues of asymmetries of information such as, for example, information about technology and cost reducing actions being private to regulated firms and unavailable to the regulators. Consideration of such asymmetries has led to the analysis of incentive-based regulation. The forms of such regulation include procedures or formulas for adjusting allowable prices as costs or realised rates of return change relative to some norm, yardstick approaches in which a firm's performance is evaluated relative to others, and incentives tied to cost or performance components. Finally, the literature also addresses various political economy issues, including how citizen vigilance or presence could be harnessed to monitor the performance of regulated monopolies and the use of the so-called "sunshine regulation," which seeks to use public opinion to regulate electricity, transport, etc., and has had some limited success in Great Britain.

The literature is rich with alternative models on the basis of which optimal regulatory rules, applicable to a wide variety of contexts, are derived. This is not an occasion to delve deep into the assumptions of various models, their algebraic formulations and derivations of rules. Let me just cite a few broad conclusions from the literature that are of relevance to us. Consideration of distributional equity are

better left to be tackled through other policy measures than through pricing and regulatory decisions. The relevance of this finding is painfully obvious from the disastrous experience with subsidies in health care, education, power, and irrigation. In industries in which scale economies are large, efficient marginal cost pricing would lead the firm to lose money. In such a case, the issue is whether one should give up insisting on marginal cost pricing and look for second-best optimal pricing rules given the constraint that the firm breaks even, or whether the firm's losses should be compensated and the resources needed for such compensation being raised through non-distortionary means. Although the latter is the first-best solution, its limitations from the perspective of implementation are many.

Another issue relates to pricing of access to networks, an inevitable consideration in electricity and telecommunications sectors in which there are potentially competitive parts of services that could be unbundled [Vickers (1997)]. There are two main approaches to this issue. The first is to unbundle the vertically integrated monopoly and bar its spin-off facility that retains the network from entering the competitive segment or to preserve the integrated firm, allow competition in the competitive parts, ensure access to the network for the competitors, and regulate access prices. In the latter case, regulation is complicated: regulated access prices, as well as any other service charges, have to be such that they do not create over-entry into competitive segments, future investment in the regulated monopoly is not discouraged, and incentives for inefficiently bypassing the access provided by the regulated firm do not arise. Two common access pricing rules are the following: one links access price to the reduction in the integrated monopoly firm's profits because of providing access to competitors in other segments to its network. The other sets access price to equal direct cost of access plus the opportunity cost to the integrated provider firm providing access. Clearly, if and when our electricity sector is truly reformed the issue of the pricing of access to transmission networks would have to be faced. Telecommunications reforms are further along in both countries. India's regulatory authority, the TRAI, is currently grappling with the issue of access across the three segments: mobile (cell), fixed-line, and limited mobility wireless, while recognising that universal service obligations apply only to the fixed-line segment.

Before concluding this section, let me draw on the Indian experience with power sector reform to illustrate how politics can frustrate reform efforts. Until recently, almost all of India's electricity generation, transmission and distribution were in the hands of State Electricity Boards (SEBs), which are monopolies owned by each state. After the introduction of irrigation-intensive green revolution technology for rice and wheat crops, electricity use in pumping irrigation water from tube-wells increased enormously. With its emphasis on attaining food self-sufficiency and the expansion of the Public Distribution System (PDS), the government guaranteed purchasing whatever amount of foodgrains farmers offered

for sale at the so-called minimum support prices so that farmers had the incentives to adopt the new technology without running the risk of price falls from expanded output. Government meant to purchase only what was needed to run the PDS at *higher* procurement prices. In addition to price support, subsidies on inputs including electricity, irrigation water from public canals, and fertilisers were offered. Over time the distinction between minimum support prices and higher procurement prices disappeared, the latter in effect becoming the former. Also a strong farm lobby emerged which succeeded in ensuring that procurement prices rose over time and subsidies expanded. In particular, subsidies on electricity sales to farmers expanded with some states giving electricity away free to farmers. Subsidising inputs including electricity increases their use. To the extent input-intensification per unit of land increases yields per hectare and output the fiscal cost of high support prices rises. Further, excessive pumping of water with subsidised power leads to lowering of water tables, water-logging, and salinity. Apart from heavily subsidised and free sales to farmers, there was widespread theft of electricity.<sup>5</sup> Even with higher charges to commercial users, the loss from theft and subsidised sales could not be covered. Over time, SEBs accumulated huge losses and were essentially bankrupt. Reserve Bank of India (2003, p. II.33) reports that the rate of return on state investment in power deteriorated from an already negative, -12.7 percent in 1991-92, to -32.8 percent in 2001-02.

The state governments, the owners of SEBs, were themselves running fiscal deficits to which the losses of SEBs were a major contributor. The redistributive public finance aspect of the subsidies is most likely to be regressive: the beneficiary farmers are not necessarily the poor, and any distortions, either in taxes levied to finance the subsidies in part or other price distortions induced by the subsidies are likely to hurt the poor more than the non-poor. Besides, this convoluted redistributive process is opaque.<sup>6</sup> The poor finances of the SEBs meant they nor the state governments were in a position to finance needed investment in capacity. Their financial condition naturally limited their ability to borrow and invest. Under these dire circumstances, it is no surprise that a decision was made to invite private investors, domestic and foreign, to invest in power generation. Given the urgency, expedited procedures for appraising proposals and devising appropriate contracts were adopted. Enron was one of the foreign investors that signed a contract to invest in a massive power plant near Mumbai in the state of Maharashtra.

The saga of Enron illustrates the many problems, both of economics but more importantly of politics, that plague privatisation in South Asia. To start with politics,

<sup>5</sup>The situation in Pakistan is apparently no different. APFOL (2002, p. 39) reports that the critical issues of "losses in generation, transmission and distribution of electricity, theft and misuse and improvement in the quality of services" are yet to be resolved.

<sup>6</sup>Ijaz Nabi drew my attention to the free supply of electricity to the Federally Administered Tribal Areas of Pakistan, adjoining Afghanistan, as another example of corrupt, inefficient, and opaque redistribution through electricity supply.

the then government in power in the state, controlled by the Congress Party, negotiated the deal for the first phase of the investment with Enron, which included a power purchase agreement (PPA). Before Enron began the construction, the Congress Party was defeated in an election to the State Assembly. The Shiv Sena, which won, had campaigned against the Enron deal, accusing the Congress Party of corruption in giving away too much to Enron under the PPA, and announced it would scrap the agreement if elected. But after a visit by Ms. Rebecca Mark, then a senior executive of Enron, to Mr Bal Thackeray, Leader of the Shiv Sena, the party agreed to go ahead with the investment, not only its first phase but also an even larger second phase. The PPA was revised, but not in any major way. Interestingly, it became public later than Enron claimed to have spent several million dollars in “educating” Indians about the agreement. I need not spell out who the beneficiaries of this “education” might have been! Both phases of investment were completed during the term of the Shiv Sena government and power generation began. At the next election, the Shiv Sena government was defeated and a coalition, including the Congress Party, came to power. The new government refused to buy power from Enron’s plant as it had become too costly. Eventually, the plant shut down and as of now, the massive power plant is idle. In the meantime, Enron has gone bankrupt, other lenders including Indian banks in the financing of investment, are still struggling to find ways for starting the plant.

Several features of this story are worth noting. First, the purchaser of power generated by Enron was the monopoly, the Maharashtra SEB. Given that it was bankrupt, Enron insisted on and obtained a guarantee of payment for electricity it sold to the SEB from its owners, the Maharashtra state government. Since that government itself was in financial stress, Enron obtained counter-guarantees from the central government in case the state government failed to pay! Clearly, the facts that the bankrupt SEB was the sole purchaser and the fiscal mess of the state government to which the losses of the SEBs contributed a significant extent dictated the guarantee parts of the deal. However, the PPA itself had aspects which reflected in part the weak bargaining position of the government given that they were desperately seeking to increase power generating capacity.<sup>7</sup> In the PPA, Enron managed to pass on to its purchasers, the State Electricity Board, exchange rate risks as well as risks from fluctuations in imported LPG, the gas which was the fuel for the plant. Further, the gasification plant, which was of a scale much larger than needed for supplying gas to the power plant, was deemed part of the power plant, and its capital costs were included in the price of power under the PPA. Thus business risks, normally borne by a supplier, were shifted to the purchaser through higher

<sup>7</sup>APFOL (2002) points out that Pakistan government had guaranteed a higher price for electricity to independent power producers (IPPs) than the state producer and distributor, WAPDA, was charging. This created a financial burden on WAPDA which eventually raised the tariffs for consumers. The award of contracts to IPPs was also apparently riddled with corruption.



purchase prices in the event of an exchange rate depreciation or a rise in world prices of imported gas. I am skipping other aspects of the PPA, including the fact that capital charges remain fixed as variable costs moved with the plant local factor. In any case, as the exchange rate depreciated and LPG prices went up, the price of power under the PPA became too high for the SEB to afford to buy, given that its average selling price to users could not be revised.

This episode illustrates how an attempt to privatise a part of an integrated monopolised sector which itself was subject to politically determined sale prices, could go awry. Now moving forward in power sector reform, some Indian states unbundled generation, transmission and distribution and allowed private sector to enter generation. Only two states, Orissa and Delhi, have privatised distribution. Many have established, ostensibly independent, regulatory commissions for the setting of electricity tariffs. Yet there has been no significant improvement in the overall power situation, even after a decade of opening up private sector accounts for only 10 percent of generating capacity. There are basically two main reasons for this. First of all, private generators still have to sell power to State monopolies and do not have much say on prices they receive. Second, unless adequate competition can be assured, privatisation cannot fully deliver its benefits.

The experience of the State of Orissa dramatically illustrates the pitfalls of poorly designed privatisation. Although there was unbundling, all generating companies (Gencos) had to sell their output to the state-owned transmission company (Transco). At the other end, distribution companies (Distcos) had to buy their power from Transco and consumers had to buy their power from the Distco in their area. Thus, no genuinely competitive electricity market was created in which generators could sell in competitive spot markets or enter into long-term contracts with Distcos or ultimate consumers. In turn, Distcos and consumers did not have many alternative suppliers to compete for their custom. Had Transco been turned into a regulated monopoly (private or public) which provided access to all comers at a regulated access price, there could have been entry and competition in both generation and distribution segments. Besides, without a fundamental reform of electricity pricing, and curbing of incentives for theft, not much progress can be expected. In large parts of the country, farmer's use of electricity is not even metered. Also, interstate transmissions of electricity through the grid has been plagued by indiscipline—states have failed to follow the instructions of grid managers and have attempted to draw more than what others could supply leading to system outage. Pakistani experience with privatisation of power generation suggests that it has had its pluses and minuses. Although the involvement of independent power producers has resulted in a number of problems [APFOL (2002), Chapter VII], a power surplus emerged (apparently only temporarily) in contrast to an estimated average deficit of 8 percent of demand in the 1990s in India.

A national market for good quality (i.e. constant voltage) and reliable (no brown-outs and black-outs) power, with a variety of market instruments such as sale and purchase in spot markets, and contracts for medium to long term and appropriate time-dependent pricing is a distant dream in India and Pakistan. But there is no harm in dreaming—sometimes, dreams become realities. One of my dreams is a *South Asia-wide electricity market*, based on a grid linking Bangladesh, India, Nepal, and Pakistan (and perhaps even Sri Lanka), and regulated by a *regional agency*. My dream gets even more fanciful on occasion, and visualises a South Asia-wide *energy market* with grids, pipelines, road and rail transport being used for transporting various forms of primary and secondary energy.

Turning away from dreams to reality, the harsh consequence of the poor quality and reliability of the electric system has been costly captive power generation, not only by industrial enterprises but even by commercial establishments, including retail shops. Were the system to be more efficient and to deliver reliable good quality power, and were it to be economically priced, it is very likely that less additional capacity needs to be created for meeting the expected growth in demand. There is also some empirical evidence suggesting that those (e.g. farmers) who are provided subsidised or free power, but of poor quality and reliability, would be willing to pay for better quality and more reliable power.

In contrast with the poor record in reforming the power sector, telecommunications reform and privatisation has been a spectacular success in India, and I am sure in Pakistan as well, if success is measured not only in terms of the revenue generated for the government from auctions, but also the dramatic fall in the cost of long distance telephone calls, domestic and international. The quality of service has improved greatly as well. On the other hand, in terms of universal service provision, the post-privatisation performance is not an unambiguous success. There are several reasons for the relative success of telecommunications reform including, first, the fact that with low tele-density, even though there was cross-subsidisation of local by long distance users, there was no strong and entrenched lobby opposing rebalancing of tariffs. Second, unlike electricity reform where a price rise was expected by almost all users, even though to a greater extent in some cases than others, it was universally expected that the cost of telecommunications service would fall with privatisation and reforms. Finally, rapid advances in telecommunications technology made dependence on traditional wire-based telephony much less of a constraint.

This is not to say that the reform process was smooth in India. Part of the problem was that telecom privatisation and reform was fairly recent even in rich countries and experience was thus somewhat limited. Second, when the Telecom Regulatory Authority of India (TRAI) was first established, the Department of Telecommunications (DOT) was not only responsible for making telecommunications policy but was also a major supplier of telecom services through a large public

enterprise owned and operated by it. Thus TRAI was in an anomalous position as a regulator, having authority to regulate over enterprises owned by an agency which also dictated policy! Eventually, the public enterprises were made autonomous, corporatised and independent of DOT. Within a few years of its establishment, TRAI itself was reorganised with the creation of a separate tribunal to hear appeals against the ruling of TRAI. The rapid change in technology has not made the task of TRAI any easier—in the first half of 2003, a private operation introduced limited mobility wireless telephony and challenged both the cell and fixed line firms. This induced a price war going on with consumers benefiting from steep falls in prices. It is too soon to tell whether a relatively stable structure has emerged in the industry.

One other cautionary tale about Indian telecom reforms is worth recounting. When bids were sought for provision of certain services, there was what turned out to be *ex post* overbidding. It is hard to tell whether overbidding was strategic or it was simply due to an overoptimistic forecast of future demands and revenues. In any case, once the winners realised that they cannot afford to pay the licence fee they had bid, they clamoured for a revision of their contract. In effect, they held up the government: either it renegotiated the contract or else the firm would go bankrupt and the promised service would not be provided. The government in effect conceded defeat by renegotiating the contract into a revenue sharing one, rather than a fixed fee one. The lesson I draw from this is that designing an auction which is collusion-proof, generates the maximum revenue, and above all avoids hold-up and renegotiation, is exceedingly complex.

Turning now to the vital financial sector, state-owned units continue to dominate in both our countries. The state acquired a large share of the investible resources of the financial sector for its use at low cost through various liquidity and reserve requirements, and had a large say, through various credit allocation mechanisms, in how the resources left with the banks were used. Of course, in both India and Pakistan, the nationalised financial sector was repressed until recently through controls on deposit and lending rates. In the era of economic reforms, we have moved forward with some privatisation and removal of controls on interest rates. However, real interest rates are still comparatively high primarily because of the floor set by administered interest rates on small savings and provident funds. The government is now borrowing at market rates rather than use the financial system to finance part of its deficit. In this era, regulation of the financial system, including enforcing adequate capital requirements, has assumed great importance. There are many open issues in designing the regulatory system. Khan (2002) in his Quaid-i-Azam Memorial Lecture has discussed them in depth. Let me just flag a few. There is some expectation that the trend towards integration of financial services (e.g., universal banking) would not only reduce costs of intermediation which are high in South Asia, but also facilitate supervision of intermediaries. In this context, should there be a single one for the extensive financial sector including

commercial banks, investment banks, insurance companies, the stock and bond markets as in the U.K., or should there be a separate agency for each segment of the sector? Given that there is a significant degree of substitution among financial instruments, how should coordination among individual regulatory agencies be ensured if there is one for each sector?

Turning to capital adequacy norms, it is clear that Basle I and Basle II norms have to be modified for our contexts—in other words, given the risk characteristics of the portfolios of our banks, what may be adequate capital in rich countries need not be so in our case. The most disturbing feature in our context is, in my view, the continuing dominance of state-owned banks. I am not persuaded that state-owned banks can be completely insulated from political interference in making their lending decisions. It will take me too long to illustrate this from Indian experience. Suffices it to say that at least one of the Indian state-owned banks has been recapitalised, not once, but several times. There can be no doubt that such repeated recapitalisation sends the wrong signal to banks that they will be bailed out even if they run out of capital because of their poor investment decisions. The point is that as long as the state owns the bank, there is no way to prevent re-accumulation of non-performing assets once the previously accumulated stock is cleaned up.

For lack of space I am not discussing interesting features of privatisation and regulation in other infrastructures such as roads, ports, railways, etc. Needless to say that in a globalising world, if we are to be competitive, our transport and communications networks also have to provide efficient services at competitive costs. There is no doubt that a poorly functioning and relatively expensive infrastructure inhibits private investment. In the era of largely publicly owned infrastructure, public investment in that sector crowded in private investment. With public investment declining, the privatisation and reform of infrastructure lagging, accelerating growth is a daunting task. There is a long way to go in reforming these activities. Let me conclude the discussion of regulation by flagging a deeper issue: regulatory agencies have executive, judicial, and sometimes even legislative functions. Their exercise of those functions could come into conflict with the branches of government to whom constitutions normally assign these functions. Clearly, independence, autonomy and credibility of the regulator would be destroyed, if the agency were to report to the relevant ministry, and the minister or bureaucrat could override its decision. On the other hand, absence of legislative oversight, and access to the judicial system for appeal against its decisions, would be inappropriate. Again, designing a system of oversight that is feasible, credible, transparent, and seen as legitimate in our context is a complex task.

#### **4. PRIVATISATION IN PAKISTAN**

Hasan (1998, pp. 289-91), in his brief discussion of privatisation and private sector development programme of the early nineties in Pakistan, points

out that the main objectives of the programme “were to reduce the drain of government resources caused by losses of state-owned enterprises and to create great opportunities of private sector investments because the public sector resources for development had become very [scarce] scarce (*sic*)” (p. 289). He noted that the agenda of privatisation covered not only industries but also banks, telecommunications, and power generation. After reviewing the pace and extent of privatisation since the creation of the Privatisation Commission in January 1991, he concludes that “the delays in implementation of the privatisation programme were to some extent natural, but they also reflected institutional weaknesses of the government and the Privatisation Commission. The result was that the actual transfer of control of assets from the public sector was quite modest, the exception being the two commercial banks” (p. 291). He is critical of the fact that the “large proceeds [from privatisation] . . . should have been used mainly to retire public debt . . . [but] instead, they were used to maintain unsustainable levels of public expenditures and current account balance of payments deficits” (p. 291).

Whether a public enterprise is losing (or making) money is not in itself an argument for its being privatised (or not)—the real issue is whether there is a good rationale for an enterprise to be in the public sector. However, implicit in this argument is the idea that if there is a convincing social rationale for an enterprise to be in the public sector, any losses incurred (or profits earned) by it should be financed (used) in a non-distortionary fashion. Such financing is unlikely to be feasible in our context. This being the case, in evaluating the social rationale for an enterprise to be in the public sector, one has to take into account the social cost of financing its losses through distortionary means. Be that as it may, many of our public enterprises lose money, and have no social rationale for being in the public sector in the first place. As such, Hasan (1998) is right in viewing their losses as avoidable drain of public resources. The case for using privatisation revenues for retiring public debt is largely based on political economy grounds, and much less on economic logic. Hasan must have had political economy arguments in mind when he expressed his preference for using the revenues for retiring public debt.

Kemal’s paper examines empirically whether privatisation in Pakistan achieved the objectives of reducing fiscal deficit, improving efficiency of operation, increasing investment, and raising growth rates and its impact on real and nominal wages as well as growth in employment. His analysis reports that as of 1998, in all 106 units had been divested and the government received Rs 59.6 billion through the sale of these enterprises. For an economy of the size of Pakistan (with real GDP at factor cost at 1980-81 price of Rs 667 billion in 2000-01) this extent of privatisation is extremely modest. Kemal’s conclusions, which are broadly supported by APFOL (2002), are worth quoting:

“Privatisation has not been able to reduce the fiscal deficit, which has continued to be in the range of six percent [of GDP] . . . average rate of growth of GDP has gone down from 5.44 percent to 4.15 percent during pre- and post-privatisation period . . . similarly average rate of growth of investment fell from 5.55 percent to just 1.82 percent . . . analysis of variance does not show any difference in growth of output . . . return to equity or return to fixed assets in the pre- and post-privatisation period. The analysis also shows that the growth of privatised industries subsequent to privatisation . . . [however] controlling for the general decline in output [during 90s] privatisation had no impact in 9 out of 14 industries, in two industries growth rate increased and in three industries growth rates fell . . . [total factor productivity] increased on an average by two percent in the privatised industries [in the post-privatisation period]. Nevertheless, improvement in productivity is observed only in vegetable ghee and transport equipment and has fallen in the remaining sectors—real prices . . . of the products produced by privatised industries have not fallen. As a matter of fact, they have increased . . . restructuring of public enterprises prior to privatisation has also resulted in loss of employment . . . compared to an annual compound growth rate of 2.0 [6.5] percent in the overall [manufacturing] employment in the pre-privatisation period, growth rate fell to 1.39 [–13.5] percent in the post-privatisation period . . . real wage rates in Pakistan have increased in the pre-privatisation period but have fallen since then” (pp. 163–65).

These results, if accepted at face value, would constitute an indictment of privatisation. However, there are many reasons why they cannot be interpreted as conclusive evidence against privatisation. First of all, the analysis consists of a simple comparison of chosen indicators before and after privatisation. As is well known, such a comparison is methodologically questionable, since there could be other factors that influence the indicators besides privatisation, and the simple comparison does not control for their effects. Second, the five year pre-privatisation (1986-91) and post-privatisation (1992-97) periods are too short to accommodate adequately for expectations about lags in response to privatisation. For example, anticipation of future privatisation could affect performance in the pre-privatisation period. Third, since privatisation covered only an *extremely small part* of the economy, its influence, positive or negative, on aggregate indicators such as fixed deficit GDP growth or investment would be very small. As such, the changes in such indicators between the two periods would be largely driven by other factors. The same is true for indicators such as aggregate and manufacturing employment, wage rates, fiscal deficit or total public debt. Fourth, the expected benefits, such as gains in productivity or returns to capital, from privatisation could be muted if the other factors (e.g. labour laws) preclude the restructuring and rationalisation of

privatised enterprises. Fifth, to the extent public enterprises employ far more workers than would be economically justified, any restructuring prior to privatisation in the expectation of realising higher sale value for the enterprise would naturally involve reduction in employment, and this reduction has more to do with over-manning in public enterprises than to privatisation *per se*.

I do not mean to dispute the facts as reported by Dr Kemal. But I do have strong reservations on his implicitly attributing the observed changes between the two periods to privatisation. Explaining the observed changes will require a more elaborate econometric exercise. The contribution of privatisation is simply the difference between what would have been the performance of public enterprises in the post-privatisation period, had they remained in the public sector, and their actual performance as privatised enterprises. This obviously involves doing a counterfactual analysis, which can be done in alternative ways. One way would be to model the determinants of enterprise performance, including factors exogenous to ownership as well as ownership. The impact of privatisation is then the effect of ownership change on performance, conditional on or controlling for other factors. Another is to compare privatised firms with two control groups consisting of firms that were privately owned always and publicly owned firms that are expected to remain so. An alternative is to use a difference-in-difference method: it compares the change in performance of privatised enterprises in the post-privatisation period relative to the pre-privatisation period with the change in performance of public enterprises, otherwise similar to the privatised ones, but which were not privatised. My point is simply that Kemal's before and after comparison is methodologically problematic. This does not necessarily mean that his conclusions would be overturned if an appropriate methodology had been used. However, I believe otherwise—an appropriate analysis would have shown a positive but modest outcome from an admittedly modest privatisation.

## 5. CONCLUSION

Let me conclude. It is evident that the process of privatisation and regulation in South Asia has not gone far and has run into problems, many of which could have been anticipated. In particular, some of the expectations about the benefits of privatisation were either misplaced or were based on a lack of appreciation of the severe constraints of political economy and governance that undercut the potential benefits of privatisation. Joshi (2000) suggests three general reasons why privatisation is being pursued:

- greater economic democracy through increased private initiatives in economic activities;
- achieving higher levels of economic growth and employment;
- reducing budgetary deficits.

This illustrates what I mean by misplaced expectations about the benefits of privatisation. It should be obvious that privatisation, limited in extent as it was, could not be a significant determinant economic growth, employment generation, and economic democracy. I illustrated how our draconian labour laws in India and Pakistan constrain the restructuring of staffing of privatised enterprises and thus reduce potential benefits from privatisation. However, I believe that once we modify our expectations realistically and allow for the politico-economic-social constraints, even our own experience with privatisation, properly analysed, would show its positive effects. As much the lesson that we should draw from our experience is not that privatisation has been a failure but only the constraints on achieving its potential benefits have to be removed. This is all the more urgent now.

The contemporary economic scene in India and Pakistan is sobering. In India, economic growth after reaching a peak of 7.5 percent per year in 1996-97 has since slowed down to as low as 4.4 percent in 2000-01. There was a significant failure of the monsoon in 2002. With an expected fall of around 3 percent in agricultural value added, the expected rate of growth in fiscal year 2002-03 is 4.4 percent [RBI (2003), Table 2.2]. In my darker moments, I fear that an Indian growth rate might be converging to its twenty-first century "Hindu" rate of growth, which I estimate as around 5 percent per year, given the structure of India's economy now as compared to the 1950s. Pakistan's growth performance in the 1990s has been poor. What is disturbing is that India and Pakistan, at their stage of development, instead of having current account deficits financed by sustainable long-term capital flows, are actually having current account surpluses. Also, both are accumulating foreign exchange reserves—India's reserves crossed \$80 billion in early June 2003, and Pakistan's also is rising. While it is prudent to hold reserves to smooth fluctuation in trade and short-term capital flows, I am not convinced that one needs reserves worth a year's level of imports or more for this purpose. Moreover, India's short-term external debt now is only 5.4 percent of reserves. The cost of holding reserves is the foregone returns relative to alternative investments—even if reserves are invested well, this cost is unlikely to be negligible. In other words, even a generous allowance for the insurance provided by reserves would not raise the marginal returns from an extra dollar of reserves to the *potential* returns from alternative uses of resources in our economies. In both our countries, fiscal deficits as a proportion of GDP are high and rising. This has not resulted in rising current account deficit (on the contrary, current account is in surplus) or in significant inflation. Interest rates have not risen—in fact, they have gone down, at least in India. Neither India nor Pakistan are favourite destinations for foreign investors—a relatively small economy such as Thailand attracted \$3.8 billion of FDI in 2001, even after undergoing a financial crisis, more than India's \$3.4 billion [World Bank (2003), pp. 268 and 520]. My inference from all these macroeconomic facts is that all is not well with the investment climate in



our region—using Keynes’s memorable phrase, “animal spirits” seem to be conspicuously down.

The poor investment climate, in my view, reflects in large part our failure to sustain and deepen our economic reforms and integration with the world economy. It is important to recognise that privatisation opens up avenues for production investment by domestic and foreign investors. Unlike Latin American countries, we have not used privatisation as a means to attract FDI. A transparent and purposive privatisation process would help revive “animal spirits.” Private investment would be attracted to labour-intensive activities in which our economies have a comparative advantage and would thus promote growth and alleviate poverty. Turning to integration with the world economy, India’s share in world exports fell from around 2.5 percent in 1948 to a low of 0.5 percent in the early 90s. After reforms of 1991, it has climbed to 0.8 percent in 2002, whereas China quadrupled its share from about 1.25 percent in 1980 to 5.1 percent in 2002 [WTO (2003a)]. I am afraid the mindset of our policy-makers, bureaucrats and the elite, is ambivalent about the virtues of liberal foreign trade and integration with the world economy, and more generally, of the market mechanism. It is well known from the Theory of the Second Best that as long as distortions continued to be present, reforms that otherwise would have been beneficial could be welfare worsening. The fact that significant distortionary trade and other barriers still exist in our economy undoubtedly diminish the potential benefits from our economic reforms.

The travails of our privatisation efforts, problems with the creation of appropriate regulatory structure, and the failure to tackle our serious governance problems are all reflections of the constraints of our political economy. I do not wish to minimise the reforms that we have been able to put in place over the last two decades. But our competitors in the developing world have gone farther than we have. Unless we renew our commitment to further reforms, pursue globalisation and privatisation seriously, address our governance problems, prevent the dead hand of bureaucracy and populist politics from stifling the economy, and above all create an environment in which incentives to invest in human and physical capital, innovate and compete are abundant, there is no hope of accelerating our rate of growth and sustaining it at a rapid rate for long. And if we fail to achieve sustained and rapid growth, we will be failing our people by condemning them to a continuing poverty from which millions in East Asia and China have escaped, a failure for which history will not forgive us.

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## Comments

### 1.

As usual, T. N. Srinivasan has produced a well-argued, logical, and comprehensive paper that is very difficult to take issue with. Of course, and this is customary for his papers. There are parts that are controversial and one can pick on some of the statements and arguments, but on the whole, his line of argument regarding privatisation and deregulation in South Asia (principally India and Pakistan) cannot be refuted. This places the discussant at a distinct disadvantage of having to look for small things to dispute and thus appearing to lose sight of the big picture. So let me say up-front that I agree with his central premise that the supposedly negative experiences of India and Pakistan with privatisation and deregulation should not be taken as a general indictment of these policies. The reform policies are still right, it was the implementation that was often flawed. Indeed, both countries should aim for bolder reforms if they are to get on a high enough growth path that will raise living standards and make a significant dent in poverty levels.

My comments focus on three main issues:

- (a) privatisation and deregulation without an appropriate regulatory framework, looking particularly at the case of banks;
- (b) estimating the effects of privatisation; and
- (c) liberalisation strategies.

#### **1. PRIVATISATION AND DEREGULATION WITHOUT AN APPROPRIATE REGULATORY FRAMEWORK**

T. N. Srinivasan says that for natural monopolies and quasi-monopolies, creating an appropriate regulatory framework ahead of privatisation is necessary. I would go further and say all types of privatisation and forms of deregulation require this regulatory framework. For example, take the case of banks, where having suitable regulations is essential. We know of the costs that banking crises in various countries have imposed—in the 1990s these costs amounted to an average of 10–20 percent of GDP. In many cases, these crises can be traced directly back to earlier liberalisations in the absence of appropriate regulatory structures. One of the basic lessons of the Asian financial crisis of 1997-98 is that a regulatory framework is fundamental in any privatisation/deregulation strategy.

There are essentially four key challenges in the design of a regulatory framework for banks: (a) redefining risk-based capital standards to take account of

new financial instruments; (b) shifting the regulatory emphasis away from capital standards towards incentive mechanisms, the risk management processes in banks, and market discipline; (c) preventing regulatory “arbitrage”; and (d) taking account of moral hazard because consolidation of banks creates institutions that are “too big to fail”.

If an appropriate regulatory framework with these types of features build in is absent, there will be a tendency towards banking fragility and banking crises.

## 2. EFFECTS OF PRIVATISATION

There have been numerous studies, including those in Pakistan, that attempt to measure the effects of privatisation. I completely agree with the misgivings expressed by T. N. Srinivasan regarding the methodology employed to determine these effects.

What is the methodology that is used? Virtually all studies use what can be called the “before-after” approach, where performance before privatisation is compared to performance after. The basic advantage of this approach is that it is easy to calculate. The problem, however, is that the before-after approach assumes all other things remain equal. It thus will not yield an estimate of the independent effects of privatisation when the non-privatisation determinants of outcomes change between the pre-privatisation and post-privatisation periods. In reality, these non-privatisation determinants do change significantly from year to year. The obvious example would be the overall macroeconomic conditions in the economy. This means that the before-after estimation of privatisation effects will typically be biased and will vary over time.

These shortcomings of the before-after approach make it a poor estimator of the counterfactual—what would have been the performance of the firms if there had been no privatisation? This approach assumes a counterfactual in which other things remain constant at their pre-privatisation levels. This is a heroic assumption. Of course, there are other approaches which do help to reduce the bias inherent in the before-after approach. A currently popular one is the control-group approach adjusted for sample selection bias and initial conditions. In many areas of economics, this newer approach is being used to estimate the effects of government intervention, and I would suggest that something like this should be used as well to estimate the empirical effects of privatisation. For me, as yet there is only anecdotal evidence on whether privatisation works or not. We need systematic empirical evidence before coming to a conclusion either way.

## 3. LIBERALISATION STRATEGIES

I don't believe there has been a well-thought out liberalisation strategy in Pakistan. What we have had are episodes of liberalisation, often in the context of

IMF programmes. What has this meant? Basically, the absence of a liberalisation strategy has meant that sectoral liberalisations have occurred almost independently, and these liberalisations have been spread out over time. For example, the financial sector reforms were not linked to trade reforms, and neither of these were linked to reforms in the energy sector. Naturally, inconsistencies developed. Take the case of capital account liberalisation under the Nawaz Sharif government. In retrospect, it was a mistake as the initial conditions and appropriate regulatory structures were simply not there. Does it make sense to liberalise the capital account when the trade account is not fully open and the financial sector is not liberalised?

Let me end by making three other points. First, T. N. Srinivasan says that corruption can cause serious social welfare problems in the sale of state assets. I fully agree but would go even further, arguing that there has been a quantum jump in corruption (at least in monetary terms) associated with the sale of state assets. Percentage commissions may still be the same, but the amounts have jumped sharply. There is a lot of evidence of this phenomenon from developing countries and transition countries. It is clear that privatisation has to proceed in the context of a well-defined framework for sales, with legally binding rules.

Second, how should privatisation resources be used? There is a major debate going on as to whether proceeds from privatisation should go towards reducing the national debt or to reducing the fiscal deficit. I would favour the first, that is, reducing the overall government debt of the country. This would have a more permanent impact and lock in the current and future governments. Reducing today's fiscal deficit with privatisation receipts is only a temporary policy.

Third, should you have a single regulatory authority or several agencies regulating the financial sector? There is a good argument for having a single authority, since the coordination problem disappears by definition. But of course a single agency can become too powerful and you may want "competition" among the regulators. While this debate between those who favour a single authority and those who prefer multiple agencies is interesting, it misses the point in some respects. The basic question is: Who do regulators report to, and can they be truly independent and report only to the legislatures?

In conclusion, this is an extremely interesting paper with an important policy message. It should be read by all reform-minded officials in South Asia. T. N. Srinivasan shows them the directions that they should move in, and the pitfalls that they should avoid.

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## 2.

It is a great pleasure to welcome Professor Srinivasan in Islamabad, and a privilege to be a discussant on his Mahbub ul Haq lecture. Professor Srinivasan wrote his PhD dissertation under Prof. Tjalling Koopmans on a two-sector optimal growth model which was viewed with awe and inspiration by generations of Yale students, especially those from the developing countries. Professor Srinivasan returned to India in the 1960s and engaged himself in research and debate on Indian planning, making outstanding contributions to the Indian planning process, which was in transition after the demise of India's first Prime Minister, who was also the Chairman of the Planning Commission. Prof. Srinivasan's involvement in policy research on India gave him a unique opportunity to study the political economy of Indian and other countries' growth and helped him to become one of the foremost development economists in the world.

Since his return to Yale in 1980, Professor Srinivasan has contributed vastly to the reputation of its Economics Department, which he headed until recently, and especially of its Economic Growth Centre, which he headed earlier and has been associated with since its inception. He uniquely combines his skills in quantitative economics, with his erudition in development theory and a deep knowledge of and insights into the problems of Asian and particularly South Asian economies, which is clearly evident in his lecture. The two volumes of the McGraw-Hill *Handbook of Development Economics* co-edited by him are an eloquent testimony to the breadth of his scholarship in a wide-ranging field.

As a discussant of his paper, I am handicapped by the non-availability of his paper. In preparing my comments, I have relied mainly on the brief abstract provided by the organisers and on Prof. Srinivasan's other writings in development economics. I will focus my comments on the first part of Professor Srinivasan's paper which focuses on the comparative experience of East Asia and South Asia and of India and Pakistan, and then on the second part, which deals with privatisation issues.

The broad theme of the first part of Professor Srinivasan's paper touches upon a question that has intrigued development economists for a long time and continues to agonise the economists and policy-makers of this subcontinent. To put it bluntly: Why has South Asia been left behind in the development race? Or, to put it in another way: What went wrong with South Asia and what made East Asian economies become a miracle, although at the start of the development race half a century ago, the latter did not have a significant, if any, advantage over the former? Notwithstanding the prodigious efforts of economists, within and outside the World Bank, there is still a dearth of convincing economic explanations, although several political economy-nuanced stories appear to be plausible.

Development economists, including Professor Srinivasan, have generally picked two palpable primary suspects in this regard; the first being excessive import substitution, and the second being overzealous state intervention in economic activities. While there is no doubt that these two factors account for a large variation in the performance of the two sets of economies, they are by no means the only factors which have been responsible for the development lag that South Asia has suffered in comparison with East Asia. Indeed, it is an oversimplification to say that the East Asians did not indulge in import substitution—although they were certainly much more selective and prudent in the matter than India and Pakistan. Again many recent appraisals have recognised the strong role that the state has played in East Asia in the economic development of their countries. In South Asia, perhaps more conspicuously and less justifiably in India than in Pakistan, the state may have played a more obtrusive role in economic activities generally, though not necessarily in economic development. Indeed, state failure of South Asia has consisted largely of acts of omission than those of commission.

The differences in the growth strategies and the performance of India and Pakistan referred to by Professor Srinivasan also provide considerable food for thought and conjecture. The *dirigistic* influence of the Mahalonobis model, which lasted for over two decades—although it could not be completely dethroned until much later, was replaced by the rise of populism under Mrs Gandhi and the rampant increase in rent-seeking behaviour that it engendered. India's Hindu growth rate of 3 percent per annum in the first three or four decades began to raise questions about the development strategy which attached priority to centralised planning, import substitution, and heavy industry, which were the essential features of the Mahalonobian scheme of things. Pakistan, on the other hand, adopted a less centralised approach in the beginning and chose the easy—rather than the difficult—path of import substitution, concentrating on consumer rather than capital or intermediate goods. Pakistan's strategy was facilitated by its greater access to foreign resources, while the Indian strategy was dictated by a much more binding foreign exchange constraint. However, as Professor Srinivasan rightly points out, while Pakistan's economic performance until the 1980s was perceptibly better than India's, it hardly matched that of East Asia.

Indeed in the 1990s, especially after the adoption of vigorous liberalisation policies in India and Pakistan, spearheaded by Manmohan Singh and Sartaj Aziz, respectively, the ranking of the two economies was reversed. The Indian tortoise finally caught up with and overtook the Pakistani hare. In my view, it was not liberalisation—or its more effective implementation—alone which has given India an edge since the 1990s, but the cumulative effect of India's slow but steady (though not always efficient) growth and development in many inter-related fields and Pakistan's continued neglect (not always benign) of its human development and other structural problems. The contrast between the elitist development ethos in



Pakistan and the middle-class pandering of Indian development strategies has also contributed to stronger growth in India in recent years. Both countries, however, have lagged far behind East Asia in their growth performance, and far behind China in equitable development (especially before the liberalisation era).

A problem shared by both India and Pakistan is the colossal under-investment in public goods, such as education and health, which is the real government failure in these countries and the main reason for the continued persistence of poverty in both countries. The one public good on which both countries overspend is defence. It is pathetic to see the rulers of both these poor countries take pride in being the members of the exclusive nuclear club, while millions in these lands are deprived of the most basic needs. If they had competed in reducing poverty and providing better amenities for their citizens (instead of competing in producing more deadly *Agnis* and *Ghouris* and in terrorising the peoples of this region with an impending nuclear holocaust), South Asia would have been a much better, and I would say a safer, place to live in—and not only a place for investment by foreigners. Ironically, the other area in which India was criticised in the past for having overinvested, viz., higher education seems to have been a blessing in disguise, helping India to capitalise on the Information Technology (IT) boom. On the other hand, Pakistan's fire-fighting efforts to compete with India in this field do not look promising because they have been undertaken too late and with little resources.

The other major theme of Professor Srinivasan's paper is privatisation. Professor Srinivasan believes that privatisation in South Asia needs to be "deepened and accelerated further". I may agree about deepening, but I think accelerating the process in the current political milieu in both countries is full of risks; a more gradualistic and cautious approach, which seems to be the case in India, would be preferable. The horror stories that one hears about the privatisation experienced in Pakistan, documented by Akhtar Hasan Khan (who is presenting a paper on the subject elsewhere in this Meeting), are enough to validate this note of caution.

Indeed, I have a much more basic point on the question of privatisation which relates to the motivation for "privatisation" during times of financial stress. Privatisation by itself is not an undesirable strategy as it releases public resources for higher priority areas. The Chinese strategy of not undertaking new public investment instead of liquidating current public enterprises makes more sense. However, the present plans on privatisation, aptly described by some as "fire sales", seem to be ill-conceived and directed to serve the interests of powerful groups. In this regard, I would like to quote a remark by Professor James Tobin, the Yale Nobel Laureate, who died last year and whom both Professor Srinivasan and myself hold in the highest esteem as a teacher. Commenting on Reagonomics over a decade and a half ago, Prof. Tobin wrote:

“The current conservative fad is “privatisation”. The administration’s budget-makers have hit upon sales of federal assets as a cute technical way to comply with Gramm-Rudman. Obviously no business accountant (except at Enron and WorldCom) would regard asset sales as deficit-reducing current revenue. But privatisation is welcome to free market ideologues any way. Although some privatisation may be desirable and cost-effective, current proposals reflect budget cosmetics and doctrinaire principle rather than case-by-case examinations of long-run costs and benefits”.

I think if one substitutes the IMF-World Bank for Gramm-Rudman, the quotation fits the South Asian situation perfectly.

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