

PUBLIC ENTERPRISES---CORPORATE GOVERNANCE AND THE ROLE OF GOVERNMENT

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Abstract

Public sector occupies a prominent position in the Indian economy. The present government policy is to divest its holding in PSUs, without privatizing profit making PSUs. It has also decided to provide full autonomy to the board of directors of those enterprises. This provides an interesting setting to examine corporate governance issues. This paper examines corporate governance issues in the context of present disinvestment policy of the government.

1. Introduction

Public sector occupies a prominent position in the Indian economy. The investment in the central public sector undertakings (PSUs) has grown from Rs.29 crores (Rs.290 million) as on 1.4.1951 to Rs. 2, 52,554 crores (Rs. 2,525 billion) as on 31.3.2000. PSUs hold a major position in terms of market size and assets. In terms of sales among the top 10 companies (Business World¹, 28th February 2005), 8 companies are in the public sector, and among the top 50 companies 29 companies are in the public sector. In terms of assets, among the top 10 companies 9 companies are in the public sector, and among the top 50 companies 32 companies are in the public sector.

Public investment in industry was a part of the planning model adopted by the Indian government immediately after independence (1947). The government decided public investment in the following three areas:

- a) Infrastructure;
- b) Investment directed primarily towards agriculture; and
- c) Investment directed towards industrial development.

The main objectives for setting up PSUs as stated in the industrial policy resolution of 1956 were:

- a) To help in rapid economic growth and industrialization of the country and create the necessary infrastructure for economic development;
- b) To earn return on investment and thus generate resources for development;
- c) To promote redistribution of income and wealth;

¹ Business world is a business magazine being published weekly by ABP (P) Limited, Calcutta, India

- d) To create employment opportunities;
- e) To promote balanced regional development;
- f) To assist the development of small-scale and ancillary industries; and
- g) To promote import substitution, save and earn foreign exchange for the economy.

The thrust area in the second five year plan (1956/57-1960/61) was building capacity in heavy industry through public investment. It was thought that PSUs would generate surplus from their operations, which would support augmentation of the capital stock. Although PSUs could generate employment opportunities, it could not generate surplus to augment the capital stock. In the words of Sukhamoy Chakravarty (1987, pp 30):

“The situation became worse because the main action correlate, that a rapid build-up of publicly owned capital stock going to help channel an increasing proportion of surplus flow into public coffers, turned out to be quite an unreliable instrument for this purpose. This was partly because of the inefficiency in setting up and running these enterprises, and partly because the government did not possess enough clarity of objectives for the public sector. In fact, much of the early discussion on public sector pricing policy was based on the idea that the public sector ought not to make profits.”

According to Amiya Kumar Bagchi (1998, pp 306) surplus generated by PSUs was larger than the amount reported by them. He writes:

“Many economists have pointed to deliberate under pricing of public sector goods and services, along with various open and concealed subsidies provided by the public to the private sector, in addition to inefficiency and under utilization of capacity in the public sector, as reasons for persistent excess of public sector investment over its savings. There is little doubt that the true surplus of the public sector would have been consistently higher if the implicit and explicit subsidies to the private sector were added to the nominal income of the public sector. But even after taking such transfers into account, there would probably remain a large and positive gap between the gross domestic capital formation of the public sector and its savings.”

Many reasons have been cited in the literature for the poor performance of PSUs. Bagchi (1998) identified various causes, other than managerial inefficiency, for the poor performance of PSUs¹.

The experience of other developing countries regarding performance of PSUs is no different. Mihir Rakshit (1997, pp 27) observes:

“An important ingredient of the industrialization policy in many developing countries, like, India, was large scale public investment in crucial sectors of the economy so as to internalize externalities, correct for market distortions and raise the overall savings ratio. However, the relatively poor performance of public sector enterprises in terms of both factor productivity and the generation of savings created serious obstacles in realizing the basic objectives of the heavy industry strategy (Choksi, 1979; Krueger and Tuncer, 1982a, 1982b). The problem was compounded by the difficulties on the political

front in closing down non-viable units or effecting their reorganization that would involve a reduction or a substantial change in the composition, of the labour force”

The seventh five year plan (1985/86-1989/90) proposed a large-scale stepping up of surplus from public enterprises. The government appreciated that though there was great potential for generating surplus by PSUs, it would not be achieved with the then prevalent style of functioning of those enterprises. The government decided to grant functional autonomy to those enterprises. It introduced the concept of Memorandum of Understanding (MOU). The policy received a boost in the wake of the new industrial policy of 1991, as a consequence of economic liberalization. In 1997 government granted enhanced autonomy and delegation of powers to PSUs that have the competitive advantage to become global giants (known as navaratnas²) and to other profit making PSUs.

As a part of the restructuring of the economy, the government decided to divest its holding in PSUs. The disinvestment process which began in 1991-92 with the sale of minority stakes in some PSUs, shifted focus to strategic sales during 1999-2000 to 2003-04. Although there is a consensus about restructuring of PSUs, it is not that every one agrees to privatization.

The United Progressive Alliance (UPA) government, the coalition government that came to power in 2004, modified the disinvestment policy. The Economic Survey 2004-05 (2005) presents the current government policy on PSUs. The main features of the present policy are as follows:

- a) The government is committed to a strong and effective public sector whose social objectives are met by its commercial functioning;
- b) The government is committed to devolve full managerial and commercial autonomy to successful, profit-making companies operating in a competitive environment;
- c) Generally profit-making companies will not be privatized;
- d) The government will retain the existing ‘navaratna’ companies in the public sector, while these companies would be encouraged to raise resources from the capital market;
- e) While every effort will be made to modernize and restructure sick public sector companies and revive sick industry, chronically loss-making companies will be either sold-off or closed, after all workers get their legitimate dues and compensation; and
- f) The government will take the help of private industry to turn-around companies that have potential for revival.

In short, the new policy will result in:

- a) Managerial and commercial autonomy to the management of public sector undertakings that are operating in a competitive environment;

- b) Change in the share holding pattern of those undertakings with the government holding more than 50% but less than 100% voting right; and
- c) Performance measurement based on commercial parameters.

The current policy provides an interesting setting for the study of corporate governance issues in the public sector. This paper explores various issues in the context of the new disinvestment policy.

In this paper we assume that the present disinvestment policy will not be reversed and PSUs, particularly those in core sectors, will not be privatized. In future government will hold majority voting rights in navratna and profit making PSUs. As a result, although private ownership might concentrate over time, those enterprises will remain in the public sector. With the listing of securities in the stock exchange, PSUs will be subject to the SEBI regulations. Those undertakings will have the same governance structure as required under clause 49 of the listing agreement³. They will be managed by professional managers without interference by the government in the day to day functioning.

2. Theory of Firm and Corporate Governance

Corporate governance is the response to the agency problems that arise from the separation of ownership and control. Agency problems are not unique to publicly traded companies. Jensen and Meckling (1976) argue that agency problem is inherent in any type of 'cooperative activity', because participants in any cooperative activity have their own preferences and bias, and they may not act in the manner expected by other participants. Therefore, to examine corporate governance issues only from the perspective of agency problem, where manager is the agent and shareholders as a class is the principal, is inadequate. It is appropriate to examine corporate governance issues by investigating the structure of a firm. There are two main definitions of firm available in the literature.

Alchian and Demsetz (1972) define a firm as a nexus of contracts. If a firm is a nexus of contracts, corporate governance is governance of a network of complex contracts. If we agree with Jensen and Meckling (1976) that every stakeholder other than shareholders can write a complete contract, in the sense that the contract covers all possible contingencies, the firm should be managed by shareholders in their best interest after enforcing the rights under contracts between different stakeholders. For example, bond holders, creditors, customers, and employees write complete contracts and therefore their share in the value (quasi rent) that the firm creates is defined ex-ante. There is no need for any ex-post adjustment. They expect enforcement of their rights under contracts. Enforcement of their rights depends significantly on the protection available to them under the law of the land and the effectiveness in enforcing the law. Not that every one agrees that stakeholders other than shareholders can write complete contracts. For example, Zingales (2004) believes that for most stakeholders writing a complete contract is either impossible or very costly. If we assume that most stakeholders including

shareholders cannot write complete contracts, corporate governance aims at equitable distribution of value ex-post. In absence of an adequate and effective mechanism, ex-post distribution depends on the relative bargaining power of various stakeholders. This results in inequitable distribution, which is undesirable.

Grossman and Hart (1986) and Hart and Moore (1990) define the firm as a collection of physical assets that are jointly owned. Ownership is important because it confers the right to make decisions in all contingencies unspecified by the initial contract. The right of shareholders is the residual right. Therefore, shareholders as a group are considered the owner of the assets and the law vests on them the right to manage those assets. Corporate governance aims to protect interests of non-controlling shareholders and debt holders, who do not have control on the operating and financing decisions of the firm. Rights of other stakeholders are protected by specific contracts and by the law of the land.

In order to discuss issues concerning corporate governance, a firm may be viewed as a collection of physical assets which are financed by shareholders and debt holders, who have claims on the value (quasi rent) that is created by the use of those assets. Stake holders other than investors can write complete contracts and their interest is protected by law. Although return on capital and the return of capital to debt holders are well defined ex-ante and fully protected in a situation when the value of the assets of the firm exceeds their claim, actual return on and return of capital is contingent on the value of the assets of the firm after the initial contract. Value of assets after the initial contract depends on the use of assets under various states of nature and contingencies. Therefore, debt holders have interest in the operating and financing decisions of the firm. They protect their right by an effective monitoring of the use of assets.

The claim of shareholders is residual. Therefore, the right to take operating and financing decisions primarily vests with shareholders. However, each shareholder cannot exercise the right individually. Therefore they delegate that right to the board of directors. A shareholder can exercise her voting right directly by attending general meetings or through proxy for electing the board of directors. Usually one share has one vote. Therefore, in absence of shareholder activism, the control on the assets of the firm usually rests with the group that has control over the maximum voting rights either through ownership or otherwise, for example, by arrangements with other large shareholders. The board of directors delegates its power to manage the assets of the firm to specialist managers primarily because of the complexity of the business. The primary responsibility of the board is to engage and monitor the executive management (the CEO and her team), and when necessary to replace it. We may view the board as the apex body in the corporate internal control system.

3. Objective Function of a Firm

The first issue in corporate governance is to establish the objective function of the firm. At the individual firm level, one should ask the question what the firm is trying to

accomplish, and how managers should measure better versus worse. Similarly, at the economy-wide or social level we should ask the question how we want to measure the performance of firms operating in our economy.

Jensen (2001) argues that the objective function of a firm should be to maximize the value of the firm. Value of a firm is the total of the market value of equity and the market value of debt. Jensen and many others argue against the stake holder theory of corporate governance, which says that corporate governance should take care of the welfare of all stake holders. According to them the stake holder theory leads to multiplicity of objective functions that managers of a firm is expected to achieve and thus, reduces their focus on the primary objective of the firm and dilutes the accountability of managers. They argue that maximization of the firm value achieves the objective of social welfare so long as a firm is not creating negative 'externalities'⁴. If a competition law is in place and proper institutions (like regulators and consumer courts) exist to protect the interest of consumers, 'maximization of firm value' is the appropriate objective function of a firm, because the product market determines the legitimacy of the existence of the firm. If a firm fails in the product market it ceases to exist. The objective function 'maximization of firm value' leads to social welfare because in the input markets, suppliers of inputs voluntarily participate in the market, and they participate so long as they earn a fair return on their investment. Even if they earn a 'rent' it is a transfer of wealth in the economy and not a waste. However, the government should protect the interest of those suppliers of inputs who have very weak bargaining power. For example, the government protects the interest of workers and suppliers of agricultural produce. If institutions in an economy are weak, 'maximization of firm value, does not lead to the welfare of the society. For example if institutions fail to ensure that 'minimum wages' are paid to workers, maximization of firm value would not lead to social welfare. Similarly, if the government cannot effectively implement the environment law, firms would create negative externalities, or if regulators are taken over by firms on the strength of their nexus with politics, 'maximization of firm value' does not lead to social welfare. Although institutions in India are quite weak, for the purpose of this paper we assume that 'maximization of the firm value' should be the objective function of a business firm.

3.1. Objective function of PSUs

What should be the objective function of a firm in the public sector? Should it be different from firms operating in the private sector? Mihir Rakshit (1997, pp 31-32) observes:

“What is no less important, performance of enterprises should be judged on the basis of their profitability and they must not be called upon to bear the cost of attaining other goals like support to special sectors or groups, however deserving they may be. The cost of all such support public sector undertakings are required to provide should be borne by the Treasury. This will help greatly in judging the efficiency of enterprises and estimating the benefit-cost of various schemes of subsidy and support.”

We do not fully agree to the views of Mihir Rkshit. We believe that ‘maximization of firm value’ cannot be the objective function of all firms operating in the public sector. Unlike a firm in the private sector, a public sector firm is not simply a vehicle for creating wealth for investors. PSUs, particularly those that are operating in areas of strategic importance, are expected to create ‘positive externalities’. For example, ONGC cannot decide ‘maximization of firm value’ as its objective function. The government would like to use ONGC as a vehicle for implementing its strategy for achieving energy security. The conflict between the objective function ‘maximize firm value’ and the broader national interest gets reflected in the following paragraph published in the Business world (7th March 2005, pp 28):

“Aiyar² apparently believes that oil and gas PSUs are marching to the beat of their own drum and aren’t acting in concert. He isn’t very happy about ONGC’s plan to set up power projects and special economic zones. He is also cut up about GAIL’s public insistence that the proposed national gas grid be set up only by them, to the exclusion of other players. There are also strong rivalries that exist today among oil and gas PSUs. While that need not necessarily be bad—after all, these companies are supposed to maximize shareholder wealth—Aiyar believes that given the larger national interest of energy security, they need to rethink their priorities.”

P. Chidambaram in his budget (2005-06) speech³ says:

“Last year, I had promised that agricultural credit will be increased by 30 per cent, and I am happy to inform the House that against the announced target of Rs.105,000 crore, we are likely to achieve a disbursement of Rs.108,500 crore. Public sector banks and regional rural banks have added so far 58.20 lakhs new farmers to their portfolio of borrowers”.

The above statement provides evidence that the government uses PSUs as instruments for social welfare and not as a pure commercial venture of the government.

In absence of a well defined government strategy and clear mandate from the government, the board of directors of a PSU makes conflicting statements about the objective function in various public communications. We may take the example of Indian Oil Corporation Limited (to be referred as Indian Oil), which is a highly respected ‘navaratna’ PSU. The vision (Annual report 2003-04, pp A-6) of the company is:

“To be a major, diversified, transnational, integrated energy company, with national leadership and a strong environment conscience, playing a national role in oil security and public distribution”. (Emphasis is added by the author.)

The company’s’ philosophy on corporate governance (Annual Report 2003-04, pp A-60) is as follows:

² Aiyar in the paragraph refers to Mani Shankar Aiyar, the Petroleum Minister in the UPA government, since May 2004.

³ P. Chidambaram is the Finance Minister in the UPA government since May 2004. The speech refers to his speech in the Parliament on February 28, 2005 while presenting the budget for the year 2005-06.

“Indian Oil consistently endeavors to attend the highest standards of corporate governance by ensuring transparency in all operations, disclosures and to maximize shareholder’s value. Indian Oil is also committed to its other business constituents like customers, employees, suppliers, dealers and the community at large. In order to fulfill these objectives , Indian Oil fully complies with the stipulations laid down in the guidelines on Corporate Governance as specified in clause 49 of the Listing Agreement executed with the Stock Exchanges.” (Emphasis is added by the author.)

The vision is to play ‘a national role in oil security and public distribution’. The corporate governance philosophy focuses on ‘maximization of shareholder’s value’. The company cannot have two objective functions that are conflicting in nature. The company will have to focus on either of the two objectives, because in many situations, the board of directors will find it impossible to balance these two objectives. The two public statements quoted above are like two guide posts directing towards two different directions. They have the potential to confuse the board of directors and stakeholders of the company, and to create unwarranted strain on the management. Moreover, multiplicity of objectives dilutes the management’s accountability.

It is appropriate that the government should use PSUs as instruments to achieve its social objectives, which is often manifested as political objectives. Economists view that PSUs are owned by public (tax payers) and managed by bureaucrats (politicians). Shleifer and Vishny (1997) describe the structure of PSUs as a situation in which bureaucrats retain concentrated control rights without cash flow rights. The bureaucrat’s main concern is to achieve their political objectives, objectives which do not coincide with the profit maximization objectives. Boycko et al. (1996), and Shleifer and Vishny (1997) observe that privatization transfers ownership to outside investors, who place greater emphasis on profits and efficiency.

We believe that privatization leads to concentration of private ownership and the government is deprived of the right to use PSUs as instruments for creating social welfare. Therefore, we support the present disinvestment policy of the government. Disinvestment should not lead to privatization.

4. Corporate Governance Models

Corporate governance models for business firms discussed in the literature are based on the assumption that the objective function of a firm is ‘maximization of firm value’. Therefore, corporate governance models endeavor to ensure that managers use resources (assets and people) to maximize the value of the firm. In this section we summarize corporate governance models available in the literature.

4.1. Provision for incentives

Incentive contracts should reward or punish managers based on objective measure of performance. The optimal contract should take into account, among other things, the risk aversion of the manager and the effect of her decision on the firm. Incentives linked to performance may drive managers to manipulate data, for example, managers may resort to earnings management. Literature has found a small sensitivity of executive compensation to the share price.

4.2. Monitoring and control

Information signals usually come from the capital market. For example, an institutional investor or pension fund disinvests (“exits”) if performance of the firm is poor. Therefore, transparency in and timeliness of corporate financial reporting enhances passive monitoring and control. However, many economists believe that short-termist and bias decisions of institutional investors reduce the effectiveness of passive monitoring and control very significantly. At the worse, it might adversely affect the quality of corporate governance, because it may tempt managers to ‘maximize the value of the firm’ in the short-term rather than pursuing strategies that would maximize the long –term value of the firm.

Active monitoring and control is made by the board of directors, a large shareholder, a large creditor, or the market for corporate control. Institutional investors often behave like traders and do not spend resources for active monitoring and control of the firm, because of the ‘free-ride’ problem⁵.

4.3. Board of directors

Evidence points at board of directors dominated by the incumbent management. Therefore, most corporate governance codes prescribe for “balanced board” with adequate number of “independent directors”, and separation of the positions of the chairman and the chief executive officer. For example, in India, clause 49 of the listing agreement requires that not less than 50% of directors should be non-executive directors; there should be at least 50% independent directors if the Chairman is executive; and in case of non-executive Chairman at least one-third should be independent directors. The expectation is that a balanced board would be able to make an objective assessment of the executive management. However, evidence suggests that even a balanced board of directors react very late and mostly under outside pressure. With regards to the board size, the literature states that optimal size should be between 6 to 8 members. However, in many of the PSUs the number of directors are any where between 12 to 20.

4.4. Large shareholders

Evidence suggests that concentration of ownership improves the control of managers by overcoming the ‘free-ride’ problem. However, evidence also suggests that a financial institution having large investment intervenes only when the firm is in distress. On the negative side, a large shareholder may indulge in ‘self-dealing’ and create private benefits. This adversely affects the interest of small shareholders or debt holders.

4.5. Large creditors

Debt is another instrument to discipline managers and reduce agency costs. The failure to repay the debt results in transfer of control from the manager to the creditor. Therefore, the manager works hard to avoid default. On the negative side, the debt holder, because of its relatively high bargaining power, may extract rent from the firm. Moreover, excessive debt in the capital structure may cause debt overhang, where the manager does not choose a good project because most returns will go to debt holders.

4.6. Market for corporate control

Proxy contests, friendly mergers, and hostile takeovers are considered complementary with internal control mechanisms. The threat of take over motivates the incumbent management to perform at the optimal level. However, there is scant evidence that operating performance of a firm increases with a takeover.

Becht et al. (2002) provides a comprehensive survey of corporate governance literature. Interested readers may refer to the paper for an understanding of corporate governance models.

5. Implications of Corporate Governance Failure

The failure of the corporate governance system should be viewed as the failure of the 'corporate internal control system'. While reviewing the performance in USA Jensen (2000) observes:

“The problem of internal control systems starts with the board of directors. The board, at the apex of the internal control system, has the final responsibility for the functioning of the firm. Most importantly, it sets the rules of the game for the CEO. The job of the board is to hire, fire, and compensate the CEO and to provide high level counsel. Few boards in the past decades have done this job well in the absence of external crises. This is particularly unfortunate given that the very purpose of internal control mechanism is to provide an early warning system to put the organization back on track before difficulties reach a crisis stage.”

Failure of the corporate internal control system results in 'waste of free cash flows'. This happens because:

- a) Managers resort to 'power-seeking' activities rather than 'value-seeking' activities. They invest for revenue growth and unwarranted diversification.
- b) Managers fail to visualize early the excess capacity in the industry resulting from decline in demand, technological changes, and globalization.
- c) Managers expropriate shareholders' wealth. They indulge in self-dealing. They benefit themselves with perquisites disproportionate to the firm performance and

- industry norms. They take decisions to improve the performance of the firm in the short term ignoring the detrimental effect of those decisions on the long-term health of the firm.
- d) Managers fail to provide the right organization culture and supporting environment.
 - e) Managers shirk responsibilities.
 - f) Managers entrench control in spite of poor performance.

6. Policy Implications for Public sector enterprises

Boubkari et al. (2004) studied a sample of 209 privatized firms from 39 countries over the period 1980-2001. They concluded that the government relinquishes control over time to the benefit of local institutions, individuals, and foreign investors, and that private ownership tends to concentrate over time. Firm size, growth, and industry affiliation, privatization method, as well as the institutional development and investor protection, explain the cross-firm differences in ownership concentration.

We assume that the experience in India will be little different because the government has decided not to privatize PSUs. With disinvestment, government holding will come down, but not below 51%. However, a few shareholders (individuals and/or body corporate) might acquire substantial voting rights in those enterprises, even if the government takes the capital market route for divesting its holding and PSUs access the capital market to raise fund. Therefore, concentration of voting rights in the hands of one or two large shareholders cannot be ruled out.

The premise of our discussion in this section is that PSUs are not pure commercial ventures of the government. As in the past, in the future also the government will use PSUs to achieve social welfare especially in situations where other instruments might fail to deliver the desired results.

6.1. Objective function

We believe that the objective function of all PSUs cannot be 'maximization of the firm value'. The government should formulate well defined strategy for each PSU and establish the objective function based on that strategy. The government should spell out the objective function of each enterprise very clearly. For example, the objective function of ONGC might be 'to help the government in achieving energy security'. Clarity and transparency in communicating the objective function to all stake holders is essential to protect the interest of non-government investors and to ensure effective functioning of the enterprise. The board of directors should use the 'objective function' as the guide post in managing the resources of the firm.

The government should review and if necessary, revise the objective function to meet structural changes in the socio-economic environment or changes in national priorities. However, frequent revisions should be avoided. Frequent revisions would confuse the

stake holders and will undermine the credibility of the government. Similarly, the government should not set multiple objectives for a particular PSU. It is said that ‘multiple objectives is no objective’, because in most situation objectives are conflicting in nature.

In short, the vision and mission statements of a PSU should be framed by the government, and that should clearly reflect the ‘objective function’ established for the particular PSU. The board of directors should adapt the same.

6.2. Managerial and commercial autonomy

The government should act as an informed and responsible promoter and majority shareholder of PSUs. After disinvestment, the government does not remain the sole-owner of the PSU. It becomes accountable to other equity holders. Therefore, it should act transparently. Transparency is the corner stone of a good corporate governance system.

PSUs should be kept immune from political and bureaucratic interferences. It is now well established that political and bureaucratic interference affects the performance of an enterprise adversely. Therefore, the government should control and monitor PSUs without interfering in their day to day management. The government policy to provide managerial and commercial autonomy to PSUs ,operating in a competitive environment, is a welcome step. We suggest that the government should grant autonomy to all PSUs, even to those enterprises that are enjoying monopoly position. The government after formulating the strategy and issuing the clear mandate should adopt the hands-off approach as regards day to day management of the enterprise.

Managerial and commercial autonomy to a PSU implies autonomy to the board of directors in taking operating decisions. It should not be viewed as autonomy to the CEO of the PSU. Ultimate accountability for managing a PSU efficiently and effectively to achieve results as mandated by the government rests with its board of directors.

KPIs and the performance metric of an enterprise reflect its objective function. For a firm that has the objective function of ‘maximization of the firm value’, economic value added (EVA), market value added (MVA) or ‘market value to book value ratio’ might be the appropriate score (a single measure) for performance measurement. None of these may be appropriate for a firm that has an objective function different from “maximization of firm value’. It is difficult to develop a single measure (the score) that captures the overall performance of such a firm. The board of a PSU should decide KPIs and formulate a score card. The score card provides a structure to managers to understand the ‘objective function’. It helps managers to understand value drivers⁴ that are to be managed to achieve desired results. The government should approve key performance indicators (KPI) and the score card proposed by the board of directors. Vetting by the government

⁴ Value drivers are variables that determine the result of an enterprise in terms of its achieving the objective function.

will ensure that the board of directors has clearly understood the objective function, the vision and mission statements, and value drivers of the enterprise

6.3. Business plan, budget and MOU

Each PSU should prepare a five-year business plan, often termed as corporate plan. Business plan period should be coterminous with the five-year plan period. The business plan should be approved by the government. At the beginning of the plan period the government should indicate the budgetary support, if necessary, it would provide to an enterprise to enable it to achieve the target performance. The approved five-year business plan provides the framework within which the annual plan should be prepared. The annual plan should be approved by the board of directors.

The present practice is that the government enters into a memorandum of understanding (MOU) with each PSU on yearly basis. The MOU is a negotiated agreement between the board of directors and the government. It sets the targets to be achieved against various value drivers. It assigns weight to different drivers highlighting the importance of each driver to achieve the desired results. The greatest advantage of MOU is that the board of directors and the government jointly decides annual targets and the type and amount of government support required to achieve those targets. On the negative side, the direct involvement of the government in formulating annual targets undermines the independence and authority of the board of directors and dilutes its accountability. Moreover, the process of finalizing MOU is a negotiation process and has the potential for political and bureaucratic interference in the operating decisions. The guidelines for MOU for the year 2004-05 reads “*specific areas in which further autonomy and financial powers desired may also be incorporated with justification as to how these additional powers will stimulate the growth of the company*”. This stipulation raises a serious doubt on the government’s intention to grant full operational autonomy to PSUs. Presumably, the stipulation is based on the government’s belief that autonomy to board of directors is negotiable.

The government should dispense with the present practice of signing MOU with PSUs, because the dysfunctional effects outweigh advantages of the practice. Similarly, the government should dispense with the practice of the periodical review of the performance of PSUs. This review at its best is a waste of government resources by duplicating an activity that is the responsibility of the board of directors and at its worse it undermines the independence and authority of the board of directors. It has the potential to place the Chief Executive Officer (CEO), who directly interacts with the government through this process, above the board of directors. This severely restrains the authority of the board of directors to control and monitor the executive management and dilutes the accountability of the board of directors.

6.4. Board of directors and independent directors

In accordance with the present disinvestment policy, PSUs will access the capital market for funds. Therefore, they will be governed by SEBI regulations. The board of directors

will be structured as per the requirement of the Listing Agreement. Accordingly, the size of the board of directors will be limited to 15 members. The government being the majority shareholder will elect its nominees to the board. However in nominating members to the board, the government should follow the principles stipulated in the draft 'OECD guidelines on the corporate governance of state owned enterprises'. The salient features of the 'Guidelines' are:

- a) The government should not impede on board's work and authority.
- b) The government should nominate member of its staff on the board. This will help to articulate the government strategy while maintaining the full autonomy and authority of the board.
- c) The government's participation in the board should be limited. This would facilitate exercise of independent judgment by the board. The excessive representation by the government might be perceived by other members as decrease of the board's independence and authority. This might also disrupt the proper dynamics of the board.

The government should appoint professionals having competence and understanding of business as board members. It may be a good idea to invite other large shareholders to nominate their representatives to the board. This will help them to understand the government strategy. This will also reduce the chances of 'self dealing' by large shareholders by reducing the possibility of private lobbying with the government outside the board.

An independent director in a PSU board should not only be independent of the executive management, she should also be independent of the government and the political parties in the power. Therefore, the government should avoid appointing individuals with perceived political affiliation to the board of directors of a PSU as an independent director.

The government, as the promoter of a PSU and as a majority shareholder, should closely monitor the performance of the enterprise and the performance of its board of directors. The government should enforce control and monitoring through government officials, who are members of the board of directors. They should clearly communicate the government strategy and government views on various issues in the board meeting without impeding the independence and authority of other directors. The onus is on the government to ensure that the government views are not perceived as government mandate by other members of the board. It is the responsibility of the government to ensure free and frank discussion of various issues in board meetings. It may be a good practice to avoid communicating government views to the board of directors through the CEO or the Chairman of the board.

6.5. The role of the Comptroller and Auditor General of India (CAG)

The failure of corporate governance is the failure of the corporate internal control system. Therefore, the CAG should ensure that the corporate internal control system is adequate

and functioning effectively. The CAG should not waste resources in reviewing the work of statutory auditors. The responsibility for improving the quality of audit lies with the Institute of Chartered Accountants of India (ICAI). Recently the ICAI has taken number of initiatives to improve the quality of audit. Moreover, with the review of the accounting policy and audit comments by the audit committee (of the board of directors), the audit quality is likely to improve.

The proprietary audit should be left to the internal auditor. It is the responsibility of the audit committee of the board to decide the internal audit brief, to ensure independence to the internal auditor and to review the 'action taken reports'. The CAG should not duplicate the efforts of the audit committee.

The CAG should focus on the comprehensive review of PSUs. It should strengthen the practice of comprehensive review. It should undertake comprehensive review of a PSU at an interval of four years. This will provide an assurance that the corporate internal control system is adequate and operating effectively and will identify the areas of weakness. It will also identify 'waste of free cash flows', if any. The comprehensive review should be more a 'management audit' than an 'operation audit'.

7. Conclusion

The corporate governance structure of PSUs cannot be exactly the same as that of private sector enterprises, because the objective function of a PSU may not necessarily be the 'maximization of firm value'. Moreover, the government cannot participate directly in the day to day management of the enterprise like a private promoter or the controlling group of shareholders, because political and bureaucratic interference affects the performance of an enterprise adversely. Therefore, the corporate governance structure of a PSU should ensure effective control and monitoring by the government without political and bureaucratic interference.

The government should grant full autonomy and independence to the board of directors. It should retain the authority to:

- a) Formulate the strategy and set the objective function:
- b) Frame the 'vision and mission statements' in consultation with the board of directors;
- c) Approve KPIs and score card formulated by the board; and
- d) Approve the five-year business plan.

It should relinquish all other direct controls on PSUs. It should dispense with the present system of signing MOU on yearly basis and the system of periodical review.

The government should not have excessive representation, through government officials, in the board of directors. It should appoint professionals with competence and business knowledge as members of the board of directors. It should ensure free and frank discussions in board meetings. The CAG should strengthen the practice of comprehensive review to ensure that the corporate internal control system is adequate and operating

effectively. It should give up the practice of reviewing the work of statutory auditors and the practice of propriety audit.

We hope that the government will bring necessary changes in the present governance structure to enhance the productivity in the public sector.

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END NOTES

¹ For details see Bagchi (1998, pp307-310). Some of the reasons are inability to choose the technology and product-mix against the pressures exerted by foreign firms because the purchase of the technology and equipment was tied up to foreign loans or aids; failure to monitor effectively the foreign contractors involved in setting up the new plants resulting in a difference between design capacity and effective capacity; and government interference and social priority stipulations by the government.

² In July 1997 the government granted enhanced autonomy and delegation of power to BHEL, BPCL, HPCL, IOC, IPCL, NTPC, ONGC, SAIL, and VSNL and called them 'navratna' (nine gems) . In November 1997 the government added MTNL and GAIL in the list of navratnas. In October 1997 the government granted enhanced autonomy to profit making PSEs and called them mini-ratnas.

³ Securities and Exchange Board of India (SEBI), the body that regulates listed companies to protect investors' interest, has issued a 'code of corporate governance'. The Code is implemented by incorporating the requirements in clause 49 of the listing agreement. Listed companies agree to honor the requirements of the listing agreement. Non-compliance results in de-listing of securities.

⁴ An externality occurs when a decision (for example, to pollute the atmosphere) causes costs or benefits to individuals or groups other than the person making the decision. In other words, the decision-maker does not bear all of the costs or reap all of the gains from his or her action.

⁵ Free riders are actors who take more than their fair share of the benefits or do not shoulder their fair share of the costs of their use of a resource, involvement in a project, etc.. The free rider problem is the question of how to prevent free riding from taking place, or at least limit its effects.