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Can privatisation crowd out net real investment?

Privatisation can ‘crowd out’ new or greenfield investment, as there is no new physical capital being created

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Representative Image.

The privatisation of state-owned enterprises, along with liberalisation and globalisation, has been a key element in the structural reform policies adopted by successive Indian governments since 1991. The gains from privatisation are usually argued to come from efficiency gains, driven by the profit motive of private agents in an economy.

Another significant gain often suggested comes from earnings or revenue to the state that can then be redeployed for spending in areas that the private sector will not undertake, as for instance, large infrastructure projects. This would ensure that the government spends within its means and adheres to the fiscal deficit norms that it imposes upon itself.

While these arguments about privatisation have been widely debated, its impact on monetary flows is rarely examined. Privatisation involves the exchange of real assets held by the government for ‘money’, the latter being the financial liabilities issued by the state itself. If the payment for real assets is made from the savings of the private sector without bank lending, it will result in a reduction in the deposit (savings and/or current account) balances of individuals and/or businesses held at commercial banks. At the same time, when the accounts of the government are credited at the Reserve Bank of India (RBI), there is an outflow of reserve money or what is commonly referred as liquidity, from the commercial banking system to the RBI.

Large disinvestment or privatisation deals could therefore result in a dearth of liquidity in money markets that could drive up money market interest rates, all else constant. Even if privatisation were to be funded by loans from commercial banks, the impact on liquidity will be the same. This is essentially the ‘crowding out’ effect wherein lending rates of commercial banks can rise and consequently dampen demand for credit for consumption and investment spending.

Privatisation can also ‘crowd out’ new or greenfield investment, as there is no new physical capital being created. Moreover, efficiency gains are realized through a reduction in the workforce, at least in the short run, that may then entail greater government spending in the provision of unemployment benefits.

Meanwhile, to negate the impact of asset sales on liquidity and interest rates, intervention by the central bank is required to bring them within the target range. This is done through repo or other transactions with the commercial banking system by exchanging government securities for liquidity. If these operations are carried out, the net effect on balance sheets of the different sectors is interesting.

The government and private sector's balance sheet will see no net effect: the sale (purchase) of asset is replaced with a credit (debit) in its deposit account held at the central bank (commercial bank). After the repo transaction, there will be an expansion of the central bank's balance sheet while the commercial banking sector will witness a contraction in its balance sheet.

There is another monetary aspect that arises from this operation: a small portion of the government's financial liabilities (money) is extinguished by way of sale of physical assets. This is because the government is taking back its own financial liabilities from the hands of the private sector. With this, the government is in effect paring down its debt. This is not otherwise possible with 'repayment' of debt because the government in such cases only issues new financial liabilities in lieu of matured ones.

The purpose of privatisation is claimed to enable the government to raise money, particularly for infrastructure spending, although it must be realized that money is fungible, and no specific application of money can actually be claimed. When government spending happens, the whole process described above is reversed. The bottom line then, in purely monetary terms of privatisation or disinvestment, is the government's ability to expand spending without recourse to issue of new debt.

This draws us into the more fundamental question: is public debt issued by an economically sovereign country, or in India's case rupee debt, really a problem *per se*? The conflation of all debt, namely debt held by households and businesses and rupee debt of the Government of India, perhaps causes this fear without realizing the fundamental difference between 'users' and 'issuer' of money in a modern economy. While private agents must repay their debt in the financial liabilities of the state, the government 'repays' its debt through the issue of its own financial liabilities and nothing else. Furthermore, it is overlooked that public debt provides (absolutely safe) financial assets to the private sector.

India's public debt is at around **62%** of GDP while disinvestment plans for FY 2022-23 are to the tune of some 65,000 crores. The reduction in debt from disinvestment or privatisation will then work to less than 0.5% of total public debt. Even going by conventional arguments in favour of public debt reduction, are these 'earnings' to pare down debt really substantial, financially speaking? At the same time, the net effect from crowding out of private greenfield investment through sale of existing assets against efficiency gains must be subject to greater empirical justification. The recent revival plans of BSNL **announced** by the Indian government indicates that efficiency is ultimately an issue of governance and if the government resolves to, it can aim to raise the bar of service and performance to the standards of the private sector, although the final benchmark cannot be purely profits.

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