Chapter 4

PRINCIPLES OF EVALUATION OF PUBLIC ENTERPRISES

At present there is considerable amount of involvement by governments in the economic welfare of the people in each and every country. The public enterprises and other social undertakings in the not-for-profit sector, share major role in the nation's total economic activity. With the rapid growth of public enterprises in every country, the problem of evaluating enterprises becomes the concern of economists as well as statesmen.

The outstanding issues involving the evaluation of public enterprises are:
(a) whether the public enterprises will be evaluated on the criterion of profitability as in case of a private enterprise?

(b) If the profitability criterion is not applicable, what are the alternative principles to be used for the evaluation of public enterprises?

(c) How far are the alternative principles feasible for evaluating an enterprise? And whether those principles are better tools than the profitability criterion in the analysis of efficiency of public enterprises?

There are a number of viewpoints on these problems, and no standard principle of evaluating a public enterprise has emerged so far. All these viewpoints can be classified into three groups.

First, some accept the criterion of profitability as the most efficient tool for the measurement of performances of commercial enterprises both in the private and the public sector.

Second, some take profitability as a capitalistic tool, and think it unsuitable to evaluate the performance of public enterprises and suggest other principles for evaluation.
Third, there is another group of economists who accept profitability as one of the tools of measuring the performance of public enterprises, giving it a minor role and suggesting other criteria on priority basis for the purpose of evaluation.

Views of these three schools of thought will be discussed in brief in search of a suitable principle for the evaluation of public undertakings in Orissa, in the succeeding paragraphs.

The first school of economists advocate that the enterprises should be evaluated on the basis of profitability irrespective of the nature of enterprise, as they find no difference between the two sectors as far as the economy is concerned. On a broader plane the distinction between the private and public enterprises is misleading. The private enterprise no doubt is guided by the ordinary commercial criteria which require the revenues to exceed costs, but the private enterprise is a part of the economy and therefore it cannot ignore the social commitments. On the other hand the public enterprises cannot ignore the consideration of profit. In other words a public enterprise has also to give due importance to the question of costs, efficiency and economy.

It is wrong to assume that a loss in a private enterprise is simply a private loss and it has nothing to do with the economy. It is also a loss to the society. Similarly a loss in a public enterprise which is a loss to the government directly, has to be borne by the people ultimately and therefore is a social loss. So whether it is a public enterprise or a private one, the loss in the physical terms is a loss to the society.

In a developing economy, the public enterprises have to earn profit, and the industries earning higher rate of profit either in producing export-goods or for the home consumption should get priority in expansion, so that they may form more capital out of the profits earned from the public enterprises. Since per capita income and savings out of it are meagre, a backward economy cannot afford to invest in the enterprises where the return on capital would be meagre or negative. As the profit earned in a public enterprise would be reinvested in the economy by the public authorities and for the public purpose there is no reason why a public enterprise will be managed without earning profits, making no contribution for the development of the economy.

The role of the profit on macro-economic level cannot be ignored. In a socialistic economy, where the entire economic
activity is carried on by the public enterprises, profits have to be earned to make further investments in accelerating the growth of the economy. Whatever may be the fact, profit as an index of enterprise's or economy's efficiency has to be accepted. In the USSR profit is regarded as an optimal index of efficiency. 'On the one hand it is organically linked with the entire activity of the enterprise, for each success and failure is reflected in the profits. On the other hand profits depend very little on changes in production list' . Of course by policy government may think of sustaining losses in an enterprise in order to give certain benefits to a section of the community or to the entire society, and fill up the deficit from the general revenues, but this cannot be extended to the entire public sector as a principle. The degree of loss or profit, with all its limitations and constraints should be taken as an index of efficiency of an enterprise.

On the other hand, it is argued that the modern productive activity is a synthetic personality which requires a complex blending of skills and talents, whether it is a public enterprise or a private one. But certainly, simply earning of more profit cannot be the goal of a public enterprise, if it is, then there would be no difference between public and private enterprises except in nomenclature. It

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means, there would be no difference between the private capitalism and a mixed economy with the public participation in the commercial enterprises. It will simply be a new form of state capitalism.3

The second school of thinkers therefore argue that profitability alone cannot judge the efficiency of a public enterprise. A losing concern might be a more important enterprise in the larger interests of the society than an enterprise earning high rate of profit. There is a specific philosophy behind the expansion of public enterprises other than earning of profit: the philosophy of democratic socialism.4 Two of the major instruments of democratic socialism are, one, larger increase in the facilities of the social services and two, large scale extension of the public sector in order to restrict the private sector and to get direct control on production.

The public enterprises have therefore certain non-commercial obligations. In evaluation of investment in the public enterprises, the non-commercial factors some time are more important than the simple analysis of the rate of profit.


Some of the non-commercial objectives are:

**Import substitution:** Saving of the foreign exchange by producing commodities which were being imported previously from foreign countries. Even though the undertakings are running at a loss to the government, they save foreign exchange and prepare the country for self-reliance. So in this case, the social benefits have to be given preference to the earnings of profits by a public enterprise.

**Basic goods:** When the produced goods are in the nature of capital goods which are essential for the rapid economic development of the economy, the profitability principle cannot be considered as the criterion for judging the efficiency of a public enterprise.

**Employment potentiality:** If an industry is capable of developing ancillary and other allied industries which will have job opportunities for the people, profitability should not be considered as the guide line for the evaluation of public enterprises.\(^5\)

**Regional Development:** Public enterprises are located in the backward regions of the country with the purpose of general economic development of the region, where no private

entrepreneurs venture to establish industries initially. These industries have to be analysed not from the point of view of earning profits but on the extent of stimulation provided in the region for the development of economic process.

If most of the public enterprises are established for the non-commercial obligations and profitability cannot measure the efficiency, which are the alternative methods to be adopted for the evaluation of the public enterprises? Some of the important propositions made by the public economists are as follows:

1. **Cost benefit analysis**: It is proposed that the measurement of efficiency may be made on the 'national economic profitability'. Instead of individual profitability the calculation of social costs and benefits must be taken into account. The market-price mechanism fails to evaluate the costs and the benefits of a public enterprise established for the attainment of certain social ends. Therefore in the public enterprises the social rate of return has to be calculated instead of direct individual returns of the public investment.

But all the public investments cannot be evaluated on cost-benefit analysis during a short period. Even if a

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cost benefit analysis is feasible, there is no surety that it will reflect the true benefits, because it is difficult to quantify all the benefits in an accurate manner. In an analysis when the benefits are more than the costs it cannot always be estimated that the society is better off. An enterprise established on the basis of cost benefit calculation which offers increased benefits to one group in the society, may at the same time substantially injure another group in the society. Therefore in most of the cases the cost-benefit analysis has limited applicability from the practical point of view, for the purpose of evaluation of an enterprise from year to year.

2. **Assessment by objectives**: The objective of each enterprise must be specified, at the time of the incorporation of the enterprise so that it would be easier for evaluation; and the profit and loss analysis would no more be the guiding principle for evaluation. The goal of a public enterprise must be specific, clear and comprehensive to all. If an enterprise attains the specified objectives for which it is established, profitability as a criterion may not be applied to measure the efficiency of an enterprise. But the whole difficulty is that the public authorities do not generally prescribe the objectives for an enterprise, and even if prescribed, they are not laid down in clear terms to be accepted as guidelines for the purpose of evaluation of an enterprise.
3. Changes in productivity: In the absence of clear objectives, certain physical norms of productivity may be prescribed for the public enterprises on a scientific basis and if the enterprise reached the norm it should be treated as an efficient enterprise. Of course fixing up of norms is also not an easy task. This method is being used widely in the USSR. But the whole difficulty here is that the government has to maintain a separate machinery for the purpose of fixing up of norms, since according to the changes in the technology and the nature of the product, the norms have to be changed from year to year and from enterprise to enterprise.

4. Production targets: If the norms are difficult to formulate, alternatively annual output targets can be fixed to judge the efficiency of an enterprise. In the USSR physical production targets are prescribed within a given range of cost of production or within a maximum cost of production set beforehand. It is stated that the targets of output reached must be given first order in the evaluation process of an enterprise. In the second place the cost benefit analysis should be applied for the evaluation. Only in the third order, the returns achieved on the resources invested have to be taken into account. But this is also not a


fool-proof method, since the authorities may fix the targets which can easily be reached and show publicly that an enterprise is an efficient one as it has reached the desired targets in the year.

THE MIXED PRINCIPLES:

There is a consensus that the public enterprises must be run on commercial principles like a private enterprise but the difference of opinion creeps in regarding the methods adopted for their evaluation. The third school of economists adopt a mixed principle -- commercial and non-commercial criteria -- for the evaluation of the public enterprises. They also do not believe in a general principle for all public enterprises. Instead they analyse each enterprise according to its nature of commodities produced (a) whether it produces public utility services, capital goods, or consumer goods and (b) according to the nature of the market, whether it is a monopoly of the public sector or it has to compete in the market with the private sector.

Once the commercial principles are introduced in a public enterprise for the purpose of management, profitability automatically creeps in. But here, the concept of profitability has to be used in a different context. Profit should not be an end in itself; it should be a yardstick for assigning performance, and guide for the reformation and renovation,
investment and disinvestment and economisation to a greater extent. But as it has been pointed out profitability alone cannot judge the efficiency of an enterprise in the public sector.\textsuperscript{9} In other words, the rate of return on capital invested should not be the sole criterion for the measurement of efficiency in a public enterprise, but it should be one of the important tools in the process of evaluation.

Two important features that distinguish a public enterprise from that of a private enterprise are, firstly, the public enterprises either in aggregate or individually have to subserve the financial policies of the government; secondly they must so operate that the financial performance should be consistent with the non-financial returns expected of them.\textsuperscript{10}

In the public sector management some of the policies that may be pursued are:

1. operation of an enterprise as a medium of indirect taxation or subsidisation.

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2. raising of internal resources in order to give relief to the public exchequer;

3. maintenance of price stability in the economy or in a particular sector of the economy;

4. to attain maximum productivity of scarce capital outlays in certain or all the public enterprises especially under the condition of foreign borrowings;

5. fixation of expected quantum of resources for the public enterprises as plan resources, by the plan authorities at the beginning of the plan period.

Under these limitations and obligations the public enterprises have to be evaluated instead of evaluating them simply as machines for earning profits. The social and external returns are not easy to find out and quantifiable on a rational manner and more often their realisation requires financial maximisation on the part of the enterprises. Three of the main external economies aimed at are employment, regional development and stimulus to agricultural, industrial or export interests.

In practice, the most popular, since it is the easiest method of measurement of performance in the investment business whether in the public or private enterprises, is estimation of return on capital invested. The measurement of performance
is believed to be a factor of profits expressed as percentage of capital employed. Efficiency is maximum when least amount of capital is employed for a given volume of sales in the enterprise.

Efficiency of investment in an enterprise must be seen from two angles (a) financial efficiency and (b) operational efficiency. In the private enterprises the performance of investment is measured only through the financial efficiency. But for an ideal evaluation of performances of an enterprise, even in the private sector Mr. Chaterji gives weightage of only 30 per cent to the internal financial performance. The rest 70 per cent is not concerned with the profit earnings of an enterprise, 35 per cent of the yard stick components are analysed from outside the enterprise which mainly measures the national and international effects of the enterprise. The weightages that should be given for a proper evaluation of a private enterprise are given in Table 4.1. If in private enterprise profit criterion has limited applicability, there is greater justification for non-profit criteria in public enterprises.

There are no standard models for the evaluation of public enterprises. In a socialist economy, no doubt objectively

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Table 4.1

WEIGHTAGES FOR THE EVALUATION OF PERFORMANCE IN AN ENTERPRISE

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<th>Criteria of performance appraisal yard stick</th>
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<td>I. INTERNAL MEASURES</td>
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<td>Balance sheet profit trend</td>
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<td>Return on Investment</td>
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<td>Other ratio trends</td>
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<td>Changes in the value of money</td>
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<td>Market position test</td>
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<td>Productivity test</td>
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<td>Value added by manufacture</td>
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<td>II. EXTERNAL MEASURES: (1)</td>
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<td>Consideration of social infrastructure</td>
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<td>Social benefits in economic terms</td>
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<td>Position of the industry in the social set up</td>
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<td>III. EXTERNAL MEASURES: (2)</td>
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The profits are taken as measures of efficiency, but the economic organisation in those economies is different from that of a democratic underdeveloped economy like India, and their experiences are less useful in the underdeveloped
countries. In a socialist economy, wages and prices are determined by the authorities as a matter of policy and the manager of an enterprise has to work under the strict directions, to produce certain commodities. Under these circumstances the rate of return can be taken as a measuring rod for the performance of the enterprises but a manager in India who has to work under an unstable economic conditions of market, wages and cost of materials, rate of return cannot be taken as the indicator of efficiency. The guidelines formed in the capitalist economies, or in the so called mixed-economies, are also of less importance for their applicability in India, since in those countries the public enterprises (or what they call it the nationalized sector) are confined mainly to the public utility sector, though there are a few exceptions. In England the public enterprises remained mainly in the utility sector with the exception of British Steel Corporation, which was nationalized and denationalized three times between the years 1951 and 1967. Therefore the British experience is not of any significant importance especially in the underdeveloped countries.\(^{12}\)

Since there are no guidelines either from socialist or developed capitalist countries for a proper evaluation of public enterprises in underdeveloped economies, the latter have to evolve their own principles of evaluation. Eventhough

different methods are suggested for evaluation of the public enterprises, as an alternative to commercial criteria, in practice in every economic system, the rate of return on capital investment is accepted as an important indicator for judging the performance of a public enterprise. In recent years, the emphasis has shifted to cost-benefit analysis for evaluation, but this method does not seem to be suitable for underdeveloped economies. Along with the difficulties cited earlier in this Chapter, two other difficulties may be mentioned here. Firstly, as a method of evaluation, it is more time consuming, costlier and unsuitable for year to year assessment for short period business decisions. Secondly, in under-developed economies, where the public enterprises are established with the objective of accelerating capital formation through public efforts, the direct earnings are of immediate concern in comparison to social costs and benefits.

For a backward economy of Orissa, an evaluation approach combining operational analysis and financial analysis has therefore greater advantage. The implications of financial and operational analysis are given below:

**Financial Analysis:** Return on capital is the most important financial indicator to judge the performance of an enterprise. In a private enterprise, from the point of view of private share-holder, the return on equity share is the important indicator. But in a public enterprise, it should
be on the return on capital employed, instead of equity shares. Because in case of public enterprises, the returns have to be viewed in terms of society as a whole instead of a few shareholders. The capital employed here is comprised of net fixed assets and net working capital of the enterprise. In a private enterprise, the net profit earnings are after the payment of interest on the borrowed funds and taxes to the government in addition to the other explicit and implicit costs. But in case of public enterprises, since most of the borrowings are from the government and taxes also go to the Government, the net profits may be taken as earnings before interests and taxes (EBIT).\textsuperscript{13}

The financial performance of an enterprise depends upon four factors: Debt to equity ratio, pricing policy, productivity and management. The debt to equity ratio and pricing policy are beyond the control of a manager of an enterprise. These two are dependent upon the policy of the government. But certainly productivity depends upon effective management. The role of the manager or the managing director in a public enterprise is very important. It is he, who gives direct guidance in operating the enterprise and with all sorts

\textsuperscript{13}The Government instead of purchasing equity shares gives loans to the public enterprises, as such interest on public debt should not be taken as cost.
of limitations in a public enterprise, it is his skill, foresight, motivation and timely decisions that make the enterprise a success or failure.

Operational Analysis: A satisfactory financial return cannot be taken always as a criterion of efficient performance of a public enterprise. The profit earnings may be due to the factors external to the enterprise, and at the same time, there may be low productivity and under-utilization of industrial capacity without achieving the objectives for which the enterprise has been established. In order to judge the efficiency in the operations of an enterprise, capital-output ratio, inventory ratio, rate of growth of output and gross and net capital formation, and utilisation of installed capacity of the enterprise are the most important indicators.

Evaluation of public enterprises of Orissa, in the following chapters, would be taken up on the basis of financial and operational results of the enterprises. While evaluating the enterprises on the basis of financial performance, pricing policies of such enterprises have not been taken into account as most of them accept the prevailing market price to transact their business. In the public utilities like electricity and transports, there is no pricing policy worth the name; whenever they face deficits, rates are revised upward to cover them. In addition to the financial and operational analysis, the causes of loss or gain of the enterprises would
be enquired into and critically examined. And on the basis of findings, remedial measures would be suggested for different enterprises and for public enterprises as a whole in the state, for improved performance in future.

SUMMARY

There are three views on the evaluation of public enterprises: commercial evaluation, non-commercial evaluation, and a mixed principle comprising the first two methods of evaluation. Principles adopted in socialist and developed western countries are not appropriate for evaluation of public enterprises in underdeveloped countries like India. A mixed method of financial and operational analysis is most suitable for underdeveloped countries. This method is adopted for evaluating public enterprises in Orissa in the succeeding chapters.