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Center-state relations in India and Brazil: Privatization of electricity and banking

Relações governo central-governos estaduais na Índia e no Brasil:Privatização elétrica e bancária

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RESUMO: Este artigo pergunta: "Quando e por que os governos estaduais se opõem (ou apoiam) programas de privatização iniciadas pelo governo central?". Nós examinamos iniciativas nacionais de privatização na década de 90 na Índia e no Brasil nas áreas de eletricidade e bancos e as diferentes respostas dos governos estaduais em cada um dos maiores centros financeiro e industrial em seus países, os estados de Maharastra e São Paulo. Possíveis explicações para a oposição dos estados às iniciativas do governo federal como nos casos do Enron e Banespa incluem: (1) compromissos ideológicos dos líderes dos estados, (2) diferenças políticas ou de coalizão política entre os governos estadual e federal e, (3) uma distribuição desigual dos custos e benefícios oriundos da privatização entre os governos estadual e federal. Este artigo sugere que a explicação (3), conflito de interesses, é a melhor explicação, embora a natureza das alianças políticas (2) e os valores políticos possam ter influência. Este artigo conclui que instâncias políticas aparentemente irreconciliáveis podem ser frequentemente melhoradas e alguma distribuição dos benefícios pode fazer o pacote mais atrativo para os líderes dos estados.
PALAVRAS-CHAVE: Privatizacão; relações intergovernamentais; federalismo; economia política.

ABSTRACT: This article asks: "When and why do state governments oppose (or support) privatization programs initiated by the central government?" We examined national privatization initiatives in the 1990s in India and Brazil in the areas of electricity and banking and the different responses from state governments in each of the largest financial and industrial centers in their countries, the states of Maharastra and São Paulo. Possible explanations for states' opposition to federal government initiatives such as Enron and Banespa include: (1) ideological commitments by state leaders, (2) political or political coalition differences between state and federal governments, and (3) an uneven distribution of costs and benefits

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from privatization between the state and federal governments. This article suggests that explanation (3), conflict of interest, is the best explanation, although the nature of political alliances (2) and political values may have an influence. This article concludes that seemingly irreconcilable political spheres can often be improved and some distribution of benefits can make the package more attractive to state leaders.
KEYWORDS: Privatization; intergovernmental relations; federalism; political economy.
JEL Classification: H77; L33.

Privatization, or the transfer of economic activities from public sector ownership to private investors, has become increasingly popular over the past decade anda half in both industrialized and developing countries.[1] Politicians at all levels, from the central government to state and municipal elected authorities, have come in the 1980s and 1990s to embrace many of the hopes of the new global pro-market ideology of competition and private entrepreneurship as the road to economic prosperity. This shift toward economic liberalization has encompassed even traditionally socialist, or at least heavily state interventionist, countries such as India, most dramatically under the leadership of Prime Minister P.V Narasimha Rao (1991-1996). Privatization and other market-oriented economic reforms also have in the 1990s come to the top of the economic agenda in other large developing countries that have been significantly more pro-capitalist and pro-foreign investment than India-yet whose actual practices over decades also have led to the development of a large state-owned productive sector. Brazil, for example, had talked a great deal about privatization since the mid 1980s, but only began to make noticeable changes under Presidents Fernando Collor de Mello (1990-1992), Itamar Franco (1993 – 1994), and now Fernando Henrique Cardoso (inaugurated 1995).

Where countries are large, federal entities, with significant ownership of public enterprises at both the central and state government levels, then the politics and economics of center-state relations often complicate the process of privatization. Furthermore, if the nature of national political competition is opening up-as in India from the mid 1980s because of the end of Congress Party hegemony or in Brazil because of redemocratization and the important changes in electoral rules in the mid l980s-privatization can become an even more complex affair. This essay uses four focused case studies to explore the question: "When and why do state governments oppose (or support) privatization programs initiated by the central government?" We examine privatization initiatives in the 1990s of the federal governments of lndia and Brazil in the fields of electricity and finance, and the varying responses of the state governments in each country's major industrial state and financial cap-

[1] The authors wish to thank the United States Agency for International Development and the Institutional Reform and the Informal Sector (IRIS) India Project for financial support, Professor Alvaro Antônio Zini for facilitating one author's trip to Brazil. and numerous interviewees in both countries. We alone bear responsibility for errors.

ital, respectively, Maharastra and São Paulo. As of this writing in June 1996, electricity privatization in the Indian state ofMaharastra had been highly contentious, but planned, incremental privatization of banking seemed likely to be less divisive. In São Paulo, by contrast, planned electricity privatization looked like it would be fairly straightforward, but banking privatization had caused a large and very public political battle between the state governor and the national government.

What explains these divergent outcomes? We hypothesize that three important reasons may lead state governments to oppose federal level initiatives to privatize: (1) economic ideas and beliefs of state level politicians, (2) partisan politics, that may cause state politicians to oppose central government initiatives simply because the two levels of government represent different political parties or coalitions, and (3) the expected distribution of benefits and costs between the central and state governments. Frustrated central government liberalizers tend to assume that state leaders who oppose their plans either are obscurantists (reason #1) or opportunists (reason #2). In fact, our case studies suggest that most politicians are pragmatists. Often a greater willingness by the center to respect the perceptions and distributions of costs and benefits as experienced by the state government (reason #3) can help to resolve these conflicts.

ln the four cases examined here we define "privatization" broadly, so that it ineludes both sale to private owners of historically state-owned enterprises and allowing new private sector entrants into sectors which previously had been legally off-limits to them. Thus, for example, "privatization" of electricity could mean either selling off a public sector firm to private owners or, for the first time, allowing a private investor to build a "greenfield" electricity plant to compete with existing public sector firms.

1. CENTER-STATE RELATIONS IN INDIA AND BRAZIL

What was the context of center-state economic relations in India and Brazil in the early l990s? First, each country had a history of activist central government intervention in both regulation and direct production. Both state governments and the private business sector often had resented the heavy hand of the center in guiding national economic development according to centrally mandated priorities.

Since its first five year plan in the early 1950s, India officially had been a socialist country.[2] Of course, since India was also a democracy, the central government could not compel the private sector to follow its plan. However, since many sectors were nationalized-including banking, power generation and distribution, most capital goods production, and production of many intermediate goods, such as steel – the central government had many levers to encourage private businesspersons to comply with central planners' preferences. In addition, India developed an extensive

[2] For overviews of the economic role of the Indian government see Encarnation (1989), Armijo (1997).

framework for licensing of private enterprise. An entrepreneur not only needed a government permit to open a new factory, but he or she also could not alter the production mix in even relatively minor ways (shifting from the production of, for example, ceiling fans to standing fans) without new government licenses. Owners also could not open new plants or close existing ones (even if they were unprofitable) without getting the agreement of several government agencies. Indians called this the "permit-license raj." Finally, not only were some sectors of production reserved to state-owned enterprises. Other entire sectors, such as the production of cotton cloth and clothes, were legally reserved for small businesses and labor-intensive production processes, as a means of guaranteeing employment.

Brazilian rhetoric and reality since the 1950s had given greater scope to private business, including multinational investors. Nonetheless, the central government's control of investment was very substantial.[3] Central government investment priorities were enforced through differential exchange rates, taxes, and credit subsidies for different kinds of production. Thus, for example, even though approximately half of the financial sector, whether measured by loans or deposits, remained privately owned (unlike in India), the ministers of finance and planning had a large influence on the patterns of national investment. The state-owned enterprise sector, by some measures, was as large as India's, although only a very few sectors (including electricity, telecornmunications, air transport, and armaments production) were declared entirely off-limits to private business. The public sector's share in gross fixed capital formation was about 34 percent in both Brazil (in 1979) and India (in 1980).[4]

Second, in India and Brazil both the nation and individual states experienced greater political competitiveness in the late 1980s and 1990s than they had in previous decades. In India, this was due to the end of the Nehru/Gandhi political dynasty's lock on national leadership, as well as the debilitation of the Congress Party which, after more four than four decades, no longer credibly could bill itself as the party of the victorious struggle for independence. As opposition parties won more state governments, they became increasingly concerned to receive what they believed to be their "fair" share of public resources, and more likely to suspect that their political opponents in New Delhi might be withholding revenues for partisan purposes. In Brazil, redemocratization in the early 1980s exposed the weaknesses of the country's fractured political party system, leading to intense competition between a plethora of mostly regionally-based, personalistic new political parties. In both national cases, one consequence of these larger political changes was to

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[3] 3 For an overview of the economic role of Brazil's government, see Malan and Bonelli (1990), or Lamounier and Bacha (1993).

[4] Figures on the public share in gross fixed capital formation (GFKF) for India are from Short (1984). Short's percentage for Brazil, 22.8%, however, is taken from Brazil 's national accounts, which include state-owned enterprise (SOE) investment with private sector investment. The estimate for Brazil cited here, therefore, comes from Trebat (1983, p.122), and includes investment by federal government "direct administration," plus large SOEs owned by the central government.

intensify the potential for politically and electorally motivated conflicts between the central government politicians and state politicians (many of whom, of course, aspired to a national stage).

2. CENTER-STATE BARGAINING OVER PRIVATIZATION IN INDIA

The context of center-state relations in India is in the process of shifting rather dramatically as Indian states, long quite tightly managed by planners in New Delhi, gain significantly greater economic decision powers at the state level. At the national level, a primary motivation for privatization appears to be the desire for achieving improvements in performance in the sectors to be liberalized. The relations between the center and the state governments, however, are influenced by both economic efficiency considerations-and by politicians' search for electoral advantage. In addition, state-level leaders, quite naturally, find themselves more absorbed by the consequences of a given development *within their own home state* than at the national level.

Privatization of electricity: Enron and the Dabhol generation plant.

From the late 1980s it had been apparent to the government of Prime Minister Rajiv Gandhi (1984-1989) that the resources at the command of the central and state governments, both from domestic savings and foreign aid, were simply not sufficient to meet the need for additional power generating capacity in the country. So, in 1986 Rajiv Gandhi opened the power sector to the Indian private sector. To the government's surprise, in the next five years it did not receive a single proposal from the private sector for the setting up of a power plant. The most important reason was the state governments' monopoly over power distribution. Paradoxically, this monopoly weakened the state governments' capacity to set profitable rates for electricity, and to recover even the subsidized payments from the consumers, especially in the agricultural sector. In 1992, when the average cost of power generation in India was Rs. 1.17 per unit, the average recovery from the agricultural sector, which consumed 26 percent of the total power generated, was a mere Rs. 0.17.[5] As a result, the loss incurred on the supply of power to agriculture was Rs. 8,384.66 ($2.67 billion) in 1993-94.[6] As the state governments showed little inclination to court disfavour with the powerful farm lobby by raising power tariffs, their capacity to pay for the power they consumed became more and more open to question. As a result, private investors did not feel that investment in power was safe.

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[5] Figures provided to the authors by the Ministry of Finance, New Delhi.

[6] Centre for Monitoring the Indian Economy (hereafter CMIE) (1995, p.14). Even this figure is a gross underestimate, because the base price of Rs. 1.18 per unit is arrived at by taking the book value of power plant equipment, and not its replacement value.

By 1992, it had become clear that the country was set to encounter a huge power crisis a few years down the line. In the late 1980s, a total of 26,090 megawatts (MW) of power generating capacity had been added to existing capacity in the country.[7] Even this was 759 MW short of the target. The next two years of structural adjustment saw the annual addition to capacity fall to 2904 MW.[8] For the eighth five-year plan (1992 – 97), the Central Electricity Authority estimated the need for an additional 38,000 MW of generating capacity. But this was scaled down to a mere 19,000 MW, as it became clear that the state simply could not raise the money.[9] As a result, the ministry of energy estimated that the peak power shortage in the country could rise from 16 to 20 percent in the early 1990s to 27 percent by 1997-98.[10]

Private investment in power projects was therefore essential. This was the sense of urgency that drove the Narasimha Rao government to send out a high-powered delegation to talk to power generating companies around the world. The end product of that initiative was that the central government signed memoranda of understanding with various foreign firms for eight large power projects. These were to be directly negotiated deals, where the accent was to be on speed. They therefore came to be known as "fast track" projects. Their secondary purpose was to break the ground for the negotiation of other private power projects in the future. The agreement negotiated with the U.S. based Enron Corporation to build a new plant at Dabhol in southern Maharastra state was the first and largest of these projects.

Enron had first proposed a 2,000 MW power plant to be built in a single phase, but the World Bank, which acted as a consultant to the Indian government, pointed out that the Western Indian grid, into which the power would have to be fed, could not take such a large input. Enron therefore agreed to implement the project in two phases of 695 megawatts MW and 1400 MW, respectively, to run on natural gas. The gas itself would be piped into Bombay (in 1996 renamed Mumbai, a name we employ henceforth), the capital of Maharastra, from the Middle East or brought in as liquefied natural gas in ships. Breaking the project up into two phases raised costs in a number of ways. Much of the infrastructure for the second phase, including port facilities and a road to link the port to the power plant could not be divided and had to be built in the first phase. In addition, a re-gasification plant for the liquefied natural gas was also included in the first phase. As a result, when the first estimates of project costs for the first phase came out-pegged at $1.3 million per MW of capacity-they caused eyebrows to be raised all over the country. This was higher than the going rate for coal-based plants being sanctioned at the time,

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[7] lbid., p.2.

[8] lbid.

[9] Centre for Monitoring the Indian Economy (1996, p.12).

[10] This figure was given by the minister for energy, Mr. N.K.P.Salve, in an oral presentation at an economic editors conference in New Delhi, September l995.

which was in the neighborhood of $ l.05 million.[11] Gas based power plants, the critics pointed out, should cost around 40 percent less than coal-based ones.[12]

There were some sound reasons for the higher capital cost in the first phase. One that got almost completely overlooked till the project was on the verge of being cancelled, was that the Dabhol estimate was for December 1997, that is, four years after the reference projects being used to criticize it. But neither Enron nor and the Maharashtra government, then under Chief Minister Sharad Pawar of the Congress Party, made any attempt to explain the reasons for the higher apparent capital cost. As a result, the impression hardened in the country that Enron had taken India for a ride. Many observers quickly assumed that this was because Enron had paid a "kickback" to the Congress Party in Maharastra. Nonetheless the contract was signed, and Enron began work on the Dabhol project in 1994.

State elections got underway in early 1995. The major challenge to the Congress Party in Maharastra came from a coalition of the Bharatiya Janata Party (BJP), a national force in Indian politics since the mid 1980s, and the Shiv Sena, a strong regional party. Their main campaign themes were, first, an appeal to rightist Hindu nationalism via an attack on India's pervasive and decades old affirmative action preferences for Muslims and the lower castes and, second, criticism of the long-ruling Congress Party for being corrupt. When the BJP-Shiv Sena coalition took office in March, its promise to cancel the Enron deal became an albatross around its neck, as the state's new leaders began to understand the seriousness of the power shortages they would have to confront. At this point, a respected news daily published a leaked version of the contract that had been negotiated by the central government but signed by the Sharad Pawar administration in Maharastra and Enron. In an analysis of the agreement, Kirit Parikh, a well-known economist, claimed, on the basis of a comparison with an almost identical power plant set up in Hong Kong, that the project cost was 15 to 20 percent too high.[13] Parikh also pointed out that the terms of the power purchase agreement were unnecessarily loaded against the Maharashtra government. More specifically, since the Maharashtra State Electricity Board was committed to buying 86 percent of the power generated by the plant, to fulfill this commitment it would have to give preference to Enron during off-peak hours over its own power plants, which were lower cost producers. Both these observations turned out to be only partly correct. But they were sufficient to force the government to announce that it would "review" the Enron project, before deciding whether it should be allowed to continue.

International reactions were predictably negative. The first was a statement from the US Department of Energy that it viewed with "deep concern" the attempts

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[11] This was the average rate used for the calculations of the cost of thermal power plants in the Eighth Plan estimates. Coal-based power projects cleared by the Central Electricity Authority in l 993 cost Rs. 3.25 crores per MW ($1.03 million). See CMIE (1995).

[12] CMIE (1995, p. 24).

[13] *Times of India* (April 1, 1995).

to reopen the Enron deal after it had been finalized. The statement expressed the fear that this would affect other projects that were also in the pipeline.[14] The American decision aroused the latent xenophobia of a large section of the Indian middle class and was therefore received with undisguised glee by the BJP. Western governments learned their lesson from this and decided virtually unanimously to refrain from any public statements. They also advised large corporations from making public statements. But the Japanese suffered from no such inhibitions. The Japanese Consul-General in Bombay minced no words and said bluntly that the decision would impede future investment in India, because it showed that, “State governments are unreliable.”[15]

The central government, led by Congress Party Prime Minister P.V Narasimha Rao in New Delhi, had embarked upon a project of significant economic liberalization in 1991, in which new foreign investment flows figured prominently; Rao’s economic team therefore was quite worried. The center was also fully aware that if the power crisis in Maharashtra became more acute not only it but also the four other large states linked together in the western electricity grid would be severely affected. In fact by July 1995, power breakdowns, which had been utterly unknown in Mumbai, were occurring every three months.[16] The Rao government therefore had every conceivable reason for stepping in and preventing the cancellation of the project. Within the cabinet in New Delhi, the energy minister, N.K.P. Salve, argued strongly in favor of stepping in and taking over the project. He was supported by the former chief minister of Maharashtra who had signed the deal, Sharad Pawar of the Congress Party. But they were overruled by other colleagues and the prime minister, who pointed out that would play straight into the BJP’s hands, and enable it to reinforce the impression, already strong in the public, that the Congress Party was trying to hide its misdeeds.[17] The prime minister, therefore, wisely decided to stay out of this fight, at least in public.

Fissures already were appearing within the BJP-Shiv Sena coalition. The BJP mainly was interested in discrediting the Congress Party with charges of corruption, paving the way for it to come to power at the national level. But the Shiv Sena (and some in the Maharastra BJP) wanted to prove to the electorate that they were the party of efficient, honest government in Maharastra state. Shiv Sena head Bal Thackery, the power behind the throne in the new government, and the new Maharastra Chief Minister, Manohar Joshi, therefore tried to keep their criticisms narrowly focused on the issue of the allegedly high cost of the project. However,

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[14] Reported in the *New York Times* and *International Herald Tribune,* as well as virtually all Indian newspapers in early May 1995

[15] *Times of India* (August 29, 1995).

[16] ln 1995 there were breakdowns on April 19, in mid-July, and on November 16. In other words, three major power failures occurred even as the Enron project was being cancelled.

[17] Off the record discussions with a senior member of the central government cabinet, Energy minister Salve later made several strong statements in parliament and to the press.

the national BJP and their allies in the Indian religious right kept public interest and press coverage of the corruption issue high. For example, an enterprising researcher discovered that Linda Powers, an Enron representative testifying before the U.S. Congress, had stated that Enron had spent $20 million in educating Indian officials about the details of world class contract negotiations and the legal frameworks necessary to attract global capital, a novelty in this country that for decades had been quite closed to foreign investment.[18] In fact, Powers was trying to convince the U.S. Congress to allocate more funds for overseas technical assistance, so that private multinationals wouldn't have to be spending their own money. Taken out of context, however, the $20 million spent on "education" sounded to the Indian public precisely like an admission by Enron that it had paid bribes to the Sharad Pawar government.[19]

After much internal bickering within the new Maharastra government, along with quiet discussions with Enron, a commitment for renegotiation of the project was made in early November 1995. Not incidentally, an opinion poll commissioned by the Times of India in nine Indian cities had, in the meantime, shown that even in Mumbai, which had been exposed most to the BJP and Shiv Sena's pre-election propaganda, 55 percent of the respondents wanted the project to be saved, that is, renegotiated. The Shiv Sena's uneasiness grew as it realised that in Dabhol itself the loss of jobs was causing a backlash against the project's cancellation.[20] Two weeks after constitution of the new negotiating committee, there was a new deal, in most important respects one not terribly different from its predecessor, but one which enabled both the Joshi administration in Maharastra and the Enron Corporation to claim that they each had bettered the terms for their side!

What were the real issues in this conflict that made the front pages of Indian newspapers almost daily during more than four months? At first it seemed, at least from the perspective of central government technocrats and, of course, worried foreign investors, as though the BJP-Shiv Sena coalition had allowed its fanatic fringe of ideological zealots to take control of public policymaking. There also was the issue of the national ambitions of the Bharatiya Janata Party, which would be served by embarrassing the Congress Party, even at the cost of leaving Maharastra without sufficient electricity. If either of these explanations is most important, however, it is hard to credit what seems like the extraordinary passivity of leading Maharastrian governing coalition members, especially Joshi and Thackery, in letting the dispute drag on for months before being settled.

The true problems with the original "fast track" contract, essentially negotiated

[18] Testimony given by Linda Powers before the Committee on Appropriations, Subcommitee on Foreign Operations, of the U.S. House of Representatives. January 31, 1995. This evidence was given three months before the Dabhol power plant ran into trouble.

[19] See, for example, the letter to the managing director, Dabhol Power Company, from Ravindra Mahajan of the SJM, dated July 14, 1995. Copy provided by the Dabhol Power Company.

[20] *India Business Intelligence* (August 30, 1995).

between New Delhi bureaucrats and Enron, were more mundane, and had to do with the distribution of both economic and political costs and benefits from the project between the central government and the new Maharastrian incumbents. The core of the many complaints from the Maharastrian BJP-Shiv Sena coalition about costs was that, in its anxiety to attract foreign investment in power, the central government had announced early in 1992 that it would guarantee a 16 percent return on the equity capital invested in power projects. As several economists quickly pointed out, this gave the investors every incentive to pad their capital costs as much as they could. The dissatisfaction rose another notch when the states realised that the basis of calculating the returns was so generous that any halfway efficient plant could earn far higher returns. In particular the basis for calculation of the power tariff was the capital cost incurred when the plant was operating at only 68.5 percent of capacity. However, all private sector projects were confident of running at 80 and even 90 percent of capacity. This would raise their returns to 25 percent and even more. The chairman of one Indian private company which made a bid to enter the power generation field reported that the low plant load factor ensured that his company would earn up to a 33 percent return on its equity capital.[21] Nearly all of the state government's complaints stemmed from the fact that while the decision on returns was taken exclusively by the center, the state electricity boards, and therefore eventually the state governments, would have to do the paying.

In fact, the essentially non-partisan and non-ideological core of this legitimate complaint on the part of the state government was underscored by the fact that the new opposition-led state government in Maharastra was not the only state government to complain. In the state of Orissa, the newly elected government also wanted to renegotiate their "fast track" power plant, the Ib valley project, which had been negotiated during the 1990s by the then Janata Dal Party state government in collaboration with the Congress Party central government of Prime Minister Rao. The newly elected chief minister, who happened to be from the Congress Party, made exactly similar allegations to those made by the Shiv Sena-BJP government in Maharashtra, and demanded a renegotiation of the project to bring its cost down. AES, the foreign investor, agreed and recast the project, increasing its size in the process. The solution for the renegotiated Enron project in Maharastra also included increasing the overall size of the project and implementing both phases jointly, thus significantly lowering its per unit cost. Moreover, Enron agreed to sell 30 percent of its equity (an increase of 20 percent over the original 10 percent) to the state government, thus sharing what were expected to be ample profits with it.

A second "real" issue was that the state government didn't want to be burdened with implementing policies that could be expected to be politically unpopular with one of its key constituencies: farmers. A publicly trumpeted concern of the Joshi

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[21] Conversation with K.L.Chugh, Chairman of TTC in November 1994. TTC was contemplating setting up a 300 MW coal based plant at the time. Differences within the company eventually made it shelve its plans.

government had been worried over possible environmental damage that might be caused by the project. Interviews conducted by one of this paper's authors in Mumbai suggested that the genuinely sensitive issue camouflaged as environmental concern had to do with purchases, from myriads of small farmers, of land needed for the project. By the time the project was cancelled, a group of farmers already had gone to court to sue the state government over the amount of compensation they had been offered. The state government believed that, if Enron itself bought the land (rather than having the Maharastra government act as intermediary), then farmers would be more likely to negotiate a fair price, since they could not threaten to withdraw their votes from the multinational. However, a 1970 law passed by the central government intended to protect small farmers had forbidden the sale of agricultural land for non-agricultural uses above a token amount-except to the state government. That this too was a concern not limited to Maharashtra became apparent when the newly elected chief minister of the state of Karnataka, Mr. Deve Gowda, passed an amendment to the Karnataka Land Reform Act raising the ceiling on the sale of agricultural land for non-agricultural purposes from 5 to 100 hectares. In doing so he simply ignored the objections of the central government that this violated the 1970 Land Reform Model Act and would require the President of India's assent to become law. His justification, given to the press, was that with a raging power famine in the state, twelve power projects awaiting clearance, and a 300-kilometer superhighway to build, he simply could not wait for the center's assent.[22] Once Deve Gowda had broken the ice, it became easier for the Maharastra government to avoid the political onus of having to negotiate with farmers by also simply deciding to ignore the 1970 law.

Liberalization of banking and finance: a bone of contention to be?

Finance in India primarily has been a national, rather than a state-level, arena of government activity. Nonetheless, major changes in the financial sector have powerful effects in Maharastra, and especially in Mumbai, because financial activity is heavily concentrated there. Any political conflicts that erupt over privatization of banks and financial institutions are certain to be extremely important in Maharastra. Through mid 1996 there had been significant, although incremental, progress in financial liberalization, with virtually all initiatives originating with the central government in New Delhi. Some of these regulatory changes had been controversial, as had some of the responses of financial markets to such changes. Interest groups with a strong presence in Mumbai, including stockbrokers, unionized bank clerks, and unions of financial institution officers at the Industrial Development Bank of India (IDBI) and the Reserve Bank of India (RBI) expressed clear

[22] Perhaps not coincidentally, Deve Gowda became India 's prime minister as the leader of a coalition of leftist parties in June 1996, after the Congress Party lost April's general parliamentary election and the BJP, which had emerged as the single largest party, proved unable to attract any coalition partners.

policy preferences on various aspects of financial liberalization, and had considerable success in enlisting media support. Nonetheless, through mid 1996, the state government of Maharastra, both under Congress Party Chief Minister Sharad Pawar in the early 1990s and under BJP-Shiv Sena Chief Minister Joshi in 1995 and 1996, kept a very low profile on the issue of financial reforms.

This section argues that two circumstances have kept banking and financial regulatory policies off the agenda of center-state conflicts thus far. First, when a major financial scandal roiled Mumbai and the country as a whole in 1992-1993, the state government was of the same political party as the central government, whose inadequate and anachronistic oversight procedures were widely blamed for permitting the misdeeds that caused the financial market crash and scandal. Second, the process of incremental financial reform clearly advantages some social groups, particularly internationally competitive private industry and new financial entrepreneurs, while disadvantaging others, especially unionized employees of public sector banks and financial institutions. Since the effects in Maharastra of gradual liberalization are bound to antagonize some politically important groups while pleasing others, there are no clear benefits to local political parties, even if they are in opposition to the central government, that might come from politicizing the issues. If the issues of financial liberalization become more politicized, then politicians may be forced to take sides.

Moreover, since most of the Maharastrian and Mumbai business communities, and most professional economists, expect gradual financial deregulation to stimulate economic growth in both the state as a whole and its capital city, it is in the interest of politicians to paint the issue as one of technical, uninteresting, and apolitical "modernization," rather than as a zero-sum game between winners and losers. However, should centrally directed financial reform begin to move in a direction that promises to drain resources or wealth from Maharastra in order to redistribute them elsewhere in India, then one might expect center-state conflicts over banking privatization to increase. In fact, though, market-oriented economic reform generally gives advantages to the strongest competitors. Thus, Maharastra state, already India's financial center, is likely to prosper from it.

In India, virtually all of the financial reforms proposed thus far involve deregulation (for example, of interest rates, which is not privatization per se), lowering barriers to entry by private firms into sectors previously reserved for public sector banks (privatization of the sector), and/or sales of minority shares in 100 percent government owned banks (partial privatization of the firm). The remainder of this section briefly reviews the reform process to date.

Through the late 1980s the overwhelmingly majority of India's entire financial sector, from commercial banking to long-term industrial credit to the insurance industry, was owned and run by the central government.[23] After years of prodding

[23] The major exceptions were the stock exchanges and a very few commercial banks, including local branches of foreign banks, which were private, and small state-level financial and development

and scolding by scholars and some members of the business community, the new government of Prime Minister P.V Narasimha Rao decided to get serious about banking reform by setting up an expert commission, composed primarily of the heads of India's major banks and financial institutions, all in the public sector, to issue recommendations.[24] Its principal recommendations included, first, "privatization" of the banking sector by liberalizing entry and, second, deregulation, particularly in the areas of interest rate controls, high requirements for banks to invest in low-yielding government securities, and high requirements for banks to make loans, frequently subsidized, to targeted groups such as farmers or small businesses ("priority sector credit"). In addition, the two private sector members of the Narasimham Committee, both well-known academic economists with private consulting experience, strongly urged abolition of the banking department of the ministry of finance, which long had exercised centralized control over staff recruitment, remuneration, and other personnel policies.

The short-term response to the Narasimham Committee report was a nationwide strike in early 1992, involving not only clerks in the nationalized commercial banks, but also by the bank officers' (middle management) unions in both the country's premiere development bank, the Industrial Development Bank of India (IDBI), and in the central bank, the Reserve Bank of India (RBI). Their fears were of job losses due to both increased competition and computerization. This strike action alone would not have deterred the Rao government from pushing ahead with deregulation. After all, many of the biggest public sector commercial banks (though not the State Bank of India, SBI, the grandaddy of them all were bankrupt, although the general public was blissfully unaware of this fact.[25]

Then, in April 1992 India's largest ever financial scandal exploded. The illegal trades and short-term liquidity problems of a single brash young investor caused investors and financial institutions, including several leading public sector banks, to lose $1.2 billion. The huge public outcry, in which commentator after commentator linked financial deregulation to illicit profiteering, stopped banking reform in its tracks for a year, and limited it to slow, technical, and non-controversial reforms for several years thereafter.[26] In this case, the political explosion was national, as Congress Party Prime Minister Rao was attacked in parliament both from the BJP on the political right (for inadequate regulatory oversight and the presumed "corruption" of public sector banks taking disallowed types of risks with depositors'

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corporations run by state governments but which, in any case, received most of their funds (which they on-loaned to smaller firms) from nationally constituted institutions.

[24] The chairperson of the expert commission was former governor of the Reserve Bank of India, M. Narasimham, who was no relation to the prime minister.

[25] In late 1991, for example, non-performing assets comprised about 40 percent of the loan portfolios of the nationalized commercial banks (that is, all public sector commercial banks except the SBI). See Srinivasa-Raghavan (1995, p. 106).

[26] On the stock and banking scam, see Kabra (1992); Murthy (1995).

funds) and the National Front-Left Front on the left (for selling out to finance capital, national and especially foreign).

After that, the financial reformers in the central government trod carefully. Some militant unionists in the IDBI, who had feared job losses resulting from competition from private sector investment banks ("merchant banks") were mollified when New Delhi awarded the IDBI the job of setting up India's first nationwide, computerized stock trading system, the National Stock Exchange (NSE). In 1991 the central government had decided to cease budget subsidies to the IDBI, while for the first time allowing the institution to float corporate debt instruments in local financial markets; by early 1996 the IDBI was meeting as much as 40 percent of its investment needs through market borrowing. In July 1995, the IDBI sold its first equity to the public, in India's largest ever initial public offering, worth Rs. 21.8 billion, or about US$66 billion.[27] The state government chose to remain on the sidelines for all of these issues, despite the fact that the IDBI headquarters and overwhelming majority of its employees were located in Mumbai.

In 1994 the Reserve Bank of India (the nation's central bank and the principal regulatory authority) decided to license new private banks. This change, too, was implemented in a very cautious manner. Previously, the only private banks were foreign banks whose agencies predated the 1969 bank nationalization decreed by Prime Minister Indira Gandhi, and those private banks too small to have qualified for nationalization then or in two subsequent waves in the early 1980s. Of around a hundred applications received, the RBI by end 1995 had agreed to extend only five or six licenses, of which three to public sector financial institutions-the IDBI, the Industrial Credit and Investment Corporation of India (ICICI), and the joint public-private Housing Development Finance Corporation of India (HDFC).[28]

The more politically challenging reform tasks have not yet been tackled including, for example, abolishing the banking department of the ministry of finance and instead giving control of hiring, promotion, and other personnel matters to bank presidents and their senior associates themselves. The following predictions can be made, however. If bank and other financial institution unions feel their jobs or perquisites threatened by liberalization and privatization, they will not be shy about taking to the streets, linking their particular troubles with other groups' related worries about virtually any aspect of economic liberalization (whether logically connected to bank privatization or not), and forging alliances with vote-seeking politicians and political parties. Within Maharastra, the Shiv Sena/BJP government will continue to be split, with the Shiv Sena, on the whole, more concerned with the Maharastrian economy (within which the private financial sector is a very important player, particularly in Mumbai) while the Bharatiya Janata Party, an aspirant to national power, might find it more convenient to take up the unions' cause-as long as the BJP is not currently governing at the center, of course! While

[27] "India 's development bank: Seeking direction," *The Economist* (March 2, 1996, p. 69).

[28] R. C. Murthy interview (Bombay, December 29, 1995).

financial sector privatization and liberalization thus far has proceeded very quietly and without great fanfare or political opposition, the future potential for the arena to become politicized remains very real, particularly so long as the center and Maharastra are governed by politicians of different parties. In April 1996 Narasimha Rao's Congress Party lost the national election. In June, after an abortive attempt by the BJP to form a national government, the center-left coalition of the National Front-Left Front (now renamed the United Front) formed a new national government under Prime Minister Deve Gowda, the pro-liberalization former chief minister of Karnataka.

3. CENTER-STATE BARGAINING OVER PRIVATIZATION IN BRAZIL

In Brazil, in contrast to India, most state enterprises in infrastructure sectors were considered to have been reasonably efficient through the 1970s.[29] However, central government finances deteriorated rapidly from about 1979, and were exacerbated by the Latin American debt crisis, which hit Brazil in late 1982.[30] Thereafter, public sector investment spending dropped off sharply. The gradual return to democracy-which officially occurred in 1985 but may with equal reason be dated from the free elections for state governors and big city mayors in 1982-meant much larger expenditures at the state level as well, as incumbents appointed by the military spent large sums of public and quasi-public monies on their election campaigns. Finally, Brazil's new democratic constitution of 1988 transferred a large chunk of federally collected tax revenues back to the state level (from whence they had been grabbed during the military regime installed in 1964), but without also transferring spending responsibilities back to state governors. For all of these reasons, the overriding impulse to rapid privatization at the federal level in Brazil has been fiscal, with considerations of improved efficiency, access to modem technology, and so on coming only second.

In contrast to India, in Brazil financial sector liberalization and privatization has progressed further than electricity privatization, also planned but thus far for the most part yet to be implemented. The center-state political conflicts over bank privatization thus are more acute, while those that later may appear in the electricity sector thus far remain latent.

Privatization of public sector banks in Brazil: The Banespa saga

Generalizing very broadly, the division of labor that evolved in Brazil 's financial sector after the far-reaching liberalizing financial reforms of the newly installed military regime in 1964-1967 was that the more lucrative corners of the financial mar-

[29] See Trebat (1983), Afonso and Dain (1987).

[30] See Fishlow (1989)

kets were left to the private financial sector, while public sector banks supplied those financial services that private banks shunned-particularly subsidized agricultural and residential housing credit, and long-term financing of all types. The country's largest commercial bank was the federally-owned Banco do Brasil, whose background and current activities make it quite similar to the State Bank of India. (Both institutions, for example, date from the nineteenth century and once served as both commercial banks and national monetary authorities.) State governments also had state-level public commercial banks, which often doubled as industrial and agricultural development banks. Several of the bigger states had more than one. Banespa, the Banco do Estado de São Paulo (State Bank of São Paulo) consistently has been one of Brazil 's top ten banks. If one looks only at commercial, investment (a.k.a. merchant), and development banks, the public and private sector each have approximately half the financial sector, whether measured by loans, assets, or net worth. If the state savings bank system (which accepts term deposits and funds mainly residential mortgage and construction lending, as well as municipal water and sewerage projects) is included, the public banks have a slightly larger share of deposits.

During the 1970s and 1980s Brazil's good economic growth, very high inflation, and the unique peculiarities of its financial legislation allowed commercial banks to expand greatly.[31] By 1989, for example, financial services, by one measure, accounted for an astonishing 26 percent of the gross national product. In 1994, 18 percent of banks' earnings were due simply to their ability to profit from the inflation that harmed the rest of society. The end in mid 1994 to what by the 1990s had become four-digit annual inflation was essential for Brazil 's economy-but very bad news for most banks and financial institutions. By 1995, their share of GDP had plummeted to only 6 percent, and inflationary earnings contributed less than 1 percent to their gross profits.[32] Not surprisingly, many Brazilian banks found themselves in serious trouble. Even the venerable Banco do Brasil, which in 1985 held 24 percent of all bank deposits in Brazil[33], announced a hole of over $4 billion in early 1996, requiring the BC to come up with a new cash infusion of $8 billion. Not including the federal aid to the Banco do Brasil, by one estimate the central government had spent about $10 billion on rescues of five private sector banks through March 1996, approximately equal to the $9.5 billion received from all privatizations up to that point![34]

The problems of the public sector banks owned by individual state governments, however, were of a different order. Although most of them, excepting São Paulo's Banespa, were fairly small, their poor financial health went well beyond unwise dependence on inflationary earnings. As noted, the return of democracy and

[31] See Zini (1992); Armijo (1996a).

[32] "De olho no porquinho," *Veja* (November 15, 1995, pp. 32-37).

[33] Baer (1995, p. 256).

[34] Rosenblatt (l996, p. 28).

competitive elections in the 1980s had encouraged governors in virtually every state and from every political party to lean on them to give loans for political purposes, either directly to the state government or in the form of unscrutinized, unsecured, low-interest loans to large campaign donors. The ill health, for example, of Banerj, the state bank of Rio de Janeiro, one of Brazil's largest and most important states, had been an open secret in financial circles since the early 1980s. ln the early 1990s, under Presidents Collor and Franco, two or three state-level public banks owned by small, weak states such as tiny Rio Grande do Norte had been "intervened" by the Banco Central (BC) and subsequently closed, over the loud but ineffectual protests of their comparatively powerless governors and congressional delegations. A related problem was the growing indebtedness of many state treasuries to the federal government, in some cases because of de facto bailouts of state-level banks by the BC, and in other cases due to other debts. By mid 1991 the total debt of state and municipal governments to the center was about $57 billion, of which the three wealthy southeastern states of São Paulo, Minas Gerais, and Rio de Janeiro owed 53 percent.[35] Given the federal government's own debt problems, this situation by the 1990s had become unsustainable.

On July 1, 1994, then finance minister Fernando Henrique Cardoso inaugurated Brazil's seventh major stabilization program since the return to civilian, democratic national government in early 1985. Dubbed the "Plano Real," this stabilization program, like many of its predecessors, involved a new currency, de-indexation, a temporary wage and price freeze, and solemn promises of cuts to the federal government budget. It differed from the failed previous plans in that it used a "currency anchor" to the U.S. dollar that supposedly would force Brazil to adjust as the domestic tradables sector would have to cut prices to compete with now fairly free imported goods. The Plano Real resembled Argentina's successful, though draconian, "currency board" system, then in place for almost three years, and, despite some opt out clauses in Brazil 's version, was rather similar to the pre-World War I gold standard. On the strength of the Plano Real, Cardoso was elected president in October 1994, running at the head of a broad and heterogeneous coalition. The president's own small reform party, the Partido da Social Democracia Brasileira (PSDB), also elected several governors on Cardoso's coattails, including Marcelo Alencar in Rio de Janeiro and Mário Covas in São Paulo, all of whom were to take office on January 1, 1995.

On December 30, 1994 governors-elect Alencar and Covas received phone calls from Pedro Malan, then president of the Banco Central but tapped as Cardosos incoming finance minister, informing them that the new administration would announce BC intervention on the following day of both Banerj and Banespa.[36]

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[35] "Estados que mais devem são os do Sudeste," *Jornal do Brasil* (September 3, l99l).

[36] The information in the next several paragraphs, except where noted, comes from several interviews done by one of the authors in São Paulo in late May 1996. Interviewees included three well-known economic journalists, a senior economic policymaker and his top aide in the São Paulo state government,

Malan explained that one reason that the intervention-which included an indefinite freeze of the deposits of all bank stockholders and direct day to day oversight by the BC-was scheduled for December 31 was that this would enable the new governors to distance themselves from the federal government's decision, should this prove politically convenient. The subsequent reactions of the two PSDB governors hardly could have been more different.

Within his first month in office, Rio governor Marcelo Alencar announced his full support for the process of recapitalization and then privatization of Banerj, and contracted with the private financial consulting firm, Bonzano, Simonsen, to implement the project. He also announced planned privatization often other state-level public firms owned by the Rio de Janeiro government. Soon thereafter he convinced the state legislative assembly to grant him the blanket authority to privatize whatever public enterprises his administration saw fit to sell. By these moves Alencar staked out positions very different from his two predecessors, both members of the PDT (Partido Democrático Trabalhista, or Democratic Workers' Party) party headed by perennial presidential candidate, veteran campaigner against the military, and Rio governor from 1982-1988, Leonel Brizola. Brizola, a longtime leftist, was a strong opponent of selling "the nation's patrimony." For example, during the Collor administration, Brizola had organized and personally led a demonstration in front of the Rio de Janeiro stock exchange on the day of the public auction for the controlling stake in what was then Brazil 's largest privatization, the sale of the federal steel mill and conglomerate, Usiminas, which ultimately raised $1.5 billion. Despite the strength of the PDT and other left parties in the city and state of Rio, not to mention his own membership in the moderately left PSDB, Alencar bit the bullet and decided to take the lead on privatization. One benefit for Alencar was that the BC agreed to advance to the Rio government the expected proceeds for the privatization of Banerj (planned for 1997) and other enterprises to be sold, thus enabling Rio to pay off its debt to Brasília.

Mario Covas in São Paulo, on the other hand, despite a proforma declaration of total support for President Cardoso 's economic and political agenda, immediately went on the offensive, vowing that Banespa would never be privatized. The battle had been joined. In fact, Covas' views were in complete agreement with those of his two predecessors, Governors Orestes Quércia (1982-1988) and Luís Antônio Fleury (1988-1994), both of the PMDB (Brazilian Democratic Movement Party), since 1985 the largest single party in Brazil. The PMDB had supplied the president in 1985-1990, José Sarney, but had been only one of many very loosely allied parties, that sometimes voted with the government, but other times did not, during the presidencies of Fernando Collor and Itamar Franco in the early 1990s.

During all of 1995 Covas fought with President Cardoso, and especially finance minister Malan, over Banespa, both publicly and behind the scenes. The

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a former director of both the Banco Central and Banco do Brasil now employed as a private financial consultant, and a federal minister in the Cardoso government.

Cardoso administration, hoping for a political settlement, refrained from using its legal authority to go one step further than "intervention" and declare Banespa federal property, forfeited because it was "technically bankrupt" with a debt to the Banco Central of $9.7 billion when Covas took office, but had risen to $15 billion by December 1995, due mainly to very high interest rates resulting from the Plano Real. In the final month of 1995, a provisional solution was announced. The federal senate agreed to extend a $7.5 billion twenty-year loan to São Paulo; the other $7.5 billion would be paid off by the transfer to the federal government of São Paulo's three major airports plus its state-owned railroad, Fepasa, all of which later would be privatized and the proceeds kept by the national treasury. In return, Banespa would not be privatized, but rather would be returned, recapitalized, to the government of São Paulo.

Nonetheless, the conflict dragged on, despite the supposed deal. While various ostensibly minor points were being negotiated, Banespa's debt to the BC, being carried at market rates of interest, mounted from $15 billion to $18 billion. In April 1996 Alencar and Covas, along with other PSDB heavyweights from around the country, appeared with the president in Brasília, announcing that henceforth they would be more supportive of the president, who had recently met several defeats **in** getting congress to pass the necessary enabling legislation for bis overall economic reform and liberalization program. In early May the state attorney general of São Paulo announced he was freezing the assets of the two former governors, Quercia and Fleury, along with 107 former Banespa administrators, pending an investigation into Banespa's losses between 1989 and 1994, widely believed to have resulted from politicized lending practices during the 1980s[37]. In May Covas went public with a complaint that the BC was discriminating against Banespa which, in his view, had received less favorable treatment than the private banks Econômico and Nacional.[38] Covas was particularly incensed over the additional $3 billion in interest obligations that had accumulated between December 1995 and May 1996. Meanwhile, the finance minister and others in Brasília felt that they could not be flexible – or perhaps even reasonable? – with the paulistas for fear of setting a precedent that other states with bankrupt financial institutions would insist on copying. As of this writing the exact details of the settlement had yet to be worked out: what was certain was that Banespa would not be privatized.

Although Banespa was not sold, the central government did not necessarily lose out. Unlike the Indian situation, increasing efficiency in Brazil's financial sector was not the central government's main goal. The years of high and highly variable inflation had made Brazilian banks among the most agile in the world. The major

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[37] See "Quércia's assets frozen," *Gazeta Mercantil International* (May 6, 1996, p. 3). Quércia and Fleury, naturally, claimed they were victims of a political vendetta. All of our informants, however, insisted that the attorney general was not acting under Covas' orders and, furthermore, that the investigation was fully justified.

[38] Ana Cristina Rosa, "Covas cobra solução do Banco Central," *Estado de São Paulo* (May 22, 1996).

impetus for privatization, from Brasília's viewpoint, was to get the states to pay off their debts to the central government – and, of course, to make it institutionally more difficult for them to rack up further debt. If the debt of São Paulo to the center could be taken care of, and better yet if the state government could be credibly warned off of using Banespa for politically-motivated lending in the future, then a substantial portion of President Cardoso's goals would have been obtained.

Still, an intriguing puzzle remains. What explains the different behavior of the two PSDB governors, Alencar of Rio de Janeiro and Covas of São Paulo? Among those knowledgeable persons interviewed for this project in late May 1996 opinions as to Covas' motivations were divided. One prominent economic journalist with extensive contacts with Covas campaign and administration was of the opinion that the rift was largely personal. He suggested that Covas, himself a senior PSDB politician, had been offended that he was not consulted in advance about the Cardoso team 's plans, but only informed when the decision already had been taken. Interviewees generally agreed that Covas long had been a believer in a strong state presence in production and infrastructure. However, this description applied with equal force to a great many of Brazil 's politicians, including President Cardoso.

The following additional considerations, which did not apply in Rio de Janeiro, seem to explain Covas' determined opposition to privatization, despite his close political ties to President Cardoso. First, the state of São Paulo, only out of twenty-six states plus the federal district, alone was responsible for 35 percent of Brazil's gross national product. São Paulo was not to be trifled with-even by a president who himself was a paulista. In addition, although the federal government had the legal right to simply take over Banespa and privatize it whether or not the state government assented, Covas possessed two specific bargaining chips not enjoyed by Alencar. Banespa's debt of $18 billion to the Banco Central was many times that of Banerj. Were the Cardoso administration to have carried out its ful1 legal mandate of summarily assuming ownership of Banespa, the state government would have been justified in declaring the entire debt quits, to the fatal disadvantage of the federal government. Furthermore, São Paulo had two state banks, Banespa and A Nossa Caixa, the state-level savings bank. Had the federal government legally snatched Banespa, the state government immediately could have transferred its lucrative banking business to its other state-level public bank, A Nossa Caixa, thus certainly provoking the precipitous and irredeemible crash of Banespa. As one informant put it, both the federal and state governments thus possessed "an atomic bomb," creating a stalemate and forcing both sides to bargain.

Moreover, the debt position of São Paulo state was perhaps even more desperate than that of the federal government, despite the state's high growth and good reputation in international markets. As of May 1995 the state's total domestic and foreign debt summed to $68 billion![39] This fact of course might explain Covas' hardball bargaining over the distribution of costs with the BC, but hardly his re-

[39] Figure from interview with senior economic journalist CM (May 22, 1996).

fusal to privatize Banespa. For that, we must understand the distribution of political benefits and costs as they looked from the viewpoint of the state government. Unlike Banerj, Banespa had an excellent reputation in its state, not only with small depositors, but also with the business and farming communities, and with politicians throughout the state, particularly in the hinterlands, which were less well served by the big private banks whose business concentrated in São Paulo City. Covas, like his predecessors Fleury and Quércia, must have realized that the politician who sold Banespa might never be elected to anything in São Paulo again. Furthermore, the consensus among policy-influential paulistas, even those generally sympathetic to Cardoso's reform efforts, was that São Paulo needed a commercial and development bank. In the words of a senior policymaker in the state government, "Once Banespa has been cleaned up financially, what's the point of selling it? After all, it wasn't Mário Covas who created Banespa's problem; it was Quércia and Fleury."

From the viewpoint of the federal government, of course, the crucial points clearly were, first, that if it let Banespa off the hook, many other states would demand equally favorable treatment, and second, that there was no mechanism to prevent future Quércias or Fleurys from using the bank to make huge quantities of questionable loans. Then, in the name of the national interest (not to mention maintaining a winning legislative coalition in congress), the Banco Central, under orders from the president, would be obliged to rescue the bank again. There was, however, one additional factor that helped tip the equation in Covas' favor: given Banespa's large size and the special expectations its customers and the state and municipal governments had of it – could a buyer be found? Surely it would be foolhardy to try to sell the bank so long as the state government opposed that route. On most points, therefore, the national government was obliged to yield. Governor Covas had succeeded in preventing the sale of Banespa.

President Cardoso and finance minister Malan clearly had hoped that the impending sale of a giant like Banespa would send a positive signal to international investors, but that plan had fallen through. The federal government needed São Paulo's help on too many other urgent matters – notably a package of liberalizing economic reforms, from removing legal barriers to foreign direct investment to social security reform – some of which required a two-thirds majority in order to push through a constitutional amendment. Because the Cardoso administration had not managed to convince Covas that privatizing Banespa would be in São Paulo's interest, as opposed to the interests of the country as a whole, the president's suasion had fallen on deaf ears.

Electricity privatization in Brazil: Peaceful thus far

In many ways the status of privatization in Brazil's power sector, as of mid 1996, resembled privatization of India's financial sector: in both cases, the central government had moved ahead with a national plan that would deeply affect conditions in the country's major financial and industrial state -but, thus far, progress had been only incremental. Furthermore, although privatization in the sector could be expected to have important repercussions for the state, thus far the state government had not chosen to engage in public battle with the central government over the terms and conditions of privatization. Whatever hard political battles actually might result were still ahead. In another way, however, electricity privatization in Brazil resembled bank privatization in Brazil: in both cases, and in sharp contrast to India, the major "public sector" firms, whether majority owned by the federal or state governments, were actually joint public-private ventures, with controlling interest (usually but not always 51 percent) maintained by the government but large numbers of minority shareholders, or even large blocs of shares, held by multinational corporations. (A Japanese consortium, for example, long had held about 20 percent of the federal steel company, Usiminas, privatized in 1991.) Privatization of the power sector would not mean simply allowing private firms, including multinationals, to enter; in Brazil, it would mean outright sale of the controlling interest. Furthermore, and unlike earlier privatizations in Brazil, the buyers for power firms, or of the concessions to construct new plants, were likely to be multinational corporations, not local Brazilian companies.

Before the 1950s, virtually all of Brazil 's electric power sector was in private, and overwhelmingly foreign, hands. From the 1950s, the Brazilian government gradually bought out the foreign investors. Through the mid 1980s, Brazil's electricity sector expanded rapidly and was considered by most observers to be generally efficient. However, due to the debt crisis and other macroeconomic problems, new public sector investment virtually had ceased from the early 1980s. By the later years of the decade, brown-outs and other indications of under-investment had begun to annoy residential and especially business consumers, making them more receptive to privatization.

In 1993 through 1995, accordingly, Brazil 's national congress passed a series of laws constructing the legal framework for electricity privatization, ranging from permission in 1993 for private industrial firms to build generating plants for their own use to 1995 legislation mandating competitive bidding for all new power concessions (that is, for the rights to build or operate a power plant or transmission or distribution grid). In late 1995, the Cardoso administration announced plans to privatize the entire electricity sector, worth, according to one (high) estimate by the U.S. Department of Commerce, up to $120 billion.[40] To mid 1996, there had been virtually no public outcry against either privatization per se – or, more surprisingly, against sale of the sector to foreigners.

Total installed generating capacity as of March 1996 was about 24,700 MW,[41] including the Itaipú plant jointly owned with Paraguay. Itaipú itself enjoys a generating capacity of over 12,500 MW, making it the world's largest hydroelectric facility. Brazil has estimated additional capacity needs of 2500 to 3500 MW annu-

[40] Rosenblatt (1996, p. 22).

[41] Altino Ventura Filho, "Utilities for sale," in Rosenblatt (1996, p. 30).

ally for the next ten years.[42] At present the federal government through its holding company, Eletrobrás, owns about three-quarters of the generating capacity, which often is located hundreds of miles from its ultimate users, as over 60 percent of total electricity comes from renewable resources such as hydroelectric power and ethanol. States and a few municipalities own the remainder. The Cardoso administration hopes to sell, either directly or through enlisting the state governments, virtually all of electricity generation. Transmission facilities are in federal hands. Due to the need for national planning and coordination among geographic areas, the tentative plan is for the federal government to remain dominant in transmission. Distribution, presently about 70 percent owned by state and local governments, also is slated for virtual full privatization. It is at this level that any future political problems are likely to appear. Of possibly great significance is the fact that, in 1993, utilities for the first time in decades were permitted to charge differential rates to customers in different parts of the country. Prior to that, federal fiat had made all electricity rates artificially equal, irrespective of actual costs. Brazil 's average cost to the consumer in 1993 was about 5 cents (U.S.) per kilowatt hour, as compared to 6.5 cents in the U.S.,[43] 4.4 cents in India – and 8.7 cents in Chile and 9.9 cents in Argentina, both of which recently have privatized electricty[44]. Since Brazilian utility managers thus far have been cautious about exercising this newly acquired right, the ultimate politics of electricity rates is not yet clear.

Electricity privatization for the most part remains notional only. Only two firms, both state-level companies engaged primarily in distribution, have been sold thus far. The first, Ecelsa, sold in 1995, is located in the small state of Espírito Santo, interestingly governed by the Workers' Party, or PT, the furthest left of any of Brazil 's major political parties. Ecelsa went for $500 million. The second was the huge generation and distribution firm based in Rio de Janeiro, known as "the Light," Along with his enthusiasm for eventual privatization of Banerj, Rio de Janeiro governor Marcelo Alencar pushed forward with this sale, accomplished in May 1996. The selling price for the 58 percent of the stock offered was $2.2 billion, making it Brazil's largest single privatization to date, and bringing the total privatizations thus far, under alj administrations, to a total of $11.6 billion.[45] The French state-owned power firm Eletricité-de-France (EDF), in consortium with two private American firms, Houston Industry and AES, took just over 34 percent of the stock, giving it the controlling interest.

In São Paulo, meanwhile, Governor Covas had given rhetorical support to privatizing his three state-level electricity firms, the largest of which, Eletropaulo, is a true giant, distributing about a third of all power in the country. Plans are

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[42] Ibid., p. 33.

[43] Ibid., p. 33.

[44] "Draining power," India Today (November 30, 1995, p. 73).

[45] Marisa Castellani and Mônica Magnavita, "Investimento na Light será de US$200 milhões," *Estado de São Paulo* (May 22, 1996).

(slowly) underway to break it up into four more manageable firms, to facilitate the job of finding buyers. Only time would tell whether electricity privatization would remain a largely technical issue to be dealt with by the relevant central and state government "experts," or, instead, would become another source of overt conflict between Brasília and São Paulo.

4. CONCLUSIONS

The lessons for national governments that wish to privatize, thus, are relatively straightforward. First, the leftist ideology and beliefs of particular politicians may be a factor in shaping politicians' attitudes toward privatization, but it is unlikely to be the most crucial one. Jyoti Basu, the long serving Communist Party Chief Minister of the Indian state of West Bengal, in the early 1990s found it advantageous to shed his historic anti-capitalist position and court foreign direct investment in bis state, and has done so with enthusiasm and success. Former Rio Governor Brizola in 1991 got national attention from demonstrating at the auction of Usiminas against "entreguismo," but was remarkably quiet about the even larger sale of the Light in mid 1996, perhaps because current governor Marcello Alencar had managed to make it popular. Successful democratic politicians are pragmatists. The opposition of Maharastra Chief Minister Manohar Joshi to the power plant deal with Enron, or of São Paulo Governor Mário Covas to privatization of Banespa, cannot credibly be explained mainly by the allegedly socialist or nationalist beliefs of these politicians.

Second, the overall political context, and particularly whether or not central and state government politicians are close political allies, does have an impact, but probably a smaller one than outside observers initially might expect to find. Thus, in 1995 the political party differences between the Shiv Sena-BJP government in Maharastra and the Congress Party coalition in the center undoubtedly heightened tension in India. Within the governing coalition in Maharastra, the more belligerent attitude of the state-level BJP than the Shiv Sena to the Enron deal clearly resulted from the national aspirations of the BJP, which the Shiv Sena did not share. Similarly, the fact that the newly elected Congress Party government of Orissa had replaced a Janata Dai Party predecessor may have contributed to that state's decision to criticize the power plant contract it had inherited. On the other hand, the political alliance between President Cardoso and Governor Covas, also in 1995, did little to mute the genuine conflict of interests in Brazil over the disposition of Banespa. That is, reasons of political rivalry may have caused state governments to *initiate* opposition to the privatization plans of a political competitor, but political party affiliation did not *prevent* conflicts in either country. Center-state disagreements also, of course, are more likely if the state leader in question disposes of useful bargaining resources vis-à-vis the center, as the different responses of Rio's Marcello Alencar and São Paulo's Mário Covas to the proposed sale of their state-level banks made clear. Covas, like Joshi in Maharastra, was the elected leader of a very powerful state, whose cooperation the central government needed across a broad range of issues. Therefore, neither Covas nor Joshi had much to fear from publicly battling the central government over privatization.

Third, and most significantly, this essay has shown that center-state disagreements over privatization generally erupt when there are real conflicts of interest at stake. In some cases, these may be primarily political, as when the state government fears being blamed for an unpopular policy that causes hardship to some constituents. Fear of being punished by constituents appears to have been important in arousing São Paulo Governor Covas' opposition to sale of Banespa, for example, and is likely to be a primary reason that the Joshi government, or any successor in Maharastra, might oppose rapid financial sector privatization, especially if it went so far as to attempt outright sale of the public sector commercial banks. In other cases, the distribution of economic benefits between the center and state appears to the state government either to be unfair, or not the best deal that it could get with hard bargaining. This motive clearly was important both in the Enron and Banespa cases. Both the Rao and Cardoso central governments legitimately can be faulted for being more attuned to the ramifications of these two, large projects as nationally useful symbols for would – be foreign investors than the central governments were sensitive to possibly excessive costs, monetary (as in Maharastra) or political (as in São Paulo) at the state level. The future privatization of most of Brazil's electrical power sector, for example, will go more smoothly to the extent that both central and state governments are involved in shaping the terms of any proposed deals.

Center-state conflicts in our cases seem not to be due primarily to state leaders' personal piques, ideological obscurantism, or even political opportunism – but rather to have arisen from genuine, and ultimately negotiable, conflicts of interests. More competitive national political environments, as in both India and Brazil from the early 1980s, gave state leaders the resources and opportunity to express legitimate dissatisfactions through a democratic if occasionally bumpy process, leading men like Joshi and Covas to active participation in bargaining with both the central government and potential private investors. All in all, these are hopeful findings, suggesting that mutually beneficial compromises between central and state government interests often exist, if only negotiators seek them out. Our findings bode well for the future of both center-state relations and the gradual process of national economic liberalization in both countries.

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