Surplus Generation Through Public Enterprise

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Introduction

Till the end of the nineteenth century, the philosophy of ‘laissez-faire’ propounded by classical economists reigned supreme, and the free operation of the forces of supply and demand in the market place was the general rule of economic policy. The activities of the State were mainly confined to providing public utilities, and creating the required economic and social infrastructure. It was strongly believed that maximization to private benefit also leads to maximization of social benefit. However, after the success of economic planning in the Soviet Union, the Great Depression of 1929 and the rising influence of Keynesianism, it was increasingly realised by the governments, especially in the developing countries, that they could no longer rely on market forces for rapid growth. Consequently, the governments were called upon to take the initiative in the development process of the country very actively and in providing goods and services. This envisaged an important role for public sector enterprises.

Presently, public enterprise has become a worldwide phenomenon. The extent of the role assumed by public enterprises in stimulating economic activities varies according to the political compulsions of the regime. In socialist countries like the Soviet Union, China and Yugoslavia, where there is virtually no private sector, public enterprises have emerged as the predominant institutional mechanism for development. In the market economies of both the developed as well as developing countries too, they have come to play an increasing role. In the developed countries like the U.K., France and Italy, a sizeable growth in the assets of public enterprises has been registered. But still in those countries private enterprises remain the primary engine for economic activity, and public enterprises act as subordinate to and supportive of private enterprises. In the developing countries, they can play the role of both promoters as well as instruments for development. But in the South Asian countries such as Nepal, India, Pakistan and Sri Lanka, public enterprises basically played the supportive role in the development of the bourgeoisie.

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In India, the ruling Congress Party for the last thirty-five years has committed itself to socialism but in fact, in practice this can be seen as no more than extending the scope of public enterprises. It has never been serious in any way curbing the growth of the private sector. Even after nationalization of banks, state supported financial institutions were as source of capital to support the growth of the private sector. Public enterprise came to play a similar role in explicit support of the bourgeoisie in Pakistan and Sri Lanka in the pre-1970 phase and for Nepal throughout this period. However, in Bangladesh and Pakistan after 1971 (after the takeover by Bhutto), public enterprises grew explicitly with a view to frustrating the growth of national bourgeoisie or reducing their power. Thus, whatever may be the objectives—defence, political ideology, social philosophy and the state of economic development—state ownership and control of enterprises has been accepted in varying degrees in different countries of the world. The world-wide acceptance of public enterprise system has led to a controversial but crucial question like whether public enterprises should generate surplus out of it?

This paper attempts to define the concept of ‘surplus generation’ as one of the prime objectives of public enterprise; put forward the case for and against it, and finally analyse its need in the Nepalese context.

Meaning of Generation of Surplus

The emphasis on the term ‘generation of surplus’ is fundamentally based upon the socio-political environment of a given country where the enterprise to be studied is located. In all modern communities, the paramount economic goal is the satisfaction of the pressing needs of the members of the economy. In economic terminology, it means the rapid economic growth in gross domestic product. But the means to achieving this economic goal differ widely among nations because of the prevailing economic factors and political system.

In the U.S.A. where free competitive market forces play an important role, pricing system helps allocate the resources. But the socialist countries like the U.S.S.R. and the G.D.R. have stressed the state-ownership and management of all the productive resources. However, within the “mixed economy model”, still other countries, especially the developing ones, have followed a path between the two extremes. For example, Nepal adopted the “mixed economy model” with the implicit understanding that the state and private sector can complement each other in the development process over time.

The terms ‘profit’ and ‘profitability’ will be interchangeably used to refer to ‘generation of surplus.’ By surplus is meant the balance of resources expected to be available with an enterprise after providing for its working expenses and interest payments, and various provisions for liabilities. To put it in an alternative way, ‘surplus’ is the amount of resources left with an enterprise in the form of retained earnings, and the provision of depreciation, besides the dividend payments to be made to the owner, viz., government. In other words, surplus is a part of the value of production which directly re-enters the economy to finance further growth. Regarding the question of generating surpluses, there are views for and against it.
Arguments For and Against the Necessity of Surpluses in Underdeveloped Countries

Profitability and Public Interest

It is possible to argue, as has been argued by some, that the aim of public enterprises is not to work for profits but to serve the public interest by providing goods and services. The profit motive of public enterprise is sometimes rejected on the ground that the enterprises running at deficits will be making a contribution to the welfare of the community through selling of cheap gas, electricity, transport, water and postage. If high prices are charged for public utilities like electricity, transport, etc., there would be a rise in the cost of production of those commodities which use them as inputs. This will have a cascading effect and the rise in the prices of finished goods may lead to creation of inflationary tendencies in the economy. It is, therefore, sometimes suggested that in consumer goods industry, the 'surplus price policy' may be followed, and in the intermediate and capital and basic goods, the 'break-even' one.

Meanwhile, the question arises: What is 'public interest', or 'social obligation'? If the term public interest is interpreted to include all policies that aim at the rapid expansion and growth of the economy, and all means that help the fulfilment of the targets of the plan, there would be no contradiction between profit-making by public enterprises and serving the national interest, because profits help serve the national interest by further growth in the economy.

In fact, there is no contradiction between financial and commercial objectives on one hand and social objectives on the other. To illustrate this, an interesting Indian case is cited here. Praxy Fernandes, former Director General of the Bureau of Public Enterprises in India puts the empirical evidence like this: "I had the unenviable task of assessing the performance of over 120 public enterprises and placing an annual report before the Indian Parliament. This assessment was a composite one, indicating both the financial returns of the enterprises and the contribution which they are making towards the attainment of social goals. The Bureau made a very curious discovery: the public enterprises which were efficiently run, which were making profits and generating surpluses were precisely the enterprises which were contributing most towards the attainment of social objectives. On the other hand, the inefficient enterprises and those which were making enormous losses were very poor in the discharge of social responsibilities. Indeed in their cases the very fight for survival had tended to create a situation of demoralization which was thoroughly undependable to the meeting of wider national responsibilities".1

However, even if in the interest of the society, performing social service is necessary, certain clear-cut instructions need to be issued.

First, the questions as to 'what is social service'? and 'what types of services rendered by public enterprises are regarded as social services'? should be defined in clear terms.

Secondly, if the government decides that prices of the goods and services (which include
a reasonable rate of return on capital) provided by the public enterprises should be comparatively lower, then it should issue instructions to the public enterprises in this regard in the clear terms.

Thirdly, once a decision regarding social service is made by the government and instructions given accordingly, the cost of social service in financial terms should be quantified. After this the crucial question arises: Who shall pay for these services and by what means? This is really a very important decision which should not be overlooked.

Next, after quantification, either the rate of return from that particular unit should be adjusted according to the government policy or the government should provide a subsidy for the estimated deficit arising from the performance of social service.

Finally, the instructions issued by the government if followed strictly, would serve as automatic control mechanism in the public enterprises.

In the U.K., the policy regarding providing subsidy is quite clear. To quote here from a U.K. report: "Where extra social or wider public interest obligations are imposed on or undertaken by the industries, they should be publicly identified and appropriately financed by the ministers concerned."

However, the argument that the public enterprises should not make any profit on the ground that they are meant to serve the people is misplaced and irrelevant, and not appealing in present times when capital has a cost and when people aspire for achieving an increase in their standard of living in the shortest possible time. In fact, in an underdeveloped country where there is extreme shortage of capital, low savings and the rate of the capital formation is quite low and much of the developmental activities have, of necessity, fallen on the state, public enterprises have to play a more positive role in the nation's economic development. In this connection, a U.N. Seminar stated that "Industrial enterprises...should normally aim at something very much more than a break-even position as they can be expected to contribute significantly to the process of capital accumulation, the surplus being either ploughed back into enterprise itself or made available for other enterprises through the Ministry of Finance or Treasury." At another place it emphasized that "in promoting domestic savings and ensuring proper investment public enterprises have an important role to play. They may operate so as to raise surplus which will be available for investments in the same enterprise or elsewhere in the economy." The Rangoon Seminar on 'Organization and Administration of Public Enterprises' held under the auspices of ECAFE (now ESCAP) has also come to the conclusion that public enterprises should make profits. Their main contention is that in the underdeveloped countries there exists scarcity of capital and a portion of surplus made should be made available for the industrial development in the country as a whole and the other portion should be ploughed back in the industry itself for its further expansion and growth. Thus the U.N. Seminar reports clearly stress the desirability of the generation of surplus in public enterprises for further expansion, diversification and growth of the concerned enterprise.
Surplus and Self-Financing

In the developing countries, governments expect the public enterprises to yield resources for financing not only the latter’s own expansion but also financing the national plans. In fact, the increasing obligations of the public enterprises in mobilizing additional plan resources have been widely and increasingly recognized in the plan documents of developing countries. This has been accepted in Nepal too since the formulation of the Second Plan.

In India, both the Government and the Planning Commission have consistently emphasized generation of surpluses by public enterprise. For example, the draft outline of the Third Five Year plan stated: “the surpluses of state enterprises will have to be maximized ...in suitable cases through adjustment in prices.” Prominent economists like D R. Gadgil, V.K.R.V. Rao, K.N. Raj and others have supported the policy of making profits by public enterprises.

In the U.K., there are some economists like I.M.D. Little and Harrod, who are in favour of earning as large an amount of profits as possible. Profit is necessary, they argue, for expansion of the concerned enterprise, for welfare of the worker and for contributing to the national revenues. They have alleged that the prices and profits in nationalized industries have been deliberately kept low, leading to a wasteful use of the products of these industries and this has distorted investment allocation.

Regarding earnings of profits by the public enterprises, I. M. D. Little states that the larger the public sector, the more important it becomes that this sector, taken as a whole, should earn profits. These profits would be required to finance expansion and development of the industries concerned. It is also equally necessary to contribute to general revenues. He suggests that profits be used partly for expansion and renewal, and partly for workers’ welfare and partly for augmenting the national revenues.

Turning to the question of surplus vis-a-vis borrowing for financing expansion programs, assuming that the government does not come forward with equity capital in full amount necessitated for the expansion, and also does not support with loan finance, the enterprise concerned has to find the necessary finance either through surplus or through institutional loans.

Each enterprise must earn certain surplus funds through pricing process if it wants to have a certain rate of expansion. Now, if the funds necessary for expansion are not provided by the pricing policy, they have to be borrowed from external sources. Then, interest payment to the lending institution becomes a cost to the enterprise. In order to keep the borrowing obligation to the minimum, the enterprise has to make reasonable rate of profit. This is even necessary to build up the unit’s creditworthiness for borrowing. But if the enterprise cannot make some profit, say, a normal rate of profit, then either the expansion program has to be discarded or it should look upon the government as its saviour, as the latter is the last resort for providing finance. In this case, government has to divert part of its scarce financial resources to the enterprise. Thus, on the whole, there is a strong case for making profit by a public enterprise.
Sir Roy Harrod even went to the extent of expressing the view "...that the nationalized industries be told in future they will have to find all their capital requirements by internal finance...".  

Unprofitable Services and Profitability

The case against profitability can also be argued in terms of the unprofitable services assigned to public enterprises. For the time being suppose that certain commercially unprofitable activities have been imposed on a particular public enterprise. As a result of this the objective of profitability cannot be achieved. But the enterprise has to earn a reasonable rate of return for its existence, and the financing of social services should come from the treasury. In the U. K., government's policy in this regard has been made clear by the White Paper of 1967. To quote here: "Where there are significant social or wider economic costs and benefits which ought to be taken into account in the industries' investment and pricing these will be reflected in the government's policy for the industries, and if this means that the industry has to act against its own commercial interests the government will accept responsibility." 

In the same paper it has also been explicitly mentioned that, where necessary, the government will make a special payment to the industry or make an appropriate adjustment to its financial objective.

The Herbert Committee (U.K.) has severely attacked the public enterprise board's wooly notions of serving public interest. To quote here, "We state our view without any qualification that the governing factor in the minds of those running the boards should be that it is their duty to run them as economic concerns and to make them pay."

Generating Surplus and the Socialist Economy

Of late, there is a striking emphasis in the Soviet Union, the home country of thousands of public enterprises, on generation of surplus. Evsey Liberman, a prominent Soviet economist, advocated that the public enterprises should have profit objective, and in fact, it should be used in conjunction with other factors for evaluating enterprises performance. After a long controversy and deliberations since Lenin came to power, the Soviet political thinkers considered the proposition seriously. This is evident from the statement of Khruschev, the then Prime Minister of the Soviet Union, at the Twenty-Second Congress of the Communist Party in October 1961.

In the socialist societies, like the U.S.S.R., Yugoslavia and so on, profits have an important place. The difference between the economic price and social price would be what may be called planned profit. In the socialist societies, the individual enterprises are permitted to retain a large share of surpluses mainly to build up the financial resources needed for following their own independent investment policies which help to increase productivity. In such societies, profit from public enterprises is one of the most important sources of revenues.

In the U.S.S.R., normally about 10 percent of the public revenue is derived from taxation and loans and the remainder from the profits of public enterprises and the turnover
tax on the products of public enterprises. This clearly underlines the importance of profits from the public enterprises in the U.S.S.R. Thus, industrialization in the socialist countries rests on the profitability of public enterprises. Profits have been quite helpful in making the process of economic development entirely self-financing.

*Profits for the Establishment of a Socialistic Pattern of Society*

The All India Congress Committee in its Ooty Seminar Report has stated, that state enterprises are not invariably social utility concerns. They have to serve as important media for raising resources for development. It also expressed the view that in the conditions of an underdeveloped country, there should be no objection in theory to the use of state trading to finance development. The Report recommended that state trading and/or differential taxation should be extended to selected commodities which yield a good margin of profit. At the same seminar, while presenting his paper, V.K.R.V. Rao argued that public enterprises must be carried on a profit-making basis. He adds that not only the public enterprise must yield an economic price but also get for the community sufficient resources for financing a part of the investment and maintenance expenditure of the government. Rao had expressed these views keeping in mind the establishment of a socialist pattern of society in the country.

*Should Profits of Public Enterprises be Comparable to those of the Private Sector?*

The U.K.'s Conservative Government in their 1961 White Paper stipulated that profits and returns in nationalized industries should be comparable to those in the private sector. If profit rates are lower in nationalized industries, the government has to support its expansion and growth, and as a result, nation's savings will be diverted to nationalized industries. In 1967, the British Government published a new White paper on nationalized Industries: A Review of Economic and Financial Objectives. It started from the position that nationalized industries should be operated basically as commercial concerns and must have the objective of promoting as efficient allocation and use of resources. It was also indicated that investment should be directed to those activities where the expected returns were greatest. As a part of more specific guidelines, public sector industries were expected to cover fully their accounting as well as operating costs, and avoid deficits. A public enterprise should be able to provide a rate of return on capital comparable with that earned by a private enterprise.

*Profit and Other Sources of Government Revenue*

On a different basis, Hanson endorses the view that public enterprises should earn profits. To him profit earning is necessary for the purpose of redistribution of income. If the enterprise makes no profit, its activities have to be financed by the government, raising the necessary funds by increasing taxation or by inducing inflation or through public borrowing. If it is possible to raise capital through public borrowing the effect will be to redistribute in favour of certain well-off members of the community.

The profit objective of the public enterprise has also been supported on the ground that it will help to reduce public debt. If public enterprises sell their product at a loss, it
will give rise to private income, and government, on the other hand, has to borrow from private sector for investment on development projects. To quote Hanson, "...in countries where (a) taking powers are weak and (b) the emphasis on state investment as means of economic development (for ideological reasons or for practical reasons or for both), the making of profits by some (if not all) public enterprises will be both desirable and necessary."²⁰ In fact, it is both a direct and convenient method of contributing towards national capital formation.

**Profit and Exploitation of Consumers**

The argument against profit-earning by the public enterprises is that once it is decided to follow a policy of profit, there may be a continuous temptation for the government to raise prices of the products of public enterprises to meet its increasing needs for revenues. This would lead to exploitation of consumers through the monopoly power enjoyed by the public enterprises. In this way the poor consumers have to be at the mercy of the state. "Public enterprises generally have some degree of monopolistic power and a directive to maximize profits would inevitably lead to 'exploitation' of consumer."²¹ It is also said that the profit motive of the enterprises should be abandoned because the public enterprises will always be tempted to hide the inefficiencies and the resultant higher costs by raising prices. However, if appropriate guidelines in regard to profit and price policy are issued, and the norms for costs are set by the government, this situation need not occur.

**Profitability and Mixed Enterprise**

The governments of developing countries have started collaborating with the foreign as well as local private sector firms. In such a case, when public enterprise has to work in collaboration with local or foreign private firms, the principle of "generating surplus" has to be followed. The private firms do not agree to invest their funds or permit the use of their patent rights without being adequately rewarded for the same.

It is quite clear that whether it is a developing economy or a developed one, capitalist, socialist or mixed economy, profit is necessary at least to keep the enterprise going and to make a maximum contribution towards the development of the country. If it does not generate any surplus for its own expansion and development, it cannot keep going and becomes 'permanent liability' to the state. In fact, "the essential propose of any enterprise is not to be an asset."²²

Stephen A. Marglin, after weighing the pros and cons of generation of surpluses by public enterprise, concludes that the possibility of recovering costs through revenue should not necessarily be decisive in the allocation of investment funds nor should the cost recovery determine price policy of public enterprises, once they are in existence. He supports the operating deficit, if any, only on the ground that the projects are in existence. He rejects the disposing off of public enterprise, just on the ground that price does not recover costs.²³

Now, to sum up the arguments in favour of and against profit-making by public enter-
prise it can be said that profit should be generated at least for the existence of the concerned enterprise and for financing the economic development of the country. There is no vicious or immoral about generating surplus in an industrial unit; it is a legitimate social aim. In fact, it should be made one of the criteria for evaluating the performance of public enterprise. In its absence, the enterprise will be a continuous burden on the government and has to be subsidized through taxpayers’ money. The government should make its policy clear regarding the rate of surpluses return on capital employed and the amount of surpluses it expects from various industries taking into account the objective of the enterprise, its constraints, etc. Non-profit making may be an exception, not a rule.

Surplus in the Nepalese Context

One of the main reasons for creating public enterprises in the underdeveloped countries, as mentioned earlier, is to raise the internal resources by way of retained earnings and dividual payments. In Nepal too, His Majesty’s Government has deliberately envisaged the public enterprises as the instrument of mobilizing resources in the country. This objective has been explicitly mentioned in various plan documents of the country since the formulation of the Second Plan in 1962. Further, HMG has issued a circular to all the public enterprises in June 1980 to earn a certain rate of return on their capital employed. Earning a fair rate of return on assets is, therefore, one of the desiderata of public enterprises in Nepal.

Earning a target rate of return is important as well as essential. Some of the arguments in support of the stand may be given here. First, the evaluation of public enterprise performance in financial terms would be facilitated. Secondly, the enterprise would be less dependent upon public money, and as a result, they could plan their productive programs independently. Finally, a prescribed minimum rate of return would help them expand, diversify and grow. Of course, the amount to be generated by public enterprise depends on Government’s policy. The Indian Planning Commission, in its Third Plan, urged that profits should be large enough for financing the expansion programs of the public enterprise.

If the public enterprises are not dependent on the government for their expansion, they can maintain their independence and initiative to a great extent. Otherwise, uncertainty with change in political situation, political and lobby pressures may come into play. These factors have played some role in the U.S. where public enterprises are subjected to annual public appropriation. The dependence on State subsidies has increased the degree of government control over the public enterprises in France. However, giving subsidies and grants to a public enterprise in a mixed economy like Nepal where the private enterprises also operate side by side is morally unjust and economically unsound. It simply helps to conceal their inefficiency and financial indiscipline, entailing a direct burden on the taxpayers.

Thus, in the context of Nepal where public enterprises have been established with the explicit objective of generating surpluses for further economic development, earning surplus is compatible with the national economic goals. The question should not be whether there is need for earning certain level of profit on investment in a given economy but it would rather
be "how much surplus is to be generated by each enterprise?" and "who is to receive it?"
Regarding the latter question, in the present context of Nepal, a part of the profit that a
public enterprise makes goes to the treasury of His Majesty's Government by way of dividend
payment\(^{26}\) which is meant for further economic growth of the country, and the balance is
apportioned for various reserve funds, and retained earnings. The amount so apportioned
could be used anytime for reinvestment, expansion and improvement of the enterprise.

Regarding the first question posed above, as to "how much surplus is to be generated?", the
government has to decide as it is the owner as well as the policy-maker. This has to be
done taking into consideration the nature of market in which a particular public enterprise
is operating, its surplus-generating potentiality, national objective, enterprise constraints, etc.

Therefore, the debate should not be about the correctness of earning the profit. It
should rather categorically be emphasized that every enterprise should earn a specific rate
of return on investment,\(^{27}\) and finally, it should be linked with the pricing policy of each
enterprise.

Even in a private enterprise economy such as in the U. K., public corporations were
created with a view to conducting their day-to-day business in a commercial way; that is, in
very much the same manner as a private company. There has been a statutory requirement
that the corporation shall pay its way; that is, "...the revenues of the Board shall not be
less than sufficient for meeting all their outgoings properly chargeable to revenue account on
an average of good and bad years."\(^{28}\) This general policy is to be found in Section 36 (1) of
the U.K.'s Electricity Act, 1947.

In India, Government policies regarding profits are quite clear. For example, the
Administrative Reforms Commission in India recommended that: (a) public enterprises in
the industrial and manufacturing fields should aim at earning surpluses to make a substantial
contribution to capital development out of their own earnings, besides making a contribution
to the exchequer, and (b) public enterprise, in any event, pay their way and should not run
into losses except in pursuance of express directives issued by the government for promoting
public interest.

The Indian Government issued some instructions guiding the policy to be adopted for
declaring dividends. They were\(^{29}\): (i) Current profits of the company should be first appro-
priated to accommodate the losses of the past years; (ii) Current profits may also be appro-
priated to writing off preliminary expenses, research and development expenditure, deferred
revenue expenditure, etc. by instalments spread over a number of years; (iii) Of the net
surplus available for distribution, a part may be appropriated to build up reasonable reserves
and augment internal resources to finance the approved schemes of capital expenditure or to
meet immediate financial obligations without much strain; and, (vi) The balance available
should be utilized for distribution as dividend on equity capital. The guidelines further provide
that in the case of manufacturing enterprises, they should aim at a dividend of at least 6
per cent going up to 15 per cent, on capital.
Finally, here it would be appropriate to quote J. K. Galbraith: "If I had to lay down a measure of performance for the publicly owned corporation in the developing country it would be the earnings that it is able to put into its own expansion. The most successful firm would be the one which by its efficiency and drive finds the earnings that allow it the greatest growth." 

Foot Notes


4. Ibid., p. 12.


13. In some articles, it is claimed that even in a predominantly private enterprise economy, public enterprises have appreciably contributed to the state revenues. Some of the Latin American and Middle Eastern countries are reported to obtain revenues from public enterprise in the form of profits. In some countries of South-East Asia and the Far East, the State ownership covers not only some basic industries but also trading in certain major articles of export which offer scope for substantial profits. In Philippines and Puerto Rico, profits made by the government or government sponsored projects and enterprises are deliberately used as a source of finance for further development. In Burma, state trading and state monopoly in rice and timber have been responsible for sizeable revenues to the exchequer. In a similar way, the monopoly of export trade in rice and fiscal monopoly in opium and tobacco have made remarkable contribution in case of Thailand's economy. See: K. Shamana, "Price and Profit Policy in Indian Public Enterprises", A.I.C.C. Economic Review (March 22, 1961), New Delhi, p. 33.


24. His Majesty's Government of Nepal, after realizing the fact that the return on its investment has been too low, issued directive regarding financial affairs to all the public enterprises on Ashadh, 2037 (June 1980) under reference no. 1/2/9034. In addition to other provisions, it instructs all industry and trade sector to generate a return of 10 percent on capital investment and other sectors like finance, transport and communication, electricity generation and distribution, construction and services, a return of 7 per cent.


26. By our definition of the term "surplus", tax and other payments to the government are not considered here. Moreover, ownership pattern makes no difference to the government regarding tax receipts.

27. It is to be noted here that the basic objective of creating public enterprise, viz., augmenting internal resources for speeding up the rate of economic growth, as envisaged in the Second and subsequent plans has not been achieved so far. The government also did not give the enterprises any specific directive to earn profits when they started their operations. For an in-depth analysis of profitability in Nepalese public enterprises, see: J.K. Pathak, "Surplus Generation in Nepalese Public Enterprises," *The Nepalese Management Review*, Vol. IV No. 1, Summer 1983, Kathmandu.

