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SOE Reform and Privatization in China
A Note on Several Theoretical and Empirical Issues

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Introduction

State owned enterprise (SOE) reform is one of the biggest issues for every transition economy not only today but also in years to come. Even the Chinese economy, which is widely known as a successful case for "gradualist" economic transition, has been faced with poor management and low efficiency of many SOEs. Shock therapists have criticized the gradualist approach insisting that it is ineffective in totally reforming state sectors, but SOE reform is still persistent and intractable even for former Soviet Union (FSU) and Central and Eastern European (CCE) countries which have followed their advice in the name of the "Washington consensus".

As in the case for well known arguments on transition strategies, i.e. gradualism vs. shock therapy, there has been a heated debate centering on the effectiveness of privatization of state enterprises. Conventional wisdom is that if an economy is to be marketized, its property rights should be privately owned. Now that transition economies want to transform themselves from plan to market, they must change their ownership structure, too, from public to privately owned. Generally, shock therapists support this view strongly, while gradualists do not. In light of "China's Rise and Russia's Fall"[1], however, the recent view generally tends to be favorable for the gradualist approach with regard to SOE property reform. It is often said that ownership of property rights does not matter.

In this paper we examine several issues on privatization, particularly of state enterprises, which have long dominated socialist economies. Is privatization useful and necessary for transition economies? If so, in what sense and in what way? How is it linked with market development and institutional evolution of those economies? What are the characteristics of privatization in China, which has been reluctant to changing property rights of their state enterprises?

This paper is organized as follows. First we briefly review China's SOEs and their performance to understand the background behind their relative shrinkage in the national economy (section 1). Then we look at the arguments regarding how to reform these enterprises, making some comments on the three different views of their reform (section 2). Then we take up a theoretical issue on the necessity of privatization in transition (section 3). After that, we discuss an empirical issue on the effectiveness of privatization (section 4). Finally, we focus on the recent privatization drive in China and its characteristics compared to FSU and CEE nations (section 5).

1. State owned enterprises and their performance in China

. Many indicators demonstrate how China's SOEs are inefficient in management and how their profitability is deteriorating at least until 1998. The share of SOEs in deficit is said to be above 43 %, and might probably be higher than 75 % in reality if hidden and repressed deficits were included. The ratio of their total deficits and profits has been rising in trend in the 1990's, when the average rate of profits has declined to almost none.

The SOEs' share of industrial production and employment has been declining (see Table 1).

(insert Table here)

On the other hand, non-public sectors, particularly private and foreign ones, have been growing so rapidly adapting themselves very well to emerging markets that they have now become characterized the Chinese "socialism" as a backbone of its economy. The table shows quite clearly how private and other non-public enterprises have flourished in the Chinese scene, particularly in the 1990's.

Table 1 also tells us that the SOE's industrial output has declined in relative terms, while their investment share does not change very much. This implies that their investment efficiency has been deteriorating. There are many indicators that show their relative inefficiency. Let us compare their industrial profitability and efficiency vis-à-vis non-state sectors, based on China's industrial censuses for 1985 and 1995 (see Table 2). Obviously, SOE's profitability measured as a ratio of profits plus taxes to revenues and their efficiency measured as labor productivity are lower than those of their non-state counterparts. The table demonstrates, too, that state enterprises distribute relatively more to their workers and employees.

(insert Table 2 here)

This table only depicts the average difference in performance between SOEs and the others.

Performance, however, varies not only with ownership types but also with other various factors, such as size, capital/labor ratio, type of industry, age, employees' educational levels etc. of enterprises. Once we control for the other factors than ownership, can we arrive at the same conclusion as above? Liu testifies to the higher efficiency of private firms than state enterprises, based on 1995 census firm level data for steel industry alone and through several regression analyses. His findings are: 1) property right reform is effective in raising productivity, 2)an increase in private capital among non-state shares contributes to productivity to a great extent, 3)property right reform in large enterprises as well as small and medium-sized ones is conducive to productivity growth.[2]

What makes state enterprises generally so inefficient, then? The following reasons, which can be applied almost equally to any transition economies, but in a context of China's economic reforms are often referred to as:

1) Government interventions or lack of enterprises' autonomy. It is a well-known fact that they are still lacking in management autonomy that must have been assured formally by several related laws. As they are state owned, it is easier for the state to control their management, directly or indirectly, and whether they are formally stock companies or not.
2) The so-called "soft budget constraint", i.e. paternalism and protectionism made by their supervising governments which shoulder any failures resulted from SOEs' mismanagement on their behalf. Under this principle, no state enterprise, particularly of relatively large size, would be allowed to go in bankruptcy, even if they run long in deficit.
3) Various "historical legacies" and social burdens borne by these enterprises. State firms, for instance, have provided medical cares for their employees. Pensions for the retired employees are a matter of their enterprises. Moreover, excessive employment characterizes SOEs as an important measure for social security. Their workers and employees can not be dismissed by the state[3].
4) Low quality of enterprise managers, who are less adaptive to changing market environment than those in the non-state sector. They are not entrepreneurs in the true sense, but bureaucrats at any rate. They are appointed by the government not according to their business ability, but based on their rankings in the bureaucratic hierarchy. Even managers of share-holding companies (and surprisingly enough, even the top leadership of a collective enterprise, too) are in fact appointed and/or approved by its supervising administrative apparatus (see Table 3). This fact illustrates how an enterprise loses the basic managerial independence. It is Ryutaro

Komiya who asserted in the late 1980's that there existed no enterprise in China at all[4]. No doubt, his assertion appears to be an overstatement at first sight today, but many SOEs are still not the enterprises in that they cannot enjoy full freedom from a variety of fetters made by the state. It goes without saying that the Chinese leadership has not sit by and watched those firms shrinking in the market. Various policies to save and reform them have been launched: Corporation law was enacted, stock markets were opened, and financial aids to settle their bad performing loans were provided. Several types of SOE restructuring programs were tried to give them incentives. Contract system that was applied quite widely in the late 1980's is such an example. However, the leadership has found that their efforts to renovate SOEs and prevent them from losing their

(insert Table 3 here)

shares further in the market has turned out to be ineffective. SOEs' financial difficulties have become aggravated. Millions of their workers were laid off. Even under these circumstances, the Chinese government has strongly and officially refused to implement a broad range of privatization policies, though "de facto privatization" has proceeded as described below. A term of privatization is still in the taboo within the Chinese officialdom. They still adhere to a long held principle of "public ownership as basis". China's ideological antagonism against a concept of "privatization" is fairly strong. Its new strategy adopted since 1997 is called "*zhuada fangxiao* (retain the large, release the small)". It is a policy to compromise their theory with practice, because large and important state enterprises can be retained as their economy's "commanding heights", while small ones are allowed to be privatized.

This is one of the characteristics that set China's SOE reform away from that FSU and CEE's transition process, where large scale privatization has been planned and implemented as an indispensable part of their economic reform (see Table 4below). The table demonstrates that the more successful a country is in transition, the more widely it is privatized, though definition of privatization remains to be open to question. In other words, privatization has been deeply incorporated in their economic transition process. In contrast to China, FSU and CEE countries have already abandoned the socialist principle as well as ideological antagonism against privatization as a result of political democracy. We will observe later how effective such privatization at enterprise level is in those countries.

Another feature of China's SOE reform is that it is less institutionalized and the property rights are more vague compared to European transition countries. Township and village enterprises (TVEs), which have been highly praised as a symbol of economic development in China, are characterized by their vaguely defined property rights. Some authors like Weitzman=Xu and Tian try to seek certain rationality in such an ambiguous property system, though it looks irrational at first sight[5].

It is undeniable that China's public firms have been gradually eroded by incessant waves of "de facto privatization" under the circumstances of less institutionalized and more vague ownership. a) Many public firms, TVEs in particular, are private in reality, though nominally in public ownership, since they know very well that they can acquire a necessary amount of loans from state banks more easily under the guise of public ownership. Moreover, b) fairly many state enterprise, let alone collectives, are actually managed in an autocratic way by the managers or their group as if their assets are really in private hands. It is reported that a tremendous amount of public assets are "washed away" to invisible hands in China today. This kind of situations has greatly given rise to a dynamic force to accelerate market development so far, but with increasing negative effects on the Chinese economy as a whole.

(insert Table 4 here)

2. SOE Reform Strategies: Three Views

The issue of SOE reforms in China has not only been argued by the Chinese in a very heated way, but has attracted worldwide attention among many China watchers as well. In the academic world of economists in China, there are basically two streams of thought with regard to state enterprises and their reform. One is the "market school" typified by Lin, who insists as follows. If only their historical burdens of social security as described above are removed, their budget is hardened, and most importantly, well-functioning markets of commodities, capital, and even managers are provided, then they can operate as efficiently with better governance as private firms can do[6].

The other school is one that can be labeled as "property right school", which places heavier emphasis on proprietorship, particularly ownership of enterprises. This school contends that unless SOEs are privatized they would not essentially be able to improve their management, since the efficient corporate governance can not be guaranteed. According to Weiying Zhang, the state ownership system can produce no true capitalist or manager, even if these enterprises are transformed into joint-stock companies. They would still encounter various sorts of state intervention, as it is the single or major shareholder. There must be owners who are the residual claimants to their enterprise's profits. Moreover, even if ordinary state firms happened to be privatized, they would still be controlled by the state that controls the entire financial channels, which are almost state owned. He goes on to recommend, then, that both financial and non-financial state enterprises be privatized at the same time [7].

These two schools just reflect the two different view on efficient governance structure in modern enterprises, but against the background that both private and individual enterprises have grown rapidly, it seems that the property right school is now gathering momentum by degrees within the Chinese academic circle. In Chinese as well as in Japanese, a term "privatization" can be translated in two different ways: one is "*mingyinghua* (management by private persons), the other is "*siyouhua*" (ownership by private hands). A term *siyouhua* is still a taboo in the Chinese political culture today, so that Zhang intentionally avoids the use of such terminology, to make his argument politically safe and acceptable in China.

Beside these two schools, there is another view on China's SOE reform. Steinfeld points out through his studies on China's steel industry that property right reform would function only when institutions protecting the property are firmly established in the real scene [8]. But, he continues, in China as well as in other transition economies, where such institutions are either lacking or underdeveloped, property rights are too difficult to reform. He concludes, then, that rather than reforming the ownership structure is a policy to make constraints on state enterprises harder more necessary in order to operate them well. Although his emphasis is placed on an aspect of institutionalization or institutional development, his recommendation resembles more or less that of the "market school" above. In the same vein, in line with the market school he asserts that privatization in FSU and CEE countries has turned out to be totally a "failure" followed by much of turmoil and disorder in the economies.

The same sort of view is shared by Jefferson, Rawski, and others to a certain extent, who argue that there arose such a mechanism in China that they call "endogenous reform": new institutions have been generated endogenously once markets were brought in [9]. With regard to SOE reforms, they stress the importance of market, saying that what is required for China now is not property right change but further development of markets. This hypothesis seems to imply that once a market mechanism starts to function, it will naturally create necessary institutions, including property rights, associated with the market.

Jefferson, in particular, defends China's state enterprises. In his view, declining profitability of those enterprises stems from increasingly keen competition with non-state enterprises, such as burgeoning TVEs , foreign and private ones. According to his analysis, SOE's productivity is high enough, though declining over time as are other sectors. Controlling for various factors and estimating the pure ownership effect, he concludes that China's rural enterprises do not necessarily outpace SOEs in productivity unlike the popular view[10].

Let us ask, however, are marketization, privatization, and institutionalization substitutes or complementary with each other in the process of economic transition? As the modern history demonstrates, generally these three factors are closely interacted (see Figure 1). For instance, private ownership must be effective in order to develop various institutions, since it requires legal institutions in order to clarify and protect the ownership as well as related rights and duties. Conversely, development of such institutions, say establishment of legal ownership rights and mechanisms to enforce these rights, would promote private proprietorship much further.

(insert Figure 1 here)

By the same token, privatization would be definitely efficient to promote the development of markets, since it is easier to clarify the owner than any other types of property rights. Developing markets, on the other hand, would strengthen the sense of self-interests of private owners. In addition, the further markets develop, the more market-related institutions are required. As the property rights are established, contracts can be implemented to reduce transaction costs, which in turn facilitates market development, as North has suggested[11]. Thus, the above three factors are interrelated so much that both institutional development and private ownership are necessary for well-functioning markets.

The question, then, is sequencing and relative causality among these three factors. They probably could not occur at the same time, interact to the same degree, and proceed hand in hand. We believe, however, that if privatization encourages market development, and if institutionalization promotes privatization as well as markets, then it seems natural to assume that privatization would be capable to strengthen further development of various institutions. Moreover, if transition costs have to be reduced in the real process, such a causal chain would be realized as marketization needs institutions, which in turn advance privatization, with the result that markets can develop further The process of China's market development and privatization appears to have been following just such sequences, as Jefferson and others insist. The remaining question is, then, how to accelerate this interactive process.

State enterprises must be reformed, by way of privatization or not, but there can be several paths (strategies) for China to follow (see Figure 2)[12]. The first one is a path, which is officially deemed most ideal for China (path A). Namely, public ownership is maintained but the market is developed. The second one is a path, which Jefferson and others think is most rational for and fitting well China (path B). Along this path, market development is pursued in the earlier stages, but later and gradually public property is transformed into private one. The third one is a path, which Zhang considers is the best for China (path C). That is to say, property rights should be revised from the beginning in keeping with market development. Privatization of state enterprise is naturally recommended as an important step. Finally, there is a path that the so-called shock therapists believe should universally be applied to any transition economy (path D) . Public enterprises must primarily be privatized in order to develop markets. They insist that privatization as well as deregulation would be able to create a spontaneous and dynamic market mechanism.

(insert Figure 2 here)

Related with a sequencing problem, thus, is a theoretical issue on the time horizon: perspectives can be different between the short-run and the long-run. More specifically, we believe that hasty privatization of state enterprises may be unnecessary in the short-run, but privatization itself must be indispensable in the long run in order to acquire the more appropriate corporate governance for those enterprises. Our understanding is that Jefferson and other "gradualists", probably Steinfeld, too, realize the necessity of privatizing most of state enterprises in the final analysis (see Figure 2 again). In this sense, their strategy of reforming Chinese state enterprises is not so different from that of the property right school as it would appear, though the paths on the way to the final goal are different.

Unlike Lin, Steinfeld, and Jefferson, we believe that ownership matters even in the case for China. Their views cannot explain very well a widespread privatization drive in the recent years in China. Certainly, privatization is not a panacea. It is true that even though state firms are privatized, they would not necessarily improve their management immediately and dramatically. But provided that, while privatizing SOEs, many restrictions constraining private enterprises (say entry restriction) were removed, the social security system like unemployment insurance were made more available, and complementary institutions protecting private property were set in motion, then their management efficiency could rise higher at least compared to a situation prior to the privatization. This statement is supported by theoretical and empirical considerations, both of which are subjects to consider in what follows.

3. Benefits and costs of privatization: economics of privatization

In the recent twenty years, worldwide privatization has been undergoing not only in transition economies but in other developed and developing countries. One of the reasons why public enterprises are sold out is that the fiscal deficits are aggravating in these countries. Thus buy-outs of such enterprises can fill deficits, though temporarily and to a limited extent. But the more important reason lies in the fact that most of these enterprises are so poorly managed that a huge amount of deficits are piled up every year which are finally filled by government subsidies. A typical example is the Japanese National Railway before privatization.

Why, then, are privatized firms expected to be more efficient in management? More precisely, why are public enterprises less efficient than private ones, other things being equal? What are main theoretical reasons for privatization, both in micro- and in macro-economic terms? How should the privatizing of public firms be evaluated? Let us comment on several theoretical aspects of "economics of privatization".

(1) Privatization without definite institutions is certainly risky as Steinfeld insists. Undeniably, if state enterprises were privatized without associated institutions such as relevant laws and regulations, then their managers would literally "privatize" their own enterprises, whether in secret or openly, as pointed out above regarding de facto privatization. However, it seems to be out of mark that privatization is impossible without well-prepared institutions as he emphasizes. When one looks at a general process of market development, one would find that they can not function properly without certain rules and regulations, but it is not after those institutions developed that markets were created or regenerated in China. More desirably, both legal institutions, formal or informal, and private property rights can develop interactively, as is indicated by Figure 1.

(2) Corporate governance of enterprises varies with their size. In large firms management must be separated from ownership while in small ones owners are often managers at the same time. Therefore, it is usually said, if only given full managerial autonomy and competitive market, any large enterprises can be efficient in their management, irrespective of ownership type, i.e.

whether they are privately or state owned. However, remember that compared to private firms state enterprises are more likely to be subject to certain state interventions whereas they can enjoy its protections, e.g. appointment of managers, basic decisions of investment, provisions of loans etc. Furthermore, it is much easier for private firms to clarify the property rights than for public enterprises. The most ambiguous ownership is that by “the whole people”, namely state ownership. Property owned by the whole people is almost equivalent to free goods, since nobody owns it. No one would be responsible for such property. Therefore, the managerial efficiency of state enterprises is, *ceteris paribus*, lower than, or at best equal to, that of their private counterparts. Let managerial efficiency of an enterprise be E, which is a function of property rights, scale, capital intensity, market conditions, type of products and services produced, and so on. Then, it seems natural to assume,

$$E(p, fi) \leq E(s, fi),$$

given fi, where suffixes p and s indicate private and state ownership, respectively, and fi represents other factors.

In other words, there is no theoretical reason that suppose that state enterprises, other things being equal, can be more efficient in management with more effective governance than their private counterparts. Compare two ownership types, private and public. Private ownership is definitely easier to impose a governance structure that managers pursue the maximization of share value as their primary objective. Neither the market school nor the institution school has ever pointed out theoretical advantage of state enterprises in governance.

Consider, why are state enterprises often subject to various sorts of state interventions, and why is it very hard for them to realize complete separation of management from ownership in these enterprises (*zhengqi fenkai*), though its necessity has repeatedly been called for since the 1980's. One reason is that in Chinese state enterprises, particularly of large size, their top leadership is controlled by the communist party. Another reason is that they are state owned, more likely to be interfered by the owner, i.e. the state, than their private counterparts. It is true that private companies, too, have been faced with state interventions, or even worse, discriminations in China. Thus privatization is not a guarantee for enterprises to enjoy full independence from state interference. Yet, it can be a step toward more autonomous management. Private firms can be more independent from the state than SOEs, or at the least, could be interfered by the state to the same extent as their state counterparts are.

(3) Consequently, state firms suffers, almost necessarily, the "opportunity loss", or the loss that could have been avoided under the private property system. Let M be a curve of marginal productivity of capital. Generally, E(p) > E(s) as Table 2 suggests. Hence, marginal productivity of private capital M(p) is higher than that of state capital M(s), holding other things constant (see Figure 3).[13] The opportunity loss can be measured, for instance, by an area of K_0*{ M(s) - M(p)}.[14] Of course, there would be no such loss if the two types of enterprises are managed with an equal level of efficiency, M(s)=M(p), which is the extreme case. If both M and K can change with time, moreover the gap between M(s) and M(p) is widened as is usually supposed and SOE investment (increase in K) continues, then the total opportunity loss in the long run will be: ${}_t K_t\{ Mt(s)- Mt(p)\}$.

(insert Figure 3 here)

(4) Thus we may conclude that unless SOEs can produce certain benefits more than the opportunity loss, there would be no economic raison d'être to maintain them, so far as economic benefits at firm level is concerned. No doubt, there can be a situation that privatization is not a good choice in the macroeconomic sense for a national economy, while it has to be pursued in the microeconomic sense.

(5) One remark should be added to the nature of loss incurred by state enterprises. As pointed out above, China's state enterprises have been faced with growing deficits. Non-state enterprises are not free from managerial loss, either, which sometimes outpaces that of state enterprises. But the nature of such managerial loss is essentially different between these two types of enterprises. SOE managers do not take responsibility for deficits that occurred, while managers of non-state enterprises have to do.

(6) So far we have ignored the privatization or "transformational" costs. It is generally recognized, for instance, that SOE privatization would necessarily bring about a serious unemployment problem (since they are holding massive surplus labor), which may cause an awful social unrest. This is one of the strong arguments against overall privatization, or just the reason that the Chinese leadership stick to the state or public ownership principle, beside for the ideological reason. But does privatization necessarily lead to an increase in unemployment and lay-off? This is far from clear, and not always supported empirically as stated below. What is more, SOE privatization may create more employment in the long run, as it facilitates restructuring of the

entire economy.

(7) Then, if the transformational costs associated with privatization were lower than the opportunity loss, particularly in the long run, privatization would produce net social welfare under the assumptions as above. Conversely, if such transformational costs were higher than the opportunity loss, there would be no benefit to privatize state enterprises in terms of the macro economy, even if their managerial efficiency improved.

4. Effects of privatization: empirical evidence

Before moving to empirical studies on privatization, it seems worthy of distinguishing two levels of privatization. Privatization itself is a process whereby public firms are "privatized" in the sense that all or part of their shares are transferred to private persons or non-public organizations. It means a change in ownership structure at firm level. On the other hand, such a situation can be often called privatization, too, as the macroeconomic share of public firms declines over time, whether public firms are privatized in the above sense or not. Let us call the former type of privatization as "micro privatization", and the latter type as "macro privatization".

Enterprises in transition economies can be classified broadly into the following three categories: public or state enterprises, (*de novo*) non-public or non-state enterprises, and privatized enterprises which were formerly public enterprises. How can a privatized enterprise perform well in practice either in the macro or in the micro economic sense? Does micro privatization always have to bear social costs like increasing unemployment or lay-off? These questions deserve to be asked, but have not been fully answered so far. Now, let us turn to these empirical issue of privatization.

It is well known that there has long been a debate in the West about relationship between enterprise performance and its ownership pattern. As for the practical effects of privatization, a general consensus has not been reached. But it seems that the recent studies are more or less favorable for privatization. Megginson and others, for instance, compared the pre- and post-privatization financial and operating performance of 61 companies from 18 countries. They conclude that after being privatized, firms were able to increase sales, profits, capital investment, and even their work forces [15].

So far as privatization effects in transition economies are concerned, empirical studies and surveys with a focus on CEE and CIS countries are being accumulated. Carlin makes a good summary of and main results from such studies [16]. Let us review very briefly some of these studies and findings.

Frydman and others found that private ownership, except for worker ownership, dramatically improved corporate performance[17]. They also revealed that privatized firms generated significant employment gains relative to state firms, contrary to conventional wisdom.

Pohl and others made a comprehensive research on 6,300 industrial firms in seven countries in Central and Eastern Europe and reached the following conclusions: privatized firms were able to gain productivity growth as much as three to five times higher than state firms; privatization methods, say buying-out to employees or mass privatization, did not affect the difference in productivity[18].

Based on a series of data sets collected by the World Bank, Estrin and others made a comparative analysis on enterprise behavior and performance of Polish and Russian firms, finding out some important facts[19]. For example, in Poland in 1993, privatized firms did not appear to be restructuring significantly more than SOEs, though de novo firms were performing much better. As far as output growth, employment growth and excess employment are concerned there was no significant difference in performance between privatized and state owned enterprises. The most striking feature of the results for both Poland and Russia was the failure of outsider-owned firms to restructure more than SOEs. Their findings, however, are derived from the data for early days in the privatization process.

Estrin and Rosevear used an enterprise level random survey of 150 firms in Ukraine and tested whether privatization had yielded improved firm performance and whether specific ownership forms had led to different behavior at the enterprise level[20]. The results of their analysis are: the hypothesis that private ownership per se is associated with improved performance was refuted. But they found barter to be associated with lower profitability, and to be less common in privatized firms.

Case 5. Six Newly Independent States

Djankov investigated a relationship between ownership structure and enterprise performance in the NIS, using detailed survey data collected by the World Bank in 1997 and 1998[21]. He tested a non-linear analysis and concluded that some significant relationships existed between different types of ownership and enterprise restructuring. These findings are, he stressed, consistent with some of the theoretical models of corporate governance in mature economies.

Finally, let us add Grosfeld and Nivet's findings to the above list of case studies. They found that large Polish firms demonstrated a clear difference in behavior between state and privatized enterprises: investment ratio of 85 SOEs is 4.8 % while that of 27 privatized firms is 11.2 %. Namely, privatized firms are more active in investment and therefore future growth. Moreover, their growth performance is not only stronger but also the growth of their output is much less influenced by sectoral output growth than is the case for SOEs [22].

Do the same conclusions hold for the case of China? To the best of our knowledge, there is still no systematic, empirical, and comparative study, at least comparable with the above studies, on China's privatization and its effects on enterprise performance [23]. However, there is sufficient evidence, albeit indirect and weak, that privatization would improve enterprise efficiency and/or profitability. For example, let us see a relationship between in-debt enterprise ratio and SOE ratio calculated at the industry level (Figure 4). It shows that the higher SOE's share is associated with the higher percentage of enterprises in debt.

In addition, we have several studies on performance of companies listed on the stock markets in Shenzhen and Shanghai. Xu, for instance, arrives at a conclusion that the higher share by the state generally produces the worse performance in those companies, while the higher concentration of shares has the same effect [24]. Chen and Jiang, on the other hand, who apply the similar sort of regression analyses to the data of electronics, commerce and public utilities of such listed firms, find that it is only in electronics industry, which is involved in highly competitive market, that the state share has a negative impact on enterprise performance [25]. Our own findings based on same sort of data of companies on Shenzhen stock market are as follows (see Table 5):

(1) As Chen and Jiang note, state share's impact on enterprise performance vary with industry, but unlike their conclusions, it is typically public utilities that the state share ratio has a negative effect on profitability of enterprises concerned. In the case of medicine industry, which is in quite competitive market, that share has even a positive effect on profitability.
(2) Contrary to our expectation, the proportion of unlisted (listed) shares is not negatively (positively) correlated with profitability. This fact seems to imply that insiders basically control the companies in question.
(3) Unlike Xiao's conclusion, it does not seem to hold that the more concentrated a company's share, the more profitable it is.

(insert Table 5 here)

Nevertheless, these findings on listed companies are subject to several limits. First of all, the data are confined to those of listed companies on Shenzhen stock market. Second, profitability is measured by profit/revenue ratios, which can be statistically weak. Third, our findings are derived from simple correlation analysis, not controlling for many other factors such as scale, age, capital intensity, etc.

More importantly, such a type of analysis as on listed companies does not strongly demonstrate that privatization of SOEs has definitely a positive effect on enterprise performance, partly because the proportion of state ownership cannot necessarily be a good indicator of privatization. Compare a company A with 90 % of state share with a company B with 60 % of cooperate share. If the firms with company B's biggest share are all state owned, then there would be no substantial difference between these two companies in nature of ownership. Moreover, share holding itself does not still guarantee good corporate governance in China today, where stockholders' meeting does not appear to be working well.

To summarize. Given the so-called selection bias[26], experiences of privatization in some European transition economies indicate that the results are certainly mixed, but roughly speaking, privatizing state enterprises is (a) generally conducive to the improvement of managerial performance in former state enterprises in relatively advanced countries like Poland, Hungary and Czech, while its effects on enterprise performance is not very significant in stagnant economies such as Russia and Ukraine. This finding requires some revision of both Lin's and Stainfeld's observations that post-socialist privatization is nothing but a failure. We have to distinguish successful and unsuccessful cases of privatization, and to ask why such a different result happens. Based on rich and coherent analyses of privatization experiences in former socialist countries, Frydman and Rapaczynski concluded, "unless closure is seriously contemplated, privatization is unlikely to be of much help". Given most state enterprises as "a set of white elephants in the middle of nowhere----with low quality of capital stock and an organizational structure incapable of functioning in a normal economic environment" privatization may produce nothing only by itself[27]. (b) It is particularly effective for medium and small-sized firms, but even for large-sized ones to a lesser extent[28]. Moreover, (c) De novo private firms perform best, and (d)there are several styles of privatization, such as managerial, employees' and foreign capital's buy-outs, but it is still uncertain which style, except for foreign-owned, is most effective as privatized ownership.

Studies on CEE transition economies also give us a good lesson of privatization effects on employment. Micro privatization itself may not necessarily be ineffective in securing jobs of the employees. Most of state enterprises are characterized by excessive employment, thus once restructured and privatized they would fire or lay-off the redundant labor within SOEs who have been hired under the socialist principle of "full employment". However, micro privatization is different from macro privatization. Part of the surplus labor which is released out of SOEs as a result of privatization may be absorbed by newly set up private firms, created during the privatization and its associated restructuring process. More concretely, privatization plus market development could offer more job opportunities for workers within state enterprises, whose marginal productivity is lower than their wage. If so, the transformational costs associated with privatization could be lower in the macro economic context, at least in the relatively long run, than we have imagined.

Thus, privatization must be evaluated from a point of view of its total effects on the entire economy. Social costs of micro privatization, for example, must be judged not only in relation to its effects on increased unemployment and lay-off but also from other aspects: macro economic benefits and costs, e.g. increases in tax revenues, employment and wages, savings, foreign trade and FDI, etc. Using data for 218 non-financial privatization cases that took place in Mexico, La Porta and Lopez-de-Silanes draw an interesting conclusion as follows:

> "The additional revenue received by the government as a result of the privatization was probably large enough to –at least in principle—offset society's cost of job losses. ---- The additional revenues that resulted from privatization would have been enough to give N$659,454 (US$212,727) to each of the 550 laid-off workers from the average firm—a very large sum given that the annual pre-privatization income of an average SOE worker is N$14,880 (US$4,800)".[29]

Finally, we should take it into consideration that privatization in former socialist economies is substantially different from that in other countries, developed or developing. It involves two objectives, Frydman and Rapaczynski say: depoliticization and creation of a new institutional structure of corporate governance[30]. Brada, too, states that it was necessary for former socialist economies in order to establish democracy and to destroy the existing basis of the Party's monopoly over the political power, i.e. SOEs [31]. It must have been a necessary process for depoliticizing FSU and CEE economies which has long been under the political tight control by the communist party. Privatization as well as the entire transition policy, then, should be, or must be, evaluated in a wider context than strictly economic effects, including its social and political impacts on the society as a whole.

5. Privatization in China and its characteristics

Since the early 1980's macro privatization has been proceeding, first hesitantly, then boldly in China. This can be shown by a rising trend of private sector's share in Table1. In 1999 when China's new constitution was adopted, private sectors were formally admitted as "indispensable part of the national economy". Formerly, they had been held in contempt as "socially ostracized", or "tails of capitalism". Once they were permitted, they began to burgeon forth.

The speed of micro privatization in China, nevertheless, is much lower, at least until recently than its European counterparts (compare Table 1 and 2). But from 1998 on, various types of property reforms have been applied to SOEs in China. According to a survey conducted by the State Statistical Bureau in 1998, among 13,726 enterprises that had been "restructured", as many as 76 % of them had undergone privatization in the sense of buyout of state capital, whether all or partial. Micro privatization proceeded quite rapidly particularly in Sichuan and Shandong provinces. According to Yang, a drive of reforming property right of small and county level state enterprises took place in Sichuan province in the early 1990's. As of the end of October 1998, 81.74 % of small firms at city and county levels underwent various forms of property reforms. As a result, he says, a majority of these post-reform firms began to perform well, changing their output structure, decreasing their debt/asset ratio, increasing employees' earnings, and raising tax revenues for the state[32]. The case of property right reform in Zhucheng of Shandong is well known as a "Zhucheng model", which transformed state property into employees' collective assets with the result that higher productivity was reportedly achieved.

What, then, characterizes China's privatization vis-à-vis the cases for FSU and CCE countries? First, it is almost confined to small and medium-size enterprises, as led by the above-mentioned official policy of *zhuada fangxiao*. In European former socialist countries, overall privatization has been carried out involving large-sized state enterprises. But in China, property rights at least of the strategically important sectors are firmly kept in the state hands, even though their relative share in output and employment continues to decline (see Table 1). Commercialization, instead, rather than privatization is now on the agenda of large SOE reform. Many large sized state enterprises are becoming stock companies, part of whose stocks are on the market, as referred to above.

Second, macro privatization has been more in progress than micro privatization, against the background of market development and the gradualist approach China has adopted. Numerous non-public firms have mushroomed, though some disappeared immediately through the hard competition in the market, but this allowed these enterprises to outperform state ones in both efficiency and profitability. Micro privatization or property right transformation, on the other hand, is more difficult than macro one, since it needs a fundamental institutional change of public enterprises.

Third, political dictatorship is still held by the Party in the privatization process in China. That is to say, no depoliticization has been kept on in the privatization drive. Establishment of the party organizations have been called for even within foreign funded enterprises. Even though state assets are gradually transferred from the state to private hands, the political structure within enterprises concerned still remains the same. In China, where the party still has a strong say in basic decisions in every corner of social life, depoliticization can not be an aim to reform SOEs. However, China's reality is that "de facto depoliticization" is likely to be going on notwithstanding the leadership's will and often-launched political campaigns.

Fourth, de facto privatization is far ahead of de jure and formal privatization. As we discussed above, SOE reform has been carries out in China without much development of associated institutions. Ambiguity, let alone proprietorship, is one of the important features of the entire transition process in China. So far it is a source of dynamic which pushes forward market evolution and creation of new entrepreneurs. But in our view, it has become an obstacle to further transition of the economic system. De facto privatization itself, too, has two sides: both advantage and disadvantage. It seems to us that its disadvantage has now outweighed the advantage, as exemplified by rampant corruption and raging literal "privatization" of public assets by managers.

The overall trend of privatization, even though still limited to small and medium-sized enterprises, would probably also affect the large firms at any rate, whether one likes it or not. In other words, macro privatization would accelerate micro privatization. Accordingly, market development widens the area of private proprietorship, as suggested by Figure 1. But the point is that market can not, or takes time to, create new institutions by itself. Laws, regulations, rules and norms to protect property rights, for example, should be basically provided as public goods by the state. Changing property structure as well as clarifying property rights is certainly a tough task, for socialist economies with a lot of people of vested interests in public property, in particular. We may be allowed to say, however, that, first, clearly defined property rights are better than vaguely defined rights, second, formal privatization is at least better than informal, spontaneous, and de facto privatization in promoting transition process. The recent trend of privatization, difficulties both state and rural enterprises encounter, and various experiments of enterprise reforms (*gaizhi*) in China seem to support these our views, directly or indirectly.

Table 1 Shares of State and Non-public Sectors (%)

	State Sector			Non-public Sector	
	Gross Industrial Output	Fixed Capital Investment	Urban Employment	Gross Industrial Output	Urban Employment
1978	77.6		78.3		0.2
1980	76.0	81.9	76.2	0.5	0.8
1985	64.9	66.1	70.2	3.1	3.9
1990	54.6	66.1	62.3	9.8	5.7
1995	34.0	54.4	59.0	29.4	24.5
1996	28.5	52.5	56.7	32.1	28.0
1998	28.2	54.1	43.8	40.0	46.7

Source) *China Statistical Yearbook*, various editions

Note) Non-pulic sector means all sectors other than state and collective ones.

Table. 2 SOE Efficiency and Profitability

	Wage Share (%)		Profit-Tax Ratio (%)		Average Wage (yuan)		Labor Productivity (10000 yuan)	
	1985	1995	1985	1995	1985	1995	1985	1995
Total	25.14	33.10	35.06	15.64	1042	5,086	1.277	7.492
State-owned Enterprises	22.02	37.08	32.94	13.45	1164	5,546	1.598	6.739
Collective-owned Enterprises	34.84	33.15	46.96	22.26	863	3,811	0.799	6.170
Private Industry		16.83		50.71		4,086		9.797
Joint Industry	21.08	32.79	64.44	18.45	1051	5,491	1.681	9.196
Share-holding Industry		26.22		25.63		6,891		12.482
Foreign Founded Industry	23.16	17.80	31.9	20.29	2138	7,590	4.693	19.548

Culculated from *Chinese Industrial Census, 1985, 1995*

Table 3. Methods of appointing managers in enterprises in China (%)

	State owned	Collectives	Foreign funded	Share-holding
Appointment by government	86.0	58.4	33.2	40.4
Election by employees' meeting but with government approval	7.4	21.4	5.0	10.8
Through auction	2.2	3.1	1.5	3.0
Appointment by managerial board	2.5	14.0	58.3	43.0
Others	1.9	3.1	2.0	2.8

Source)Zhongguo Qiyejia Diaocha Xitong, "Hongguan Gaige yu Qiye Fazhan (Macroeconomic Reform and Enterprise Development)" , Guanli Shijie (Management World), 1995 No.1

Table 4. Development of Privatization in Selected European Transition Countries

	1990	1991	1992	1993	1994	1995	1996	1997
Private Sector Share of GDP (%)								
Russia					50.0	55.0	60.0	70
Ukraine				30	30.0	40.5	35.0	50
Poland		45.3	48.2	53.5	56.0	60.0	60.0	
Hungary		33	44	52.4	55.0	60.0	70.0	75
Romania	16.4	23.6	26.4	34.8	38.9	45.0	52.0	58
Czech	12.3	17.3	27.7	45.1	56.3	66.4	75.4	
Slovenia		15.7	19.5		30.0	45.0	45.0	50
Private Sector Share of Employment (%)								
Russia	12.5	13.3	18.3	28.1	33.0	34.4	35.0	
Ukraine			24.1	23.7	27.7	26.9	48.1	52
Poland	48.9	56.6	58.8	62.2	64.9	66.8	72.3	
Hungary (in Non-Financial Sector)			40.8		53.8	54.7		
Romania				46.3	51.3	52.6	53.8	54.2
Czech	19.3	28.7	38.9	59.3	63.7	74.9	76.9	
Slovenia		12.1	15.9	18.7	22.4	37.5		

Source) Public Enterprise Reform and Privatization Database, ECSPF and DECRG

Table. 5 Correlations of profit/revenueratio with share strucrure in listed companies by industry

Category (number of samples)	number of samples with state shares	Profit-revenue ratio with state share ratio	Profit-revenue ratio with unlisted share ratio	Profit-revenue ratio with dominant share ratio
Manufacturing total (302)	(203)	0.1057	0.0364	0.1320
Medicines (23)	(17)	0.4776	0.2475	0.2070
Chemicals (49)	(42)	-0.0439	0.0646	-0.0735
Machinery in general (93)	(54)	-0.1329	0.0979	0.1096
Transport Machinery (26)	(20)	-0.0792	0.2977	0.2454
Metals (30)	(20)	-0.0994	0.0123	0.0293
Textiles (31)	(18)	0.1199	0.0317	0.0088
Energy (24)	(20)	0.1789	0.0490	0.1227
Public Utilities (14)	(10)	-0.3527	0.1797	-0.0896
Com merce (26)	(22)	0.2353	-0.0974	0.2843

Notes) Listed companies on the Shenzhen stock market only. Dominant share ratio means a proportion of the largest marketed shares.

Source) Lin, Yixiang (ed,), '*2000 Shangshi Gonsi Fenxi* (Analysis of Listed Corporations 2000), Zhongguo Caizheng Jingji Chupanshe, 2000

[1] See Nolan, Peter (1995), *China's Rise and Russia's Fall---Politics, Economics and Plannng in the Transition from Stalinism*, MacMillan Press. Of course, we can re place Russia by CEE, FSU, Mongolia, etc.

[2] Liu, Deqiang (2000), "Kokuyukigyou niokeru Shoyuken Kaikakuha Yuko ka? (Does Property Right Reform Improve the Productivity of State-Owned Enterprises?", *mimeo* He estimates that if SOEs were completely privatized, their productivity would increase by 80 to 100 % than now. One of the shortcomings of his analysis is, in our view, that their share of private stocks measures "privateness" of enterprises.

[3] A Chinese economist describes the secured status of SOE workers as such that their dismissal is much harder than putting them in jail.

[4] See Komiya Ryutaro (1989), *Gendai Chugoku Keizai* (The Economy of Contemporary China), Todai Shuppankai

[5] Weitzman, Martin and Chenggang Xu (1994), "Chinese Town ship-Village Enterprises as Vaguely Defined Cooperatives", *Journal of Comparative Economics* Vol.18, pp.121-145, and Tian, Guoqiang (2000), "Property Rights and the Nature of Chinese Collective Enterprises", do., Vol.28, pp.247-268. In our view, their arguments are not con vincing. TVEs' dynamic can be interpreted as stemming from their "de facto privatized" nature.

[6] Justin Lin et al. (1998), *State-owned Enterprise Reform in China*, The Chinese University of Hong Kong

[7] Zhang Weiying (1999), *Qiye Lilun yu Zhongguo Qiye Gaige* (Firm Theory and Enterprise Reform in China), Beijing Daxue Chupanshe

[8] See Steinfeld, Edward(1998), *Forging Reform in China--The Fate of State-Owned Industry*, Cambridge University Press

[9] Jefferson, Gary and Inderjit Singh (eds.) (1999), *Enterp rise Reform in China --Ownership, Transition, and Performance*, Oxford University Press

[10] Jefferson, Gary (1999), "Are China's Rural Enterprises Outperforming State Enterprises? Estimating the Pure Ownership Effect", in Jefferson and Singh (eds.), *op.cit.*

[11] North, Douglas (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge University Press.

[12] This figure is a revision of Imai's. See Imai, Ken -ichi (2000), "ko-pore-togabanansu-no Chugokuteki Kadai (A Task of Corporate Governance for China), Nakagane, Katsuji (ed.), *Gendai Chugoku-no Kozo Hendo dai2kan Keizai—Kozo Hendo to Shijoka* (Structural Transformation of Contemporary China Vol.2 Economy—Structural Transformation and Makrketization), Tokyo Daigaku Shuppankai. He insists that l arge enterprises can not be but governed by able managers rather than being privatized. The thing is how to find and rear such persons. We do not believe that some success stories of SOE management, such as of Changhong, the biggest TV maker in China today, can be a useful guide to entire reform of state enterprises.

[13] If M(p) crosses M(s) like MPK(2) in the Figure, of course, the conclusion differs,but this possibility is very small as Liu's analysis suggests.

[14] The privatized firm in the Figure still suffers another sort of the opportunity loss, since it does not utilize its capital as much as the MPK equals the interest rate. In China, the capital is used at the suboptimal level due to the underdevelopment of capital market and public ownership sys tem.

[15] Megginson, William, Robert Nash, and Matthias van Randenborgh (1994), "The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis", *Journal of Finance*, Vol.49 N0.2

[16] Carlin, Wendy (2000),"Empirical Analysis of Corporate Governance in Transition", in Rosenbaum, Eckehard et al. (eds.), *Privatization, Corporate Governance and the Emergence of Markets*, MacMillan Press

[17] Frydman, Roman, Cheryl Gray, Marek Hessel , and Andrzej Rapaczynski (1997), "Private Ownership and Corporate Performance: Evidence from Transition Economies", *World Bank Working Paper* No.26

[18] Pohl, Gerhard, Robert Anderson, Stijin Claessons and Simeon Djankov (1997), "Privatization and Restructuring in Central and Eastern Europe", *World Bank Technical Paper* No. 368

[19] Estrin, Saul (1998), "Privatization and Restructuring in Central and Eastern Europe" in Boone, Peter, Stanislaw Gomulka and Richard Layard (eds.), *Emerging from Communism--Lessons from Russia, China, and Eastern Europe*, the MIT Press.

[20] Estrin, Saul and Adam Rosevear (1999), "Enterprise Performance and Ownership: The Case of Ukraine", *European Economic Review* Vol. 43, pp.1125-1136

[21] Djankov, Simeon (1999), "Ownership Structure and Enterprise Restructuring in Six Newly Independen t States", *World Bank Working Paper*

[22] Cited in Carlin (2000), p.116.

[23] Liu's study cited above may be an exception. But his study is confined to the steel industry, and the non -state capital ratio as an index of privatization is open to question.

[24] Xu, Xiaonian and Yan Wang (1997), "Ownership Structure , Corporate Governance and Firms' Performance : The Case of Chinese Stock Market Companies", *World Bank Policy Research Working Paper,* No.1794

[25] Chen, Xiao and Dong Jiang (2000), "Guquan Duyuanhua, Gongsi Yeji yu Hangye Jingzhengxing (Ownership Pluralization, Firm Performance and Industry Competition), *Jingji Yanjiu* No.388, pp.28-35

[26] It is often the case that well performing firms are privatized first, leaving loss-making ones state owned.

[27] Frydman, Roman and Andrzej Rapaczynski (1997), "Corporate Governance and the Political Effects of Privatisation", in Zecchini, Salvatore (ed.), *Lessons from the Economoic Transition: Central and Eastern Europe in the 90's,* Kluwer

[28] As far as we know, case studies on privatization effects on large enterprises are neither many nor extensive as compared to those on medium and small ones, probably either because the number of cases is few (e.g. China), or because extensive surveys on large scale privatized enterprises is relatively difficult.

[29] La Porta, Rafael and Florencio Lopez-de-Silanes (1997), "The Benefits of Privatization: Evidence from Mexico", *World Bank Working Paper* No.6215

[30] Frydman, Roman and Andrzey Rapaczynski (1994), *Privatization in Eastern Europe: Is the State Withering Away?*, Central European University

[31] Brada, Josef (1996), "Privatization is Transition--Or is It?", *Journal of Economic Perspectives*, Vol.10 (2), pp.67-86

[32] Yang, Gang (2000), "Zhongxiaoxing Guoyou, Jitiqiye Chanquanshidu Gaige Fenxi (Analysis of property right reform in medium and small sized state and collective enterprises)", paper presented at a workshop held by the Institute of Developing Economies, in Chiba in January 2000.