Competition or Privatization: China's Experience in SOE Reform

Zhibin Zhang, Nanyang Technological University, Singapore

INTRODUCTION

China is usually recognized in economic transition literature as a special case which achieved tremendous economic success simply through competitive market forces, without fundamental reforms in ownership system. That is, the Chinese model is generally regarded as an alternative to the privatization approach which was widely adopted in East Europe and Russia for economic and especially State Owned Enterprise (SOE) reform[1].

This paper examines the characteristics of the Chinese model and identifies the exact nature of China's SOE reform. For this purpose, this research adopted a comprehensive literature review as methodology, with particular focus on existing empirical studies on China's SOE reform and Share Issuance Privatization (SIP). Specifically, first, this paper will describe the process and consequences of economic and SOE reforms in China. Second, it will identify the patterns and features of China's privatization.

ECONOMIC AND SOE REFORM IN CHINA

China officially started economic reform in December 1978. The process of economic reform or more precisely the process of SOE reform[2], according to its coherence to certain targets, can be divided into four phases: expanding SOE autonomy and fiscal decentralization, contract responsibility system and dual track system, corporatization and market economy, and privatization. The major events and policy initiatives since 1978 are summarized in table 1. The first part of this paper will briefly discuss the first three stages, leaving privatization to be examined separately in more detail. The first part of this paper will also review the debate on the nature of Chinese reform, including the arguments and empirical evidences presented in both schools. It then concludes with the identification of existing problems in SOEs.

Table 1: Major Events and Policy Initiatives of Economic and SOE Reforms, 1978-2004[3]

Year	Events and Policy Initiatives	New Laws and Regulations
1978	Economic reform officially launched	
1979	SOE decision-making autonomy and profit retention expanded Development of Township and Village Enterprises encouraged	*Law of Joint Venture*

[1] Zhang, Zhibin *Ownership, Competition, Organizational Change, and Firm Performance: China's Experience in Privatization*, Unpublished Doctoral Dissertation, The George Washington University, 2004

[2] This research mainly focuses on the reforms in the industrial sector, namely the SOE reforms. Other reforms such as agriculture and foreign trade system, which also achieved great success, are omitted.

[3] Data sources are from Gao, S. *Two Decades of Reform in China*. River Edge, NJ: World Scientific, 1999; Jefferson, G., & Rawski, T. China's Emerging Market for Property Rights. *Economics of Transition*, *10*(3), 585-617, 2002; Qi, G. Major Events of Economic Reform since 1978. *People's Daily*, 2003, Oct. 20; and the author.

1981	Individual business encouraged to reduce unemployment	*Contract Law*
1982	Commission for Restructuring the Economic System established	New *Constitution*
1983	'Tax for Profit' and 'Loan for Appropriation' The share of contract workers increased; the use of bonus expanded Party leaders and SOE managers separated	Interim Provisions on SOEs
1986	Contract Responsibility System (CRS)	*Law of Foreign Funded Enterprises*
1987	The share of planning economy dropped to 50% 70% of SOEs implemented CRS at the end of 1987	
1988	Price decontrol tried but failed Competitive mechanism in the selection of SOE managers adopted Small SOEs allowed to be leased to private sector	*Constitution* amended to recognize private sector *SOE Law*
1990	Shanghai Stock Exchange inaugurated	
1991	Shenzhen Stock Exchange inaugurated	
1992	The momentum of economic reform renewed by Deng Xiaoping Socialist Market Economy defined as ultimate goal of reform	
1993	Large-scale layoffs Price decontrol restarted Futures Market inaugurated	*Constitution* amended to remove 'plan economy'
1997	Deng Xiaoping, the greatest man in modern China, died Large scale privatization of small SOEs started	*Price Law*
1998	Layoffs in SOEs accelerated Central government reorganized	
1999		*Constitution* amended to support private sector
2000		*Private Enterprise*

		Law
2001	Access to WTO	
2002	Communist Party opened door for private entrepreneurs	
2003	New State Assets Management Commission established Proposed constitutional amendment backs private property	
2004		*Constitution* amended to back private property

Expansion of SOE Autonomy and Fiscal Decentralization (1978-1983)

China started economic reform in industry[4] with the initiatives of expanding SOE autonomy and promoting incentives, aiming at improving the operation of SOEs[5]. In 1979, SOEs were granted marginal authority and control over decisions about marketing, technical innovation, and, most importantly, the quantity and variety of output beyond mandatory planning targets. Meanwhile, SOEs were allowed to retain part of their total profit. The retained profit was required to deposit into three different funds – welfare, bonus, and investment[6]. Consequently, worker bonuses were adopted widely and rapidly in SOEs as a major component of employee compensation to boost incentives.

Besides granting SOEs autonomous authority and control over operation, the Chinese government decentralized its fiscal system as well. In 1980, a revenue sharing system was established for the central and local governments to 'eat at separate kitchens,' encouraging local governments to develop their own revenues[7].

Contract Responsibility System and Dual Track System (1984-1991)

The second phase of economic reform witnessed further expansions of SOE autonomy and the introduction of a dual track (plan and market) system with an attempt to strengthen the responses of SOEs to market forces. Dating from 1984, the contract responsibility system was implemented to supplant plan targets and to promote additional enterprise autonomy. Under this system, SOE managers or the entire work force signed a contract with the supervising government to fulfill specific total profit targets, long-term profit remittances, productivity increases, in return for extensive control over enterprise operations, including production plan inside the enterprise, substantial retention of excess

[4] Naughton indicates that most accounts which hold that Chinese reforms began in the countryside are actually inaccurate. Rural reforms were launched later than industrial reforms but reaped tremendous success by 1984, much earlier than the still troubled and uncertain status of industrial reforms. The Chinese publicists thus usually claim that reforms had begun agriculture.

[5] Lin, J. Y., Cai, F., & Li, Z. *The China Miracle: Development Strategy and Economic Reform* (Revised ed.). Hong Kong: The Chinese University of Hong Kong Press, 2003

[6] Naughton, B. *Growing out of the Plan: Chinese Economic Reform, 1978-1993*. Cambridge: Cambridge University Press, 1995 (henceforth *Growing out of the Plan*)

[7] Ma, J., & Norregaard, J. *China's Fiscal Decentralization*. Unpublished manuscript, International Monetary Fund, Washington, DC, 1998.

profit, and wage distribution[8]. The contract responsibility system then spread through other areas of economic reforms.

In the beginning of economic reform, SOEs were allowed to transact marginal supplies and commodities outside the plan at market prices which responded increasingly to the forces of demand and supply, with the persistence of compulsory deliveries at state fixed prices in the planning sectors. A dual track system of plan and market, namely the coexistence of commending plan and market channel for resource allocation and goods pricing, emerged, evolving into a most striking feature of the Chinese approach to reform[9]. This Chinese characteristic then pervaded every aspect of economic reform, including sectoral reform, regional development, price decontrol, labor market development, foreign trade promotion, central-local fiscal arrangement, and even ownership reform[10].

Corporatization and Market Economy (1992-1996)

Due to political turmoil in 1989, Chinese reform retrenched till 1992 when Deng Xiaoping renewed the reform momentum. In October 1992, the 14th Communist Party Congress proclaimed that the ultimate objective of economic reform was a "socialist market economy". The year of 1992 marked an irreversible turn for China toward a market economy.

At the apogee of marketization, problems in SOEs persisted, leading to a widely accepted recognition that the root of the poor performance of SOEs could not be just from the lack of market mechanisms. Ownership transformation, however, was politically and ideologically constrained as a solution. Instead, China put its stakes in a Modern Enterprise System (MES), attempting to commercialize SOEs into modern corporations through introducing the private corporate governance practices. The establishment of two stock exchanges in Shanghai and Shenzhen in 1990 and 1991, respectively, created the preconditions for the Modern Enterprise System. Corporatization was fully underway after the *Company Law* came into effect in 1994.

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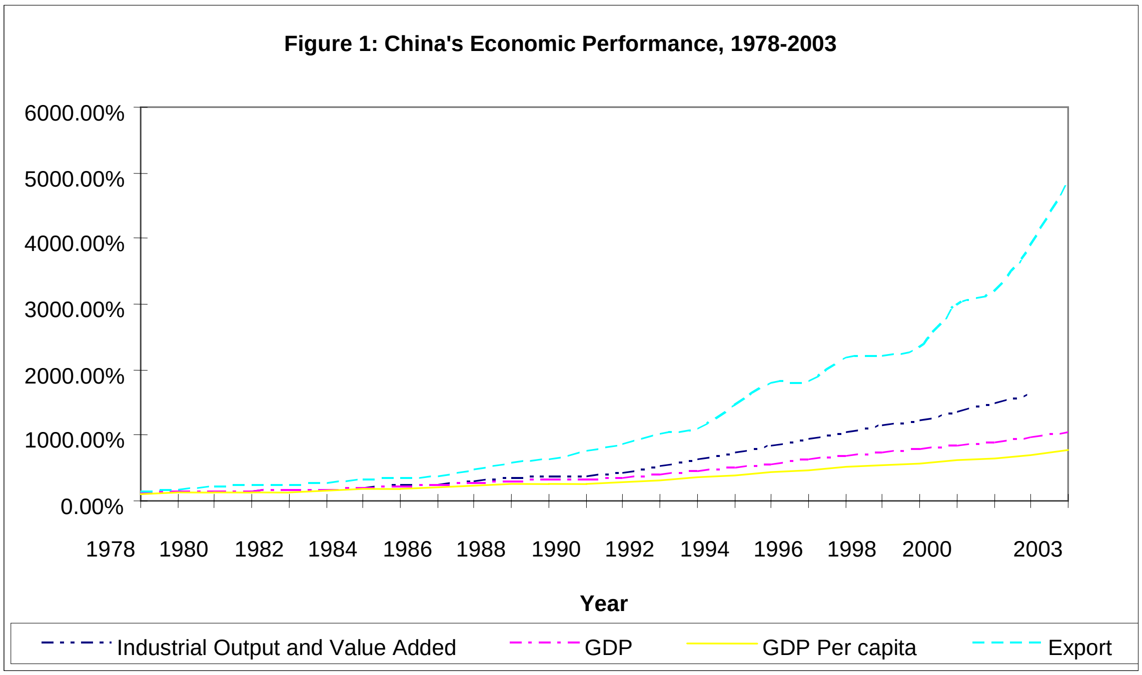
[8] Jefferson, G., & Rawski, T. "Enterprise Reform in Chinese Industry". *Journal of Economic Perspectives, 8*(2), 47-70, 1994 (henceforth "Enterprise Reform") & Naughton, B. *Growing out of the Plan.*

[9] Byrd, W. "A Plan and Market in the Chinese Economy: A Simple General Equilibrium Model". *Journal of Comparative Economics, 13*, 177-204, 1989; Opper, S. "Dual-Track Ownership Reforms: Lessons from Structural Change in China", 1978-1997. *Post-Communist Economics, 13*(2), 205-227, 2001 (henceforth "Dual-Track Ownership"); Tenev, S., Zhang, C., & Brefort, L. *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets*. Washington, DC: World Bank and International Finance Corporation, 2002 (henceforth *Corporate Governance*).

[10] Sachs, J. D., & Woo, W. T. Understanding China's Economic Performance. *NBER Working Paper Series, #5935*, Cambridge, MA, 1997 (henceforth *NBER Working Paper*).

An Alternative to Privatization?

Chinese reform achieved astonishing performance as shown in figure 1[11] in terms of the growth of industrial output, GDP, GDP per capita, and exports. It is very clear that in the first three phases the Chinese model of reform is totally based on a central assumption that the problems of SOEs can be addressed sufficiently by market forces, significant privatization is unnecessary. All reform measures are designed and implemented around a central target of establishing a competitive market, leaving the ownership structure basically unchanged. The existing evaluations of this model, however, are inconclusive and controversial. The review of these evaluations is organized into two parts as follows: the first part discusses different interpretations to the nature of Chinese reform and the second part examines the empirical evidences presented by different schools.



Data Source: Constructed by the author based on China Statistical Yearbook 1996, 1997, 1998, 1999, 2000, 2001, 2002.

The Nature of Chinese Reform

Sachs and Woo[12] identify two schools of thought in interpreting China's successful economic performance and the nature of Chinese reform. One school, labeled by Sachs and Woo as 'experimentalist school,' attributes the economic success to the evolutionary, experimental, and incremental nature of Chinese reform. The other school,

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[11] All original value of GDP, GDP per capita, industrial output value, and exports in 1978 are treated as 1 or 100 percent. The growth rates of GDP per capita and export for 2003 are estimated. Therefore, the value of exports in 2003, for example, is about 50 times of the value in 1978. Caution: the line of the industrial output and value added between 1978 and 1991 reflects the change rate of gross industrial output value, while part of this line between 1993 and 2002 reflects the change rate of industrial value added. Therefore, this line is inconsistent.

[12] Sachs, J. D., & Woo, W. T. *NBER Working Paper #5935, Cambridge, MA, 1997*.

the 'convergence school,' holds that China's successes are derived from the convergence of its institutions with those of existing market economies. Correspondingly, the experimentalist school believes that to sustain success China must continue the distinctive innovations and exceptional strategies. While the convergence school holds that the gradualist nature of Chinese reform is not innovation at all. It simply reflects the lack of a comprehensive and coherent reform blueprint in advance. China's future depends on how fast and how well its institutions are harmonized with normal market economies. Privatization, therefore, will be inevitable with the progress of harmonization.

Specifically, as one of the proponents of the experimentalist school, Naughton[13] argues that the Chinese approach illustrates the feasibility of gradual reform. It shows that SOE performance can be improved through incentive mechanisms and competitive markets in the context of a state-run economy. Jefferson and Rawski[14] argue that the expanded autonomy, reconfigured incentive, and dual track system created a competitive market structure, which induced SOEs to behave like private firms and resulted in rapid economic growth and a significant increase in productivity, demonstrating the viability of gradualism and experimentalism of the Chinese model. Focusing on large SOEs in China, Nolan and Wang [15] argue that, contrary to the 'transition orthodoxy,' large Chinese SOEs have grown and modernized rapidly, showing the possibility to reconstruct industrial institutions without privatization. McMillan[16] attributes China's economic success to the 'nonconformist' nature of Chinese reform, namely the massive entry of new firms and the introduction of profit incentives with only minor privatization. McMillan even advocates generalizing a Chinese approach to other transitional countries.

The most important ingredient of Chinese gradualism is the dual-track system. Laffont and Qian[17] defend this institutional arrangement, arguing that the dual-track system represents a dynamic process in which reform starts in areas or sectors where political constraints are weak and then, after building up constituencies and momentum, extends to other regions or sectors. This propagation process of the dual track system will eventually lead to drastic reforms of overall institutions. Liu and Garinos[18] argue that the dual track system is optimal because it facilitates competition but avoids the cost of ownership transfer.

The convergence school, however, disagrees on the correlation between gradualism and China's economic performance. Sachs and Woo[19] attribute China's rapid economic growth to its extremely low initial condition which provides ample space for rapid catching up. China's phenomenal growth is largely due to the changes outside the state sector, including the transfer of surplus agrarian labor to the industrial sector, the rapid development of non-state firms, and the openness to the world economy. All these

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[13] Naughton, B. *Growing out of the Plan*.
[14] Jefferson, G., & Rawski, T. (1994). "Enterprise Reform".
[15] Nolan, P., & Wang, X. Beyond Privatization: Institutional Innovation and Growth in China's Large State-Owned Enterprises. *World Development, 27*(1), 169-200, 1998.
[16] McMillan, J. China's Nonconformist Reforms. In E. Lazear (Ed.), *Economic Transition in Eastern Europe and Russia: Realities of Reform*. Stanford, CA: Hoover Institution Press, 1995.
[17] Laffont, J.-J., & Qian, Y. The Dynamics of Reform and Development in China: A Political Economy Perspective. *European Economic Review, 43*, 1105-1114, 1999.
[18] Liu, G. S., & Garinos, G. Privatisation or Competition? *Economics of Planning, 34*(1-2), 37-51, 2001.
[19] Sachs, J. D., & Woo, W. T. *NBER Working Paper*.

changes have nothing to do with the gradualism[20]. The increasing deterioration of SOE financial performance since the mid-1990s actually illustrates the failure of gradualism. Furthermore, they attack the dual-track system, arguing that it merely delays the most critical problems China has to overcome for the future.

Particularly, Sachs, Woo, and Yang[21] point out that, if not recognized that economic reforms are only a small part of large scale constitutional transition, the assessment of reform performance will be very misleading. In this sense, China's economic success so far might be illusionary because, under political monopoly due to the absence of constitutional transition, economic reform will be easily hijacked by state opportunism. China's gradualism represented by the dual track system, despite its short-term benefits of buying out the vested interests, generates very high long-term costs of constitutional transition.

Qian[22], however, argues that gradualism and convergence are not necessarily conflicting. Acknowledging that the transitional institutions such as the dual track system and fiscal contracting incur higher costs and generate lower benefit than those 'best practice' institutions, Qian emphasizes that they are the most feasible policy choices for Chinese reform. More importantly, the plan track was finally abolished and fiscal contracting was ultimately replaced with a rule-based modern tax system, illustrating that transitional institutions do not necessarily lead to a partial reform trap, and incremental reforms do not always create obstacles to block further reforms. The destiny of Chinese reform, of course, is to converge with those of existing market economies in developed countries. But the contribution of gradualism and transitional institutions innovated by Chinese reform should not be denied because of their *ad hoc* nature.

In brief, the interpretations of the nature of Chinese reform and the corresponding policy choices they advocated for the future are contentious. Empirical evidences are found supportive of different schools of arguments. To look closer at the truth of Chinese reform, this paper turns to the empirical studies of the Chinese style approach.

The Empirical Evidences

As summarized in table 2, the empirical evidences on Chinese economic and SOE reforms are mixed and inconclusive as well. Some found positive correlation between reform measures and efficiency or productivity improvement, while others found counterproductive or insignificant impact of reforms on firm performance. The following discussion of these empirical studies is organized around specific reform measures.

Table 2: Empirical Studies on Economic and SOE Reforms in China

Study	**Sample description, study period, and methodology**	**Summary of Empirical Findings and Conclusions**
Groves,	Using data of 769 SOEs in four	Managers were induced by

[20] Sachs, J. D., & Woo, W. T. "Experiences in the Transition to a Market Economy". *Journal of Comparative Economics, 18*, 271-275, 1994; & Woo, W. T. "The Art of Reforming Centrally Planned Economies: Comparing China, Poland, and Russia". *Journal of Comparative Economics, 18*, 410-437, 1994.

[21] Sachs, J. D., Woo, W. T., & Yang, X. *Economic Reforms and Constitutional Transition*. Unpublished Manuscript, 2000.

[22] Qian, Y. "How Reform Worked in China". *William Davidson Institute Working Paper #473*, 2002.

Hong, McMillan, and Naughton (GHMN)[23]	provinces in China from 1980 to 1989, examine whether SOE managers respond to expanded autonomy to strengthen employee incentives and whether these incentives lead to productivity growth.	output autonomy and profit retention to strengthen worker discipline. The fraction of bonus in workers' salary and the fraction of contract workers in total labor forces generate increased productivity. However, evidence showing that expanded autonomy increase pre-tax profit is weak. Much of the benefits of autonomy have gone to the SOE workers instead of remitting to the state.
Groves, Hong, McMillan, and Naughton[24]	By the same data of 769 SOEs as the authors did in 1994 in four provinces in China from 1980 to 1989, examine the evidence of managerial turnover, the relationship of performance to managerial contract term and manager selection.	66 percent of SOEs experienced managerial turnover. Managerial turnover with prior low performance is usually involved with auction in the selection, larger security deposit and shorter managerial contract term of new managers. Significant performance increase occurred under a new manager if the previous one was demoted. Meanwhile, managerial incentives are significantly related to linking manager's pay to firm performance. The authors conclude that China had developed a managerial labor market that incorporated many of the incentives present in Western managerial labor markets.

[23] Groves, T., Hong, Y., McMillan, J., & Naughton, B. "Autonomy and Incentives in Chinese State Enterprises". *The Quarterly Journal of Economics*, 109(1), 183-209, 1994.
[24] Groves, T., Hong, Y., McMillan, J., & Naughton, B. "China's Evolving Managerial Labor Market". *The Journal of Political Economy*, *103*(4), 873-892, 1995.

Li[25]	Using a panel data set of 272 SOEs from 1980 to 1989, examines the effectiveness of China's incremental industrial reform by measuring the change of marginal productivity of factors and total factor productivity (TFP).	The marginal productivity of labor and capital except intermediate materials experienced significant increase. Growth in TFP was 4.68 percent per year from 1980 to 1989 and accounted for over 73 percent of output growth. The improved resource allocation, growth in employee bonus, and the increase of competition all contribute significantly to the growth of TFP. The findings suggest that SOE restructuring can improve firm performance without formal privatization.
Liu and Zhuang[26]	With the same panel data as GHMN did in 1994 and 1995 but with a different stochastic cost frontier function, measure the effect of various reform measures on cost efficiency which combines both technical and allocative efficiency.	Despite cost efficiency improved annually with 1.18 percent, the efficiency effects of the industrial reform programs are mixed. Competition has significant positive effect. But the expanded autonomy and the increased proportion of contracted employees are counterproductive, and the use of bonus has no significant effect on cost efficiency. An adequate structure of incentives remains unsolved. But China's experience shows the SOEs are reformable without privatization.
Xu, Zhu, and Lin[27]	Relying on a data set of 884 SOEs nationwide in China during all of 1997 and the first quarter of 1998, study the effects of political control, agency problems, and ownership types on the performance of reformed SOEs.	Both the lessening of politician control through expanded enterprise autonomy in labor deployment and the mitigation of agency problems through introducing corporate governance mechanisms have

[25] Li, D. "A Theory of Ambiguous Property Rights in Transition Economies: The Case of the Chinese Non-state Sector". *Journal of Comparative Economics*, 23(1), 1-19, 1996.
[26] Liu, Z., & Zhuang, J. "Evaluating Partial Reforms in the Chinese State Industrial Sector: A Stochastic Frontier Cost Function Approach". *International Review of Applied Economics*, *12*(1), 9-24, 1998.
[27] Xu, L., Zhu, T., & Lin, Y.-M. *Politician Control, Agency Problems, and Ownership Reform: Evidence from China*. Unpublished manuscript, Washington, DC: the World Bank, 2002.

		positive effect on SOE performance. Relative to state ownership, foreign ownership has positive effect, while employee ownership has negative effect. Furthermore, expanded enterprise autonomy except for labor autonomy has a negative effect, indicating serious agency problems caused by partial reform measures.
McGuckin and Nguyen[28] (1993)	With a data set of enterprises with different ownership (state, collective, and private) in 1980, 1984, and 1985 from the industrial census in 1985, examine the impact of two waves of reforms (1978-1979 and 1983-1984) on the change of gross output and value-added.	Collective and private firms outperform SOEs in the growth of total factor productivity. The proportion of technical workers in total workforce is positively correlated with productivity growth. The profit retention rate in SOEs contributes significantly to the productivity improvement. However, bonus to employees has negative effects.
Dougherty and McGuckin[29]	Using data of 23,000 large and medium industrial firms in China in 1995, isolate the impacts of jurisdiction governance and ownership structure from other factors on productivity.	Regardless of ownership type, industrial enterprises controlled by local governments exhibit significant superior productivity to those owned by central government. Thus decentralization plays a prominent role in improving firm performance. Among centrally controlled firms, ownership is a key determinant of different productivity performance. But for locally controlled firms, virtually no productivity difference between different non-state ownership types, indicating local government administration tends to equalize performance across ownership types.

[28] McGuckin, R., & Nguyen, S. V. "Post-reform Industrial Productivity Performance in China: New Evidence from the 1985 Industrial Census Data". *Economic Inquiry*, *31*(3), 323-341, 1993.
[29] Dougherty, S., & McGuckin, R. *The Effects of Federalism and Privatization on Productivity in Chinese Firms.* Paper presented at the International Society for New Institutional Economics, 6th Annual Meeting, Cambridge, UK, 2001.

Sun[30]	Using data set of 539 SOEs in 13 industries over 4 provinces from 1990 to 1994, examine the effects of the softness of budget constraints due to state ownership and competition on the behavior and performance of SOEs.	SOEs supervised by central government, due to the soft budget constraints, exhibit higher wage rates but significantly lower labor productivity and total factor productivity. Competition, in general, has positive effect on the growth of total factor productivity. But it is not adequate to contain the problems of soft budget constraints caused by state (central government) ownership.
Li, Li, and Zhang[31]	With a big data set over 400,000 SOEs from the third industrial census in China from 1993 to 1995, examine the driving forces behind privatization in China.	Cross-regional competition derived from decentralization triggers privatization.
Shirley and Xu[32] (1998; 2001)	Using GHMN panel data set to analyze the experience of Performance Contracts (PCs), examine whether PCs work in China and how firm performance was affected by different PC provisions, including incentives, targets, bidding, contract length, managerial bonding, and competition.	PCs on average were not significantly correlated with productivity improvements in a large sample of SOEs in China. PCs can only improve productivity when they simultaneously specify sensible targets, offer strong incentives, signal commitment, and in competitive environment. And PCs tend to achieve the effects above under the oversight of local government.
Xu[33]	With the same panel data set as GHMN did, examine the effects of a series of SOE reforms including expanded autonomy, increased competition, performance contract, and managerial	The study finds significant positive correlation between value-added per employee and increasing competition, managerial turnover, raising

[30] Sun, J.. *State-Owned Enterprises in China: Soft Budget Constraints and Competition*. Unpublished manuscript, Department of Economics, Washington University, St, Louis, MO, 1999.
[31] Li, S., Li, S., & Zhang, W. "The Road to Capitalism: Competition and Institutional Change in China", *Journal of Comparative Economics*, 28, 269-292, 2000.
[32] Shirley, M., & Xu, L. "Information, Incentives and Commitment: An Empirical Analysis of Contracts between Government and State Enterprises". *Journal of Law, Economics, & Organization*, *14*, 358-378, 1998 & Shirley, M., & Xu, L. "Empirical Effects of Performance Contracts: Evidence from China". *Journal of Law, Economics, & Organization*, *17*(1), 168-200, 2001.

	turnover on value-added per employee as the proxy of firm performance.	profit retention rate, and managerial discretion on wages and production. However, the performance contract did not improve performance significantly.
Huang and Kalirajan[34]	Using panel data of 67 SOEs from China's four coastal cities in 1992 and a stochastic varying coefficient frontier approach, examine the contribution of enterprise management reform and the competitive market forces to the growth of technical efficiency.	The proportion of planned production in SOEs is negatively correlated with the firm, capital, and labor specific efficiency measures. The degrees of participation in exports significantly raised the technical efficiency. However, the enterprise management reform measures including asset responsibility system, the contract system, the director responsibility system, and the share-holding system have no significant correlation with the growth of technical efficiency.
Opper[35]	Using macroeconomic data from 1978 to 1997, compare different employment adjustments in the dual-track system.	The structural adjustment in employment in the old planning track lagged far behind the market track. The increasing competition from the market track did not force structural adjustment of the old track as long as institutional settings of SOEs are not significantly changed.
Lee[36]	With a panel data set of 681 SOEs in four provinces from 1980 to 1994, examine the effect of corporatization on worker wage, employment, and productivity.	Corporatization lowered basic wages by 11 to 15 percent, but the incentive payment keeps unchanged. Corporatization improves productivity by 6 percent as well. Evidence shows the correlation between corporatization and adjusting employment is weak. Corporatization has the potential

[33] Xu, L. Control, "Incentives and Competition: The Impact of Reform on Chinese State-Owned Enterprises". *Economics of Transition*, 8(1), 151-173, 2000.
[34] Huang, Y., & Kalirajan, K. P. "Enterprise Reform and Technical Efficiency of China's State-Owned Enterprises", *Applied Economics*, 30, 585-592, 1998.
[35] Opper, S. "Dual-Track Ownership".

		to be an effective mechanism to restructure troubled SOEs in China.
Lin and Zhu[37]	Using data set of 2,632 corporatized SOEs in 1998, present the profile of corporatization process and organizational features; examine how the corporatization process was shaped by various factors.	Corporatization is seriously defective due to continued government interference. However, such government involvement is inevitable because of the lack of necessary institutions. The long run success of corporatization, therefore, depends on the development of legal and market institutions.
Tian[38]	Using panel data across 30 provinces and municipalities in China from 1985 to 1997, examines the contribution of investment from different ownership to the growth of GDP and productivity in these provinces and municipalities.	The more the investment moves to private hands, the more GDP growth. Provinces with more privatization witness greater gains in productivity and economic growth. And this is robust in different categories of ownership.
Li and Wu[39]	Based on a panel data set of 680 SOEs in China from 1980 to 1994, examine the relative effectiveness of ownership transformation and management improvement on firm performance (total factor productivity and gross rate of return on assets).	Ownership diversification through introduction of other types of ownership yield significant improvement in performance of SOEs. While the effects of management reform including expanded autonomy and profit incentives are mixed. China, therefore, should focus on ownership reforms in the future.
Wen, Li, and Lloyd[40]	Comparing enterprises with all different ownership types within six industries as well as across these industries from the third industrial census of China in 1995, examine the	Evidence shows that enterprises with ownership types other than state ownership, domestic collective ownership, and joint domestic ownership are

[36] Lee, Y. "Wages and Employment in China's SOEs, 1980-1994: Corporatization, Market Development, and Insider Forces". *Journal of Comparative Economics*, 27, 702-729, 1999.
[37] Lin, Y.-M., & Zhu, T. "The Restructuring of Ownership and Governance in China: An Empirical Study of the Shareholding Reform". *Seoul Journal of Economics, 13*(3), 279-300, 2000.
[38] Tian, L. "Government Shareholding and the Value of China's Modern Firms". Unpublished manuscript, 2002.
[39] Li, D., & Wu, C. "The Ownership School vs. the Management School of State Enterprise Reform: Evidence from China". William Davidson Institute Working Paper #435, 2002.

	relationship between ownership and technical efficiency with the stochastic frontier production function approach.	technically more efficient on average than these three ownership types.
Zhang, Zhang, and Zhao[41]	Via a panel data set covering all industrial enterprises in Shanghai from 1996 to 1998, examine and quantify the effect of ownership and market competition on the productive efficiency and efficiency growth.	Different ownership types lead to significantly different efficiency levels, with foreign ownership exhibiting highest efficiency and SOEs lowest. The degree of competition from international market is positively associated with firm efficiency. However, domestic competition has no such correlation with efficiency. The ownership effects are robust across different competitive markets and different industries, indicating the overwhelming effects of ownership to competition.

The analysis above presents a brief description of the market oriented Chinese reform. The evaluations of this Chinese model, nevertheless, are mixed and inconclusive. The empirical studies verify the contributions of Chinese reform to the spectacular economic performance, but also find extreme limitations of the competition without privatization strategy. In fact, despite those market measures introduced since the end of the1970s, including the expanded autonomy, the use of incentives and contracts, and corporatization, the financial performance of SOEs has been increasingly deteriorating since the early 1990s. According to Sachs and Woo[42], two-thirds of SOEs ran losses in 1992 even with a 13 percent output growth in that year. And in 1996, with total loss at 79.07 billion RMB and total profits at only 41.26 billion RMB[43], the whole SOE sector slid into deficit for the first time. The National Statistical Bureau reports that, in 1998, the ratio of total debt (the sum of liquid liabilities and long term liabilities) to total assets in SOEs is 65.9 percent, with 2.2 percent higher than average level nationwide; and the debt interest accounts for 37.9 percent of the total sale profits.[44]

Having realized the limitations of competition without privatization, the 15th Communist Party Congress in 1997 officially proclaimed an ownership transformation

[40] Wen, M., Li, D., & Lloyd, P. "Ownership and Technical Efficiency: A Cross-Section Study on the Third Industrial Census of China". *Economic Development and Cultural Change, 50*(3), 709-734, 2002.
[41] Zhang, A., Zhang, Y., & Zhao, R. "Impact of Ownership and Competition on the Productivity of Chinese Enterprises". *Journal of Comparative Economics*, 29, 327-346, 2001.
[42] Sachs, J. D., & Woo, W. T. *NBER Working Paper*.
[43] Qi, D., Wu, W., & Zhang, H. "Shareholding Structure and Corporate Performance of Partially Privatized Firms: Evidence from Listed Chinese Companies". *Pacific-Basin Finance Journal, 8*, 587-610, 2000.
[44] National Bureau of Statistics. *The Prosperous Industrial Economy*. Beijing: National Statistical Bureau, 1999.

policy of 'grabbing the large and letting go of the small ones,' namely privatizing the medium and small SOEs but retaining the dominance of state ownership in large ones. China's privatization, once again, is characterized by the dual-track strategy. Despite the reserved commitment of the leadership, China's privatization accelerated. The Chinese reform formally entered its fourth phase of privatization.

PRIVATIZATION IN CHINA

China undertook the sale of state property to the private sectors – the strict definition of privatization, although occurring very late at the end of the 1990s, including the Share Issuance Privatizations (SIPs) and direct sale of state assets. Particularly, China's commitment to a massive or large-scale 'normal' privatization program seemed intensified in recent years.

China started SIPs in December 1990 and July 1991 with the inauguration of two stock exchanges in Shanghai (SHSE) and Shenzhen (SZSE), respectively. SIPs grew rapidly in China, although with significant instability. In 2000, the total market capitalization in two stock markets accounted for more than half of GDP. The basic information of SIPs is summarized in table 3.

Table 3: Basic Information of Share Issuance Privatizations in China, 1992-2002[45]

Year	Number of Total Listed Firms	Total Market Capitalization (100 Million RMB)	Ratio of Market Capitalization to GDP	Float Market Capitalization (100 Million RMB)	Ratio of Float Market to Market Capitalization
1992	53	1048.00	3.93%	N/A	N/A
1993	183	3531.00	10.20%	862.00	24.41%
1994	291	3690.61	7.89%	969.00	26.26%
1995	323	3474.00	5.94%	938.00	27.00%
1996	530	9842.00	14.50%	2867.00	29.13%
1997	745	17529.00	23.54%	5204.00	29.69%
1998	851	19506.00	24.90%	5746.00	29.46%
1999	949	26471.20	32.26%	8214.00	31.03%
2000	1088	48090.90	53.77%	16088.00	33.45%
2001	1154	43522.20	45.37%	14463.00	33.23%
2002	1223	38329.13	37.43%	12484.00	32.57%

The blueprint for SIPs is the *Company Law* effective on July 1st, 1994. In accordance with this law and other relevant regulations, tradable shares are divided into domestic (A- shares) and foreign (B-shares, sold solely to foreign investors and residents from Hong Kong, Macau, and Taiwan; H-shares, issued in Hong Kong stock market; and N-shares, issued in New York stock market). The average ratio of foreign shares to all

[45] This table is constructed by the author based on China Statistical Yearbook 1996, 1997, 1998, 1999, 2000, 2001, 2002 (National Statistical Bureau) and the website of China Securities Regulatory Commission (CSRC) at www.csrc.gov.cn

companies is less than 2.5 percent[46]. Due to their insignificance, analyses of foreign shares are simply omitted in this research.

Not all shares in any listed SOEs are publicly tradable. That is, the publicly traded A-shares only account for a portion of the total shares in listed SOEs. The *Company Law* requires the ratio of A-shares to be 25 percent or more of total outstanding shares when the company makes its initial public offering. But in practice this ordinance was not followed particularly in the early stages[47], the actual ratio of A-shares ranges from 17 to 33 percent of total shares[48]. A-shares are the only type of equity that is permitted to be traded among domestic investors at the two exchanges. Hence the total shares or the total market capitalizations in Chinese stock markets do not reflect the true traded volume. Instead, China uses an unusual indicator of "float market capitalization" to measure the value of tradable A-shares, which accounts for about 33 percent of total market capitalization in recent years. The effects of A-shares on firm performance in China are inconclusive and controversial. Most scholars argue that A-shares have a trivial impact on corporate governance owing to two reasons: A-shares are extremely dispersed and the turnover rates of A-shares are exceptionally high (the average holding period is about 1 to 2 months, compared with 18 months in United States[49], indicating the investors have low motivations and usually free-ride to monitor firm performance because of the loose correlation of cost and benefit of such behaviors. However, still some researchers argue that A-shares have positive performance effects owing to their nature of pure private ownership.

Besides tradable A-shares, a listed SOE has three other shares: state shares, legal person shares, and employee shares. State shares are held by the central government or local governments, but usually controlled by state asset management agencies, financial bureaus, or solely state-owned investment companies. To preserve the dominance of state ownership, it is required that SOEs must issue shares to the government for free and these state shares must not be less than 35 percent of total shares. This requirement, however, was not well followed in practice either. In 1995, the state controlled 35 percent of total shares in SHSE listed firms but only 22 percent in SZSE[50]. Nevertheless, in many cases, the largest shareholder is always the state, without any comparable and contestable second or third largest shareholders. By 1999, for example, 42 percent of the largest shareholders are state shares[51]. State shares are not permitted to be publicly traded, but are transferable to domestic institutions even including private institutions upon the approval of the China Securities Regulatory Commission (CSRC). SIPs in China, therefore, are a kind of partial privatization. Although theoretically some researchers argue the desirability of partial privatization[52], generally, most view it as a poor

[46] Sun, Q., & Tong, W. H. S. "China Share Issue Privatization: The Extent of it Success". *Journal of Financial Economics, 70,* 183-222, 2003 (henceforth "China Share Issue").
[47] Mok, H. M. K. "The Evolution of China's Stock Market". In C. K. Lo & T. K. Yuen (Eds.), *China Review1995* (pp. 1-14). Beijing: Chinese University Press, 1995.
[48] Sun, Q., & Tong, W. H. S. "China Share Issue".
[49] Xu, X., & Wang, Y. "Ownership Structure and Corporate Governance in Chinese Stock Companies". *China Economic Review, 10*, 75-98, 1999 (henceforth "Ownership Structure").
[50] Ibid.
[51] Tenev, S., Zhang, C., & Brefort, L. *Corporate Governance*.
[52] Jefferson, G. China's State Enterprises: Public Goods, Externalities, and Coase. *American Economic Review, 88,* 428-432, 1998; Perotti, E. C. Credible Privatization. *American Economic Review, 85*, 847-859,

governance structure, making monitoring difficult and the mechanisms of takeover and bankruptcy incredible.

Legal person shares are held by domestic institutions, including industrial enterprises, stock companies, trust and investment companies, foundations and funds, construction and real estate companies, transportation and power companies, and technology and research institutes[53]. Most of them, however, are eventually state owned. As in the case of state shares, many of the largest shareholders are the holders of legal person shares. In 1995, for example, 24 percent of legal person shareholders in SHSE-listed firms held more than 50 percent of total outstanding shares and the same case for 25 percent of SZSE-listed firms[54]. Legal person shares are not allowed to be publicly traded, but transferable upon the approval of CSRC. Hence in most cases, the state directly or indirectly (through legal person shares) owns and controls listed companies. Although most domestic institutions are eventually state owned, those with legal person status are somehow independent from the state with separate accounting systems and self-responsibility for benefits and losses. Thus legal person shareholders are suggested to have more incentives than the state to monitor listed firms for efficiency improvement and profit maximization. But still other researchers argue that legal person shares are vulnerable to state interference, and, moreover, sometimes legal person shareholders may benefit themselves at the expense of other shareholders[55].

Employee shares only make up less than 2 percent of total shares, functioning primarily as benefits for employees and management rather than an incentive mechanism and completely unimportant in firm operation. After having been held for 6 to 12 months, employee shares can be sold in the open stock market upon the approval of CSRC. The issuance of employee shares was discontinued in 1998, making it even more insignificant in the ownership structure.

To summarize, the patterns of ownership structure in Chinese listed firms through Share Issuance Privatizations (SIPs) are as follows:

(1) SIPs in China are partial privatizations. The state still retains substantial shares in most of the listed firms.
(2) Correspondingly, ownership structures are relatively concentrated. Tenev et al. find in their sample of 257 SHSE-listed firms in 1999 that, on average, the three largest shareholders held 58 percent of total shares, of which the largest one held 47 percent, 8 percent for the second largest and 3 percent for the third largest[56].
(3) The total shares are equally divided among three parts: state shares, legal person shares, and tradable A-shares, with each accounting for approximately 30 percent of total outstanding shares.

1995; Schmitz, P. W. Partial Privatization and Incomplete Contracts: the Proper Scope of Government Reconsidered. *FinanzArchiv, 57*, 395-411, 2000.

[53] Tenev, S., Zhang, C., & Brefort, L. *Corporate Governance.*

[54] Xu, X., & Wang, Y. "Ownership Structure".

[55] Chen, Y. M., & Gong, S. C. Ownership Structure and Corporate Performance: Some Chinese Evidence. In T. A. Fetherston (Ed.), *Advances in Pacific Basin Financial Markets* (Vol. 6, pp. 177-193). New York: JAI, 2000; Sun, Q., & Tong, W. H. S. "China Share Issue".

[56] Tenev, S., Zhang, C., & Brefort, L. *Corporate Governance*.

(4) The tradable A-shares are highly dispersed with exceptionally high turnover rates, indicating individual investors in China primarily seek short-term trading profits rather than dividend or long term growth.
(5) Legal person shareholders are similar to the institutional investors in the advanced market economies, with most of them eventually state owned or controlled.

Consequently, the governance structures, consisting of the board of directors, supervisory committee, and shareholder annual meeting, are biased to the control of state or legal person shareholders. First of all, the board of directors is overrepresented by state and legal person shareholders. Although each of state shares, legal person shares, and tradable A-shares makes up approximately 30 percent of total shares, the board membership controlled by A-shares is extremely low. Xu and Wang find that, in their sample of 154 listed firms in 1995, individual shareholders have no more than 0.3 percent of the total board seats on average[57]. Tenev el al. find a much higher ratio in their sample of 257 SHSE-listed firms[58], but still with no more than 6 percent of total board membership representing individual shareholders. On contrast, based on different samples, some find that the state is highly overrepresented with 50 percent of board membership[59], others find the legal persons are overrepresented with 63 percent of board seats[60]. Secondly, such highly biased governance structures occurred in the supervisory committee and shareholder annual meeting as well, characterized with extremely low presence of individual shareholders. In short, the governance structure is not proportional to the ownership structure, with biases to the state or legal person shareholders.

These ownership and governance structures seem problematic, reflected in the deteriorating performance of Chinese stock markets in the past years. The average earnings per share was 0.35 RMB in 1994, 0.27 in 1995, 0.29 in 1996, 0.248 in 1997, 0.185 in 1998, 0.2069 in 1999, 0.211 in 2000, 0.136 in 2001, and 0.127 in 2002[61], while China's GDP was soaring during the same period. However, some researchers argue that such structural arrangements, even though inconsistent with the best practices, are feasible adaptations to the particular political and economic conditions in China, reflecting the government's serious concerns to protect stock markets and their commitments for continuous Share Issuance Privatizations. In other words, through remaining substantial state ownership and disproportionately high state control, the government can maintain an orderly flow of privatization so as not to overwhelm the fledgling stock markets and thus make it possible for following Share Issuance Privatizations in the future. Meanwhile, high state shares signal the government's confidence in the listed firms and a business guarantee, lowering the *ex ante* uncertainties for domestic investors[62]. Nevertheless, others argue that if the firm performance

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[57] Xu, X., & Wang, Y. "Ownership Structure".
[58] Tenev, S., Zhang, C., & Brefort, L. *Corporate Governance*.
[59] Xu, X., & Wang, Y. "Ownership Structure".
[60] Tenev, S., Zhang, C., & Brefort, L. *Corporate Governance*.
[61] Han, Q. *Solving the Conflict between Tradable and Non-tradable Stock*, from http://www.my0578.com/news/2003/01/21/1044403.htm, 2003.
[62] Chen, G., Firth, M., & Rui, O. *Have China's Enterprise Reforms Led to Improved Efficiency and*

continued deteriorating, both the concerns to protect stock markets and the optimal signal effects would fail. Resorting to empirical evidences, therefore, is the best way to clarify the debate and figure out what on earth the effects of such ownership and governance structures on firm performance are. The findings from these empirical studies on Share Issuance Privatization (SIPs) in China are summarized in table 4 as follow:

Table 4: Empirical Studies on Share Issuance Privatizations (SIPs) in China

Study	Sample description, study period, and methodology	Summary of Empirical Findings and Conclusions
Xu and Wang[63]	Using panel data set of all listed firms in China from 1993 to 1995, examine the effects of ownership concentration on firm performance and then differentiate the effects of different ownership type with particular focuses on state ownership and legal person ownership. The proxies of performance are the market-to-book value ratio (MBR), return on equity (ROE), and return on assets (ROA). Ownership concentration is measured by the proportion of shares held by the top 10 shareholders.	Ownership concentration has significant impact on performance. Because the largest shareholders usually concentrate on state and legal person shareholders, this impact should be interpreted as positive correlation of firm performance to state and legal person ownership concentration. However, the positive effects on firm performance are only found in the legal person ownership types. Both state ownership and individual ownership are negatively correlated with firm performance. Furthermore, the inefficiency of state ownership is evident in its deviating political objectives in excessive employment.
Qi, Wu, and Zhang[64]	With a data set of all listed firms in SHSE from 1991 to 1996, examine the relationship between shareholding (ownership) structure and firm performance.	Firm performance is positively correlated with the proportion of legal person shares but negatively related with state shares. Moreover, performance increases with the degree of relative dominance of legal person shares to state shares. However, the relationship between firm performance and tradable A-shares and foreign B-shares is insignificant.
Sun and Tong[65]	With a panel data set of 634 listed firms in China from 1994 to 1998,	Real net profit (RNP) increased significantly after SIPs, but the ratio of

Profitability? Unpublished manuscript, The Hong Kong Polytechnic University, Hong Kong, 2002; Mok, H. M. K., & Hui, Y. V. (1998). Underpricing and the Aftermarket Performance of IPOs in Shanghai, China. Pacific-Basin Finance Journal, 6, 453-474.

[63] Xu, X., & Wang, Y. "Ownership Structure".

[64] Qi, D., Wu, W., & Zhang, H. "Shareholding Structure".

	examine the effects of Share Issuance Privatizations (SIPs) on firm performance by MNR method[66], namely comparing the performance of 3 year pre- and 3 year post-privatization. Meanwhile, they explore the relationship between performance changes and ownership structural changes after privatization.	profit to sales decreased. And, contrary to other findings, leverage level increased after privatization increased. These results are robust with considering the changes in macroeconomic activities, indicating partial privatization through SIPs in China achieved limited success. Further analyses show negative effects of state ownership on firm performance, but increase in legal person ownership and foreign ownership contribute positively to performance improvement.
Jia, Sun, and Tong[67]	Using panel data of 41 firms listed in Hong Kong Stock Exchange from 1993 to 1998, compare performance changes after privatization with MNR methods and explore the relationship between different ownership type and performance changes.	Net profit dropped after privatization, but without statistical significance. However, returns on sales, on assets, and on equity all significantly decreased after privatization. Moreover, privatization did not result in reduction of leverage. Nevertheless, real output increased significantly. Further analyses show that the remaining state ownership has a negative role in profitability, while the legal person shares and foreign shares contribute positively to performance improvement.
Chen, Firth, and Rui[68]	Using panel data set of 735 listed firms privatized from 1991 to 1997, examine the effects of Share Issuance Privatizations on profitability, asset efficiency, capital expenditure, sales, and debt ratios with MNR methodology but extending the post-privatization period to 5 years.	Both profitability, measured by the ratios of profit to sales, assets, and equity, and asset efficiency, measured by the ratio of sales to assets, deteriorated significantly after privatization. Though sales and capital expenditure efficiencies, measured by the ratios of capital expenditure to sales and to assets, improved significantly. Moreover, the debt to equity ratios dropped after privatization. These findings are robust across different ownership types. Privatization in China, therefore, is unsuccessful at least in terms of profitability and efficiency.

[65] Sun, Q., & Tong, W. H. S. "China Share Issue".
[66] Megginson, Nash, and Randenborgh in 1994 first use the comparison of 3 year pre and 3 year post privatization to measure the effects of privatization on firm performance. Then Megginson and Netter (2001) call it as 'MNR' methodology.
[67] Jia, J., Sun, Q., & Tong, W. H. S. (2002). *Privatization via Overseas Listing: Evidence from China's H-Share Firms*. Unpublished manuscript.
[68] Chen, G., Firth, M., & Rui, O. *Have China's Enterprise Reforms Led to Improved Efficiency and Profitability?* Unpublished manuscript, The Hong Kong Polytechnic University, Hong Kong, 2002.

Wei, Varela, D'Souza, and Hassan[69]	Using panel data set of 208 listed firms (but for some regressions, only 82 firms are used) in China from 1990 to 1997, measure the effects of privatization on firm performance with MNR methods and then compare the performance difference.	Profitability represented by net profit experienced significant increase, but return to sales has insignificant changes. Both real sales and real assets increased significantly. However, employment had insignificant increase. Sales per employee increased and leverage decreased, both significantly. Further analysis shows privatized firms outperform full state-owned firms in profitability. Therefore, privatization works in China.
Wang [70]	Using a panel data set including all listed firms in China from 1994 to 2000, examine the effects of two different types of state shareholders, bureaucratic state shareholders and corporate state shareholders, on firm performance and managerial turnovers.	Firms with corporate state shareholders (SOEs or state-owned economic entities act as shareholders) outperform those firms with bureaucratic state shareholders (government bureaus act as shareholders). Meanwhile, managerial turnovers in firms with bureaucratic shareholders are less sensitive to poor performance. No significant differences of performance and managerial turnovers exist between firms with corporate state shareholders and those without state shares at all.
Chang and Wong[71]	With a survey data of 71 firms listed on SHSE from 1997 to 1999, examine the effects of political interference with proxies of the degrees of party control and the presence of government representatives on the board on firm performance.	By separating the effects of political interferences from agency problems, both the degree of party control and the increasing ratio of the presence of government representative on the board have detrimental impact on firm performance.
Wong, Opper, and Hu[72]	Using the same survey data set Chang and Wong did in 2002, examine the relationship between ownership structure, political	Party control is negatively correlated with the ratio of tradable A-shares, but has insignificant relationship with the ratios of legal person shares or foreign

[69] Wei, Z., Varela, O., D'Souza, J., & Hassan, K. "The Financial and Operating Performance of China's Newly Privatized Firms". *Financial Management, 32*(2), 107-126, 2003.
[70] Wang, J. *Governance Role of Different Types of State Shareholders: Evidence from China's Listed Companies.* Unpublished Doctoral Dissertation, The Hong Kong University of Science & Technology, Hong Kong., 2002.
[71] Chang, E. C., & Wong, S. M. L. *Corporate Governance, Political Interference, and Corporate* Performance of China's Listed Companies. Unpublished manuscript, 2002.
[72] Wong, S. M. L., Opper, S., & Hu, R. *Shareholding Structure, Depoliticization, and Firm Performance:* Lessons from China's Listed Firms. Unpublished manuscript, 2003.

	interference (party control), and firm performance.	shares. Furthermore, party control is significantly negatively correlated with performance measured by ROA and ROE. This negative effect, however, can be significantly mitigated by the existence of legal person shares, but not by A-shares or foreign shares. Therefore, both exit (increasing the ratio of A-shares) and voice (increasing the ratio of legal person shares) channels exist to address the party control problem in listed firms of China.
Fan, Lau, and Wu[73]	Using a panel data set of 496 listed firms in China from 1997 to 1999, examine the effects of ownership structure, board structure, and managerial compensation on firm performance.	Ownership concentration and the fraction of employee shares have positive impacts on firm performance, but the ratio of major officer's shareholdings does not. Both the ratio of insider directors and managerial compensation are insignificantly correlated with firm performance, indicating the supportive evidences for the effectiveness of governance mechanisms in Chinese listed firms are weak.
Tian[74]	With all listed firms in China from 1994 to 1998, examine the impact of different shareholdings on corporate value.	The government shareholding is negatively correlated with corporate value. This relationship, however, is not monotonic. That is, when the share of government shareholding is small and dominated by non-government shareholdings, the negative impact is small too. With more shareholdings moving to government, the detrimental effect increases. But when government shareholdings are sufficiently large as to dominantly control the firm, the negative correlation decrease again. The U-shape relationship indicates government can be both detrimental and helpful.

[73] Fan, D., Lau, C.-M., & Su, S. "Corporate Governance Mechanisms". In A. Tsui & C.-M. Lau (Eds.), *The Management of Enterprises in the People's Republic of China*. Boston: Kluwer Academic Publishers, 2002.
[74] Tian, L., *Government Shareholding and the Value of China's Modern Firms*. Unpublished manuscript, 2002.

CONCLUSION

The objective of this paper is to provide an understanding of the nature of China's SOE reform. It began with the description of the Chinese model for economic reform. This Chinese approach, despite its spectacular economic achievements, demonstrated an incomplete and informal nature in many of its institutions. These limitations were primarily from the central strategy and assumption of the Chinese SOE reform, namely SOEs could be improved simply with competitive forces, significant ownership transformation was unnecessary. Market measures, including enterprise autonomy, incentives, price liberalization, and corporatization, were all introduced and tried to save SOEs. However, SOE performance has been increasingly deteriorating since the early 1990s.

Having realized the limitations of the Chinese model, China officially initiated privatization programs in the late 1990s. Particularly, the generally defined privatization, the sale of state property, particularly the Share Issuance Privatizations (SIPs), developed rapidly in the 1990s. These privatizations, however, were tainted by the incomplete and informal nature of Chinese reform, reflected in their biased ownership structure and ineffective corporate governance, which is further embodied in the limited performance improvement in those listed firms.

It seems that privatization is clearly the answer for China's future SOE reform. Particularly, the empirical studies show that private ownership outperformed state ownership in almost every area. In order to maintain the current momentum of rapid economic growth, China should commit itself in a comprehensive and fundamental ownership transformation from state ownership to private ownership. China's experience in SOE reform, therefore, only provided proofs that privatization is ultimately the fundamental way for economic transition, although it requires more deliberate design and more effective management.