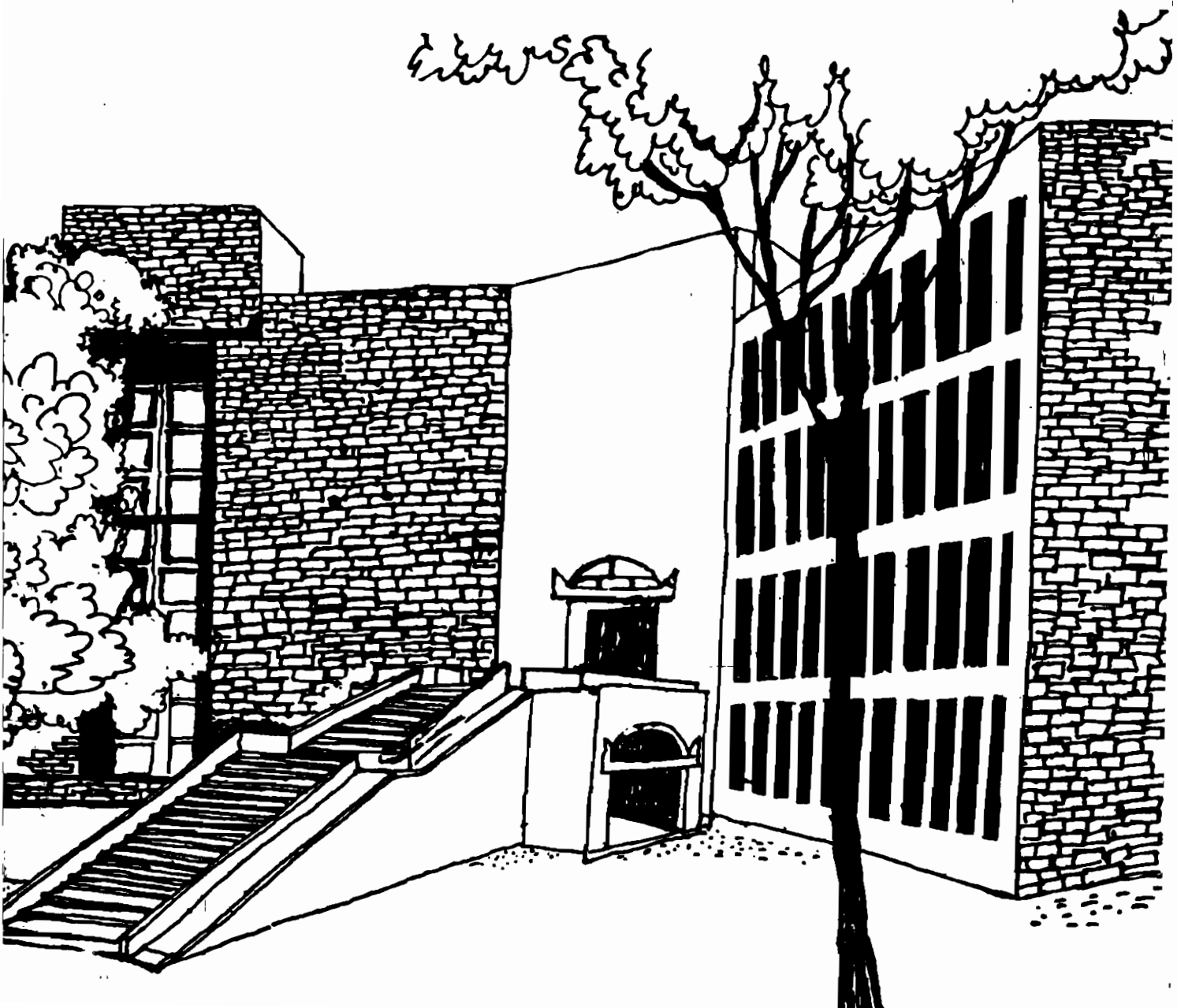




Working Paper



Privatisation in China: Softly, softly does it

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Abstract

India's halting attempts at privatisation and its preference, for the most part, for disinvestment have been roundly criticised by many as being inadequate. A more aggressive privatisation drive, it is contended, would make for superior economic performance. In popular discourse, China's privatisation efforts are often compared favourably with India's.

This paper examines China's record of privatisation to see whether it accords with popular perceptions. The record shows that China has proceeded cautiously in its privatisation efforts. It has privatised – that is, sold off to private owners- only the smaller SOEs. The state retains control over the larger SOEs that dominate industrial output and profits. In respect of these, China has opted for gradual disinvestment with disinvested shares residing mostly with state-owned entities.

Over a long period, China has pushed through reforms of SOEs, including conferment of greater autonomy on enterprises and introduction of incentives for workers and managers. The empirical evidence is that performance at SOEs has improved consequent to these reforms. It could be argued that full-blooded privatisation might have produced even better results. However, given the possible implications in terms of job losses as well as the absence of effective governance mechanisms in China's underdeveloped capital market. China's rulers may well have been justified in hastening slowly with privatisation.

Privatisation in China: softly, softly does it

T T Ram Mohan

Introduction

India's economic reforms and the performance of the Indian economy cannot escape comparison with China's- and India tends to suffer in comparison. This is true of privatisation as well. In pronouncements made by politicians favourably disposed towards privatisation and also in the business press in general, China is portrayed as having proceeded vigorously with privatisation in stark contrast to India's own bumbling efforts in that direction.

China, we are told, has sold off thousands of state-owned enterprises (SOEs) to private owners whereas we in India have barely managed to sell a handful. China has fewer hang-ups about the state withdrawing from commercial activities than India and this is part of the reason why China has experienced more rapid growth.

Is this true? Does China's privatisation mark a major reversal of the communist party's ideological position favouring a dominant position for

SOEs in the economy? These questions are worth addressing because of the linkage that is sought to be established between aggressive privatisation and rapid growth. SOEs have been a big part of the economy in China (as in India), so it is useful to examine China's approach to privatisation to see whether it holds any lessons for us in India.

The rest of the paper is as follows. Section 2 provides an overview of SOE reforms in China. In Section 3, we review some of the empirical evidence on the impact of SOE reforms and privatisation in China. Section 4 examines the contention that privatisation might have been a better alternative to SOE reforms and disinvestment. Section 5 concludes.

2. SOE reforms in China: an overview

Like most other economic reforms, China's substantive reform of SOEs, culminating in privatisation in recent years, precedes India's by more than a decade. It is worth emphasizing at the very outset that this process, which commenced in the late seventies, has, for most of the period, largely involved SOE reform rather than privatisation. Privatisation in the sense of sale of SOEs to private parties is a relatively recent development.

State ownership of enterprises is seen to have two fundamental flaws. There is a 'soft budget' constraint, meaning funds are available regardless of

whether the businesses are profitable; and, secondly, there is lack of autonomy or political interference that makes it difficult for firms to pursue commercial objectives whole-heartedly. These problems can be further magnified if the state sets prices instead of leaving it to markets to do so.

China's reform of SOEs has been aimed at addressing each of these problems. Hay et al (1994) have chronicled the progress of such reforms up to the mid-nineties in detail. They identify four stages in the reform process up to the early nineties. From 1978-80, the focus was on increasing enterprise autonomy; in the second stage, 1981-82, reform focused on contract profit delivered to the state; in 1983-86, profit delivery was sought to be substituted by taxes; and from 1987 onwards, the focus changed to the institution of a contract-responsibility system. In 1992, a new stage began, namely, the share system.

Alongside these reforms aimed at improving enterprise autonomy, price reforms were also carried out. There was also a certain hardening of hard budget constraints and greater competition in product and factor markets was encouraged.

To take up price reforms first, meaningful price reform commenced only in May 1984 when a dual-price system was adopted for the inputs and outputs

of SOEs. Inputs and outputs that were part of state plans would be covered by state-determined prices; inputs and outputs that were outside the plan quotas could be sold at market prices with an upper limit of 20 per cent over the mandatory prices. Over time, the number of products governed by state plan quotas was reduced- the number had fallen from 256 to 23 by 1986.

As Hay et al (1994) point out, the dual-track system could be faulted on a number of counts. For instance, since output and input quotas were determined on the basis of past performance, this tended to penalise efficient enterprises- they would get a larger output quota and a smaller input quota. Further, it created incentives for enterprises to understate their capacity so that they were allotted a lower output quota and a greater surplus was available for sale at market prices. Not least, there were multiple prices for different transactions. Thus, the dual-track system, while useful up to a point, was limited in its ability to deliver higher levels of efficiency in the system.

The enterprise-level reforms, including the conferment of greater autonomy, had a greater impact on performance than some of the other reforms. As mentioned earlier, China started off with contracts between the state and SOEs regarding delivery of profit, switched to a profit tax system in 1983 and reverted to a modified form of the contract profit system in 1986.

At the same time, through the eighties, responsibility for enterprises was transferred gradually from the Party to the enterprises themselves. Further, as the World Bank (1997) notes, there was substantial decentralisation of government authority with all but about 2000-3000 industrial enterprises being placed under the supervision of local governments rather than under the central government.

Under the profit delivery arrangement, introduced in 1979, firms contracted to deliver a certain quota of profit to the state. As this allowed room for bargaining over the share of the state, this was replaced in 1983 by a flat rate of profit tax on medium and large enterprises. The modified form of the contract profit system introduced in 1986 was tougher than the one that had existed earlier. For instance, firms were obliged to deliver a minimum of profit. If a firm did not generate profit equal to the quota in a given year, it was obliged to make up the quota from its own funds or savings deposits. Secondly, the contract period was enhanced from one year to three years or more, with yearly targets for quotas being subject to revision based on economic conditions.

In the case of small SOEs, lease contracts began to be encouraged by the end of the eighties. Further, by 1984, the practice of awarding performance-

related bonuses had become widespread. However, as Yao (2004) notes, the system was asymmetric: the manager would be rewarded for his successes but not punished credibly for failure. As a result, collaterals began to be required of managers.

The combination of greater autonomy, tougher constraints and better incentives in the new contract responsibility system is generally perceived to have resulted in improved enterprise performance. Hay et al (1994) note that Chinese GDP grew at an impressive annual rate of 10.6% during the 1980s with the state-owned industrial sector growing at over 8% per annum in the period and at nearly 12% per annum in the main reform years 1983-88. The authors are, however, quick to add that even faster growth in productivity in private enterprises as well as in collectively owned enterprises suggests that ownership reform must remain a priority for China.

The nineties saw a fresh burst of enterprise reform (World Bank, 1997). In early 1994, the government embarked on a programme of corporatising, that is, converting into companies, 100 large and medium SOEs at the central level and 2500 at the local level. By 1997, 414,400 companies had been formed (Yao, 2004). Of the 2500 local SOEs, 1080 had been transformed into either limited liability or shareholding companies with diversified equity ownership by the end of 1997.

Another initiative involved reduction of SOE debts and raising of asset-liability ratios through fiscal incentives. A third programme related to the reinvigoration of 1000 large SOEs through technical renovation, interest payment exemptions, debt forgiveness and redundancy payments for idle workers. A process of transferring social responsibilities of SOEs, such as housing, hospitals, schools etc, to municipal or regional governments also commenced. Divestitures of small firms to private hands took place. Partial disinvestment in SOEs was, however, more common, a process that received a boost with the opening of the Shenzhen Stock Exchange in 1990 and the Shanghai Stock Exchange in 1991. Further, the management of SOEs was gradually taken away from ministries and vested in State Asset Operating Companies at various levels- national, provincial, municipal and district.

Until the first half of the nineties, only about 2-5% of the 118,000 Chinese industrial SOEs had been divested to the non-state sector and virtually all of these had been small firms. Clearly, in the initial phase of reforms lasting nearly a decade and a half, privatisation was not a priority for the Chinese authorities. For the rest, shares were sold to employees, the public and to financial institutions. In the case of the latter, the government imposed

restrictions intended to prevent the state from losing control of the listed SOEs. .

Five categories of shares were created. First, there were state shares which referred to shares held by the central government, local governments or solely government-owned enterprises and these were not tradeable. Another category of shares was 'legal entity shares' that were shares held by domestic institutions partially owned by the central or local government. These were only partially tradeable. Similarly, shares issued to employees could be traded only amongst employees.

Then, there were A, B and H categories of shares. 'A' category of shares were similar to ordinary equity shares except that they were meant exclusively for Chinese citizens and domestic institutions. 'A' shares were required to be no less than 25 per cent of total outstanding shares when a company made its initial offering. 'B' category shares were intended for foreign portfolio investors and generally accounted for less than 5 per cent of the total shares of a company. 'H' shares were shares of mainland Chinese enterprises listed on the Hong Kong Stock Exchange. The process of disinvestment was thus carefully designed to maintain state control.

The overall policy, it must be emphasized, was “keep the larger and let the smaller go” under which the state would retain control over the top 500-1000 large firms. As Yao notes, this meant that state control over a large proportion of industrial assets would remain strong- in 1997, the 500 largest state firms had 37 per cent of the assets of state industrial firms, contributed 46 percent of the tax collected on all state firms and 63 per cent of total profit in the state sector.

This should help place perspective the talk in India of the ‘hundreds’ or ‘thousands’ of SOEs that have been privatised in China. Chinese privatisation has, for the most part, involved transfer of ownership only in the case of the smaller SOEs that account for a relatively small proportion of industrial assets and profit. It has not involved a significant reduction of state ownership or control over business enterprise. The larger, corporatised SOEs are run either by the concerned supervisory departments as before or by state-owned asset management companies.

As Yao (2004) points out, such privatisation that has taken place has stemmed from pressures on scarce state resources arising from large numbers of SOEs. China’s tax reforms in the nineties had not progressed rapidly enough to create sources of revenue that could substitute for the state’s preemption of profits from SOEs. At the same time, SOEs’ profits

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had fallen with the ending of monopolies and this pushed SOEs towards increased reliance on bank credit and high gearing ratios. There was little alternative to privatising the smaller SOEs and also allowing the injection of private capital into the larger ones.

While enterprise reform did yield results, as the World Bank (1997) noted, profitability at SOEs in the aggregate remained an area of concern. In 1996, about 50 percent of industrial SOEs incurred net losses, amounting to 1.3% of GDP. SOEs absorbed more than three-fourths of domestic credit and produced a lower rate of return on assets (6 percent) compared to the return of 8.4 percent and 9.9 percent earned by collectives and foreign-funded firms respectively.

3. Disinvestment and performance of Chinese enterprises

What has been the experience with disinvestment – the limited degree of private ownership of SOEs-in China? This again is relevant to us in India given the conventional wisdom that disinvestment cannot bring about any improvement in performance of SOEs, only wholesale privatisation can. We briefly review the evidence on post-disinvestment performance of Chinese SOEs.

Sun, Tong and Tong (2002) review the performance of all companies listed in the Shanghai and Shenzhen stock exchanges over the period 1994-97. They choose 1994 as the starting period because that is when China started to adopt an accounting system that was closer to international standards. They measure performance as the ratio of market to book value of equity (a proxy for Tobin's q), controlling for the effects of foreign ownership, firm size, the firm's leverage, location and industry.

The authors find that government ownership of shares, whether as state shares or as legal entity shares, has a positive and significant relationship with performance. This, of course, raises the question why the Chinese government would go in for disinvestment in the first place. The authors hypothesise that the relationship between ownership and performance might be non-linear- it might have an inverted U-shape, that is, 100 per cent government ownership might not be good but nor would no government ownership. In other words, there is an optimal relationship between government ownership and performance. Their results support this hypothesis.

Why would this be so? The authors suggest that too much government holding might mean too much interference while too little holding might mean lack of adequate support from government. They also speculate that

floating some of an SOE's stock might have a signaling effect: it signals the government's confidence in the partially privatised firm's ability to perform well, so that the government can eventually privatise the firm completely. High equity retention by the state might thus lower the ex-ante uncertainty for investors.

Moreover, where markets are underdeveloped, high government ownership might make for a monitoring role by government where monitoring by other parties, such as the investing public, is weak or inadequate. Finally, government ownership has positive effects where SOE reform is a priority: as noted earlier, the Chinese government has moved to strengthen SOEs through debt restructuring, reduction in tax, infusion of fresh equity, etc. Legal entity ownership might also contribute through business connections. It would be incorrect, therefore, for us in India to suppose that disinvestment cannot ever produce superior performance; we have just cited a whole host of reasons as to why it can.

Xu and Wang (1997) investigate whether ownership structure has significant effects on the performance of publicly-listed companies in China and in what way, if at all. Using pooled data for listed companies on the Shanghai and Shenzhen stock exchanges over three years (1993-95), they

first run regressions of performance variables on concentration ratios without distinguishing between different types of shares.

Next, they examine the effects of different types of ownership- state, legal person and individual- on firm performance. The authors use three ratios to measure firm performance, the market-to-book value ratio (MBR), return on equity and return on assets. Ownership concentration is measured by the percentage of shares controlled by top 10 shareholders and by the Herfindahl index of ownership concentration, the sum of squared percentage of shares controlled by each top 10 shareholder. The authors control for a variety of factors such as firm size, industry, location, firm leverage and firm growth.

The authors find that the market value and profitability of firms increase with ownership concentration. As regards ownership mix, firms' performance is found to be positively correlated with the fraction of legal person shares but either negatively correlated or uncorrelated with the proportion of state shares and tradable A-shares.

The authors conclude that, while market-oriented reform measures have helped improve the economic efficiency of China's SOEs, diversification of state ownership through the introduction of other large stakeholders is

crucial to improved performance. The answer to ownership diversification, however, is *not* dispersed private ownership- as mentioned, the results point to individual shareholdings being insignificantly related to firm performance or having a significant *negative* effect.

Large institutional shareholders seem to hold the key to firm performance, no matter that these shareholders are state-owned, a finding that ties in with the evidence from the literature on corporate governance about the importance of large institutional shareholders. This finding has important implications for Indian privatisation for in India too, disinvestment has led to transfer of government-owned shares to government-owned financial institutions, although institutional shareholding is quite small in most cases.

Groves et al (1994) examine the impact of autonomy and incentives on productivity in Chinese SOEs. They do so by looking at annual data for 769 enterprises in four provinces over the period 1980-1989. Large firms were over-represented in the sample. The sample thus covered firms for which it was believed that progress in reforms had been modest compared to the small, non-state sector. The firms had benefited from the moves towards greater autonomy described earlier, such as the right to retain a share of profits, to sell some output outside state delivery quotas and the freedom to give bonuses to workers and to hire workers on fixed contracts.

The authors ask three questions. Did managers respond to autonomy by strengthening workers' incentives? Did stronger incentives translate into higher productivity? Did autonomy result in higher returns to the stakeholders- workers, management and the state? To test for worker incentives, they used as independent variables the real bonus per worker and the number of contract workers as a fraction of the total number of workers and dummy variables for the presence of autonomy and the enterprise's ex-ante marginal profit-retention rate. They found some evidence that worker incentives had indeed been strengthened consequent to greater output autonomy and an increase in the profit-retention rate. The authors also found evidence that in the five industries into which they had broken up the data, at least one of the two incentive variables generated increased productivity.

As for returns to various stakeholders, the authors found only weak evidence that the reforms had a positive effect on profits. Much of the benefits of autonomy seemed to have gone to the workers with significant increases in real average employee wages in several industries. Interestingly, managerial wages did not rise with autonomy.

The authors suggest this might be due to the emergence of a managerial labour market in China in the 1980s and hence the greater competition for

managerial jobs, a hypothesis for which Groves et al (1995) find evidence. The authors' broad conclusion is that industrial reforms in China met with considerable success in terms of inducing behavioural changes at the firm level. SOE reform is by no means a forlorn cause, going by China's experience.

In the same vein as the above paper, Li (1997) examined the impact on economic reform on Chinese SOEs in the period 1980-89, using a panel data set of 272 enterprises drawn from the same data pool as the above paper. The paper addressed the following questions: did reform increase enterprise productivity? If so, how much of the productivity gain was attributed to improved factor allocation between enterprises, to improved incentives within enterprises, and to intensified competition in product markets?

The study found market improvements on every count. The marginal productivity of labour increased by over 54 per cent between 1980 and 1989. Total factor productivity (TFP) growth was 4.68 per cent per year in the period and accounted for over 73 per cent of output growth, which 6.37 per cent. The remaining 27 per cent of output growth was attributable to increases in factor inputs.

Improved factor allocation, that is, shifts in resources from less productive enterprises to more productive ones increased output growth by 1.79 percentage points per year during the period and accounted for 28 per cent of output growth and 38 per cent of TFP growth. Growth in bonus per worker and market competition contributed 2.29 percentage points to TFP growth, accounting for 49 per cent of TFP growth and 36 per cent of output growth. As for the impact of competition, the study found that the market power of state enterprises, measured by market price to marginal cost markup, eroded by 15 per cent between 1980 and 1989.

The authors' conclusion reinforces that arrived at by many others, “ .. enterprise restructuring can improve enterprise performance even without formal privatization and .. the marginal economic liberalization as practiced in China can improve resource allocation when entry barriers to the state-monopolized industries are also lowered to foster competition.”

Wei et al (2003) attempt an analysis that is along more conventional lines, using financial measures of performance instead of productivity and they come up with conclusions that are somewhat contrary to the ones mentioned earlier.

In keeping with standard studies on privatisation, they ask whether performance as measured by profitability, real output, real assets, leverage and employment improve following privatisation. Their analysis is based on data on 208 firms that completed public share offerings in China in the period 1990-97. They find that real output, real assets and sales efficiency improve while leverage declines significantly following privatisation. Contrary to the results of other studies, profitability does *not* change significantly post-privatisation; however, employment does decline significantly in the long run.

Out of the sample of 208 firms, 46 were fully privatised, meaning that state shares were zero; 76 firms had more than 50 per cent state ownership. The authors divide the sample into two sub-samples, one containing firms in the first category and the other containing firms in the second category. They find that firms where voting control had passed to private investors experienced significant relative gains in profitability, efficiency and employment over those with majority shares following privatisation.

The authors explore the issue of profitability post-privatisation further. Since profitability of enterprises in general has been declining, they suggest this could bias their results. So, they compare profitability and net income over the period 1994-99 for 41 firms from their sample with 41 fully state-

owned firms. They find that privatised firms outperform fully state-owned firms. They conclude that privatisation works in China, especially when control passes to private investors.

4. SOE reform versus privatisation

The empirical evidence cited in the earlier section leaves little room for doubt as to the effectiveness of SOE reforms in China. But the last paper cited also raises the question: would full-blooded privatisation have worked even better?

There is, of course, a political economy argument to be made in favour of SOE reform in China, one that is applicable to India as well. SOE reform, which can be seen as a gradual approach to privatisation, can ensure that job losses, if not eliminated, are contained at a level at which social discontent does not become unmanageable. This is especially so when social security nets are not available.

Huang (2003) comes up with strong arguments against the political economy line of thinking. It is worth examining these arguments at some length because they constitute the strongest possible repudiation of SOE reform as an alternative to privatisation.

Huang argues that SOE employment has been maintained at the expense of quality of assets in the Chinese banking system. If SOEs are allowed to go bankrupt, the costs will be borne by depositors. If the government decides to recapitalise the banks, the burden will fall on taxpayers. If there is a financial crisis, the entire population will be losers.

Moreover, continued support to SOEs, Huang contends, has stifled growth in China's private sector-it has resulted in China's failure to create globally competitive firms despite a fast-growing domestic market and export opportunities. Huang suggests that China's ruling class has accepted these economic costs because politically it was more palatable to forgo losses in the future than to suffer losses in the present.

Huang is thus dismissive of the notion that China's privatisation policy is vindication of the gradualist approach to reform. Gradualism, according to him, would have meant that the government should go in for privatisation in a sequential manner. This would have implied *a faster* process of privatisation in China once some of the essential conditions for success in privatisation were in place, such as the emergence of a private sector and price liberalisation. By the early nineties, these conditions had been satisfied. Yet, to this day, China's rulers have set their face against privatisation of large SOEs. Only the privatisation of small SOEs was approved in 1997.

The SOE reforms of the mid-nineties, as we have seen earlier, did not constitute privatisation in the sense of transferring control to private hands. They involved two things. One, they re-assigned ownership rights among the different government agencies. Second, they involved listing of shares of SOEs on the exchanges with only a small portion of these going into private hands.

Huang cites Xu and Wang (1997), who found that individual shareholders controlled only 0.3 percent of the board seats while owning 30 percent of the shares. The state retained 50 percent of board seats while owning 30 percent of the shares. Control remained firmly in government hands in this phase of SOE reforms. Moreover, the proceeds of privatisation were used to fund investments in the larger SOEs so that the aggregate ownership role of the state was not reduced.

What of the contention that the “big bang” approach to privatisation is fraught with risk? Huang argues that the Russian privatisation disaster is no argument against a bigger thrust towards privatisation in China in the nineties. Genuine privatisation would not have caused major political and economic disruption in China for two reasons. China had developed a large entrepreneurial class and it was also not leery of foreign investment. The

absence of private entrepreneurs and wariness of foreign investment had led Russia to opt for insider privatisation- sale to firm managers- which is what had created problems.

Huang does not subscribe to the view that rational and pragmatic considerations- the need to manage the process in ways that did not create economic and political instability- at all dictated the course of Chinese privatisation. He believes China's leadership moved slowly on privatisation entirely on ideological grounds: it wanted to preserve socialism. Private capitalists were seen as a threat to the socialist state, so their growth had to be curbed.

It is worth quoting Huang:

a doctrinal commitment to state ownership remains a first among equal governing principles in today's China. The primacy of state ownership can be circumvented and even shortchanged but cannot be openly and explicitly challenged... The Chinese state is pragmatic, but up to a point. The famous aphorism by Deng Xiaoping- 'it does not matter whether the cat is white or black, as long as it catches mice'- has not yet been applied to privatization of

large SOEs. The colour of the cat apparently matters, and matters a great deal.

It is possible, of course, that ideological considerations have dictated the nature of privatisation in China. At the same time, we cannot ignore the considerable accommodations of principle and departures from doctrinaire socialism that have marked China's move towards a market economy.

As in India, so also in China, it is possible that the political establishment was sensitive to the dangers of a monitoring vacuum that might arise when state control was withdrawn without adequate governance mechanisms being put in place. China's capital markets are, if anything, even more underdeveloped than India's and the governance framework also, perhaps, lags behind. China's rulers would have good reason to be wary of placing enormous assets in the hands of private owners accountable only to dispersed shareholders.

An effective alternative to state control is the existence of large institutional shareholders. In China, as in India, this would require that government-owned financial institutions be privatised before SOEs are. But this is an even more contentious issue than privatisation of industrial SOEs, given that

the financial sector is perceived as a strategic sector and hence must be the last to be privatised.

Academics are entitled to take the view that, no matter that SOE reform works, privatisation would work even better. But the bottomline is that, where SOE reform works as well as it has in China and contributes to extraordinary economic growth, the impulse to go in for full-blooded privatisation is bound to be weak. Huang's contention that the fiscal costs of maintaining state control over SOEs have thus far been buried in the banking system is valid. Sooner or later, the fiscal costs will materialize and will show up as government debt. But, if China's economic growth continues at the present rate, surely these are costs the economy can live with?

5. Conclusion

For more than two decades now, China has pursued SOE reform with considerable success. There have been moves to induce greater competition, to make inputs and outputs of SOEs more and more market-determined, the provision of greater autonomy and introduction of incentives for employees. Privatisation has occurred extensively only in the case of small firms. Such privatisation as has taken place in the larger firms has taken the form of

issue of equity to the public and to domestic and foreign institutions, with the state still owning a large equity stake in the firms and retaining control

Several studies have documented the positive impact of SOE reforms, including limited privatisation, on firm productivity and financial performance. Critics of the programme, however, argue that complete privatisation, the transfer of control to private owners, could have produced even better results in the nineties. Some conditions for the success of privatisation at least existed, such as the emergence of an entrepreneurial class and openness to foreign investment. Hence, the Chinese establishment's reluctance to reflected a doctrinaire opposition to any meaningful withdrawal of the state from commercial activity.

On the other hand, the absence of satisfactory governance mechanisms and the relatively underdeveloped nature of China's capital markets might well have justified China's gradualist approach to privatisation, especially when enterprise reform was producing impressive results. The parallel with the Indian context is very strong indeed. In both the countries, a political establishment, responsive to popular perceptions and wary of the risks to selling of the biggest SOEs to private firms, has chosen caution as its watchword in its approach to privatisation. Contrary to what is stated in

popular discourse in India, it is certainly not true that the Chinese have been a lot bolder in their privatisation drive than India.

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