

# 2

## Development of the role of private enterprise in China

This chapter describes generally the development of the role of private enterprises in China prior to introducing the Survey results in later chapters.

### An historical perspective

After the founding of the People's Republic in 1949, China quickly built up its state economy with support and aid from the Soviet Union. In 1949, private enterprises produced 63 per cent of the national industrial output; by 1952, this percentage had declined to only 39 per cent.<sup>1</sup>

During this early period, the government aimed to place the private sector under control of the plan system by means of 'state capitalism'. By 1952, 56 per cent of the private sector's industrial output was to or through the government.

Alongside 'state capitalism', some private firms were transformed into state-private cooperatives. In 1952, their output accounted for 5.7 per cent of the national total. In 1953, the Communist Party proposed a timetable in *The General Guidance for the Transitional Period* to complete the socialist transformation of private firms and individual handicrafts in 15 years. However, the socialist transformation process was later accelerated as a result of several factors.

In October 1953, the central government implemented the policy of *tonggou tongxiao*, or centralised purchases and centralised sales. This policy put the procurement from farmers and wholesale trade of grains, cotton, edible oil, and clothes under the control of the government. The objective of this policy was to provide stable and low-priced supplies of food and necessities to support China's heavy industry-oriented industrialisation. This policy enabled the government to control over 70 per cent of the total national wholesale volume by the end of 1953. At the same time, the government increased the share of government orders and purchases in private firms' output which also rose to 70 per cent. Since two thirds of the private firms produced light products, the

*tongguo tongxiao* policy forced a large part of the private sector under the state's control and made it much easier for the state to carry out the socialist transformation of these firms.

Starting in 1952, China began to imitate the Soviet Union by implementing five-year plans. However, the plan only covered state-owned firms. As a result, there was imbalance between private and public supply and demand of many material supplies. This created an incentive for both state and private firms to accelerate transformation.

The strength of the cooperative movement in the countryside turned the political atmosphere against the existence of private ownership and operations even in the cities. The squeeze by the state caused the financial situation of private firms to deteriorate, and their workers' welfare declined. Encouraged by the cooperative movement of the peasants, workers from private firms also demanded transformation.

Finally, the good record of the first five-year plan period and weak resistance, and sometimes even enthusiastic response by private owners to the transformation reinforced the government's confidence in socialism and encouraged it to accelerate the socialist transformation.

The socialist transformation of private firms was rapidly completed in 1956. Private owners were assigned jobs in their own factories and allowed to receive a payment equal to 5 per cent of the value of their assets for 10 years (1956–65). In the meantime, the socialist transformation was implemented for individual handicraft shops. Individual craftsmen were re-organised into large cooperatives. During the Great Leap Forward in 1958–59, the majority of these cooperatives were transformed into local, state or commune factories.

By May 1959, amongst the 100 thousand cooperatives in the country, 37.8 per cent had been transferred into local state ownership, 35.3 per cent were absorbed into communes, 13.6 per cent were changed to wage-earning factories, and only 13.3 per cent were still run as cooperatives. Only after the catastrophe of the Great Leap Forward did the central government again recognise small individual businesses, including individual handicraft shops. Small individual businesses were totally shut down when the Cultural Revolution began in 1966, re-emerging only in the late 1970s. Private firms beyond the industrial enterprises were not allowed to operate until 1988.

The private economy operated underground during the period 1966 to 1979. This situation began to change when the rural reforms were initiated at the end of 1978. This change, like most of the recent reforms carried out in China, was not a result of conscious planning by the central government, but rather a spontaneous process triggered by a series of historical and current economic factors.

In the countryside, the re-emergence of the private economy was a by-product of the rural institutional reform that restored family-based farming under a collective farmer contracting arrangement. This reform raised farmers' incentives and boosted agricultural output (Lin 1992). As a result, farm households accumulated a considerable amount of wealth in the process of fast output growth. On the other hand, following labour's intensive engagement in agricultural production at the outset of the reform, redundant rural labour began to emerge.

These two factors, income growth and surplus labour, worked together to redevelop private businesses in China's rural areas. In fact, the new farming system, although it did not acknowledge private freehold ownership of land, did recognise the legitimacy of private production. This sent a strong signal to farmers and encouraged them to engage in small non-agricultural activities. The Communist Party sanctioned farmers' initiatives by issuing a formal document in the Autumn of 1980.<sup>2</sup>

In the cities, the resurgence of the private economy was brought about by the pressure on the government to solve the problem of unemployment amongst urban youth. In the late 1970s and early 1980s, millions of urban youths, who had been sent to the countryside during the Cultural Revolution, returned to the cities. The employment of these youths became a big burden to the government.

To solve the problem, the government encouraged the youths to engage in self-employment as well as to take up formal jobs assigned by the government. This policy was clearly stated in several government and party documents issued in 1981 that provided guidelines to solve the problems related to individual businesses such as land use, material supplies, business administration and ultimately, government recognition.<sup>3</sup> In particular, a document issued jointly by the Central Committee of CCP and the State Council in October 1981 set the tone of the Party and the government toward individual economic units.

Another document issued by the State Council in July 1981 proposed concrete policies that awarded individual businesses some privileges, such as material supplies and land use, that were previously held by the state and collective economic units. In the same document, a new business category, *geti gongshang hu*, or single industrial and commercial proprietor, was defined. *Getihu* became a popular word in the 1980s.

The Party and the government were cautious toward the development of *getihu*. In the July 1981 document, a cap of 5 was set on the number of employees a *getihu* could hire. In addition, individual economic units were only defined as supplementary to the state and collective economic units and allowed to develop only within certain limits.

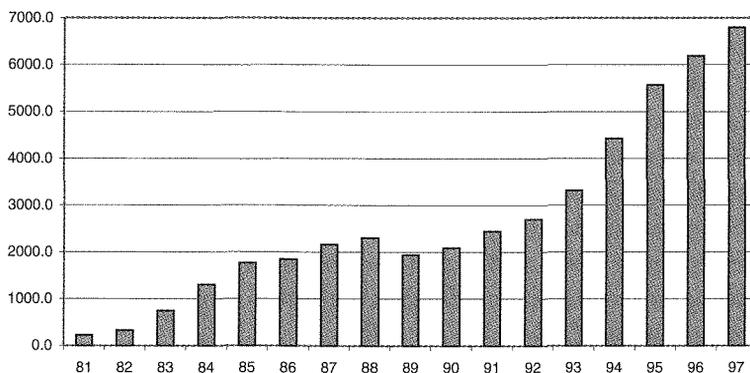
Nevertheless, *getihu* grew fast and gained momentum in 1988 when their numbers reached 23.1 million, or 10 per cent of the national total non-agricultural labour force (Figures 2.1 and 2.2). This rapid growth of *getihu* was made possible by several factors.

The urban reform undertaken in the 1980s created a dual-track price system that released a considerable amount of goods and services into the market. The biggest beneficiary of this reform was the rural population. For the first time in more than two decades, they began to have access to scarce industrial materials, although at higher prices than state enterprises. This helped the rural *getihu* to flourish.

The rural reform brought sizeable gains to the farmers and provided initial capital to the rural private economy. This initial source of capital was vital for the rural private economy since the state did not provide bank loans or credits to rural *getihu*. Not until these private businesses were well established and generated sizeable sales, income, employment and tax revenue, did the local governments provide funding to them.

Finally, the demand for standard consumer goods such as foods, garments and daily materials was high due to rising urban and rural purchasing power. On the other hand, after more than two decades of heavy industry-based development, the supply of consumer products was limited. As a result, a large market opportunity was created in which *getihu* could develop.

**Figure 2.1** Workers in the private sector 1981–97 (10,000)



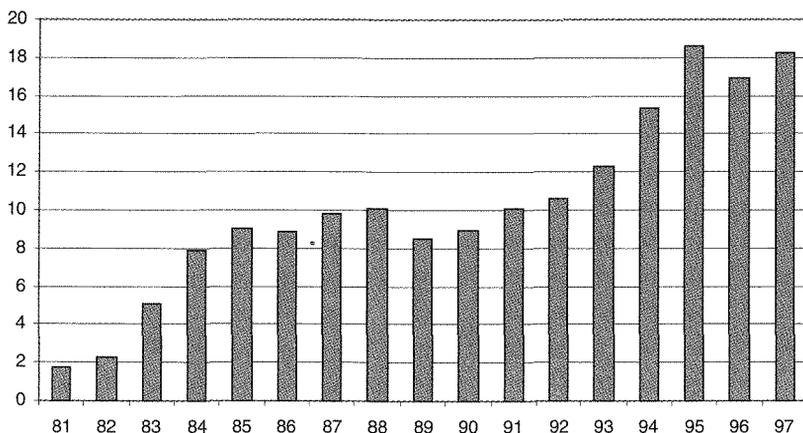
**Notes:** Before 1991, only *getihu* are included. Starting in 1991, both *getihu* and private firms are included.

**Sources:** *Yearbook of China Industrial and Commerce Administrative Management*, 1992–98, and *China Statistical Yearbook*, 1982–98. Gregory et al., 2000, *IFC Report*, Figure 1.2 p.1

The growth of *getihu* in the early 1980s laid a solid foundation for less constrained private firms to enter the scene. In June 1988, a government document *Tentative Stipulations on Private Enterprises* (TSPE) was issued to govern the registration and management of private firms.<sup>4</sup> In this document, a private firm was defined as 'a for-profit organisation that is owned by individuals and employs more than 8 people'.<sup>5</sup> Firms that hire 8 or fewer people, could still be registered as *getihu*.<sup>6</sup> This seemingly arbitrary distinction was made based on an example Marx used in *Das Kapital* with more than 8 people to illustrate the capitalist production process. It was therefore thought that hiring more than 8 people was a sign of exploitation while hiring less people was not.

The TSPE defined three types of private firms: sole ownership, partnership, and limited liability incorporation. For the first two types of firms, the TSPE still provides the standard government regulations for their registration. For the last type of firm, the *Law of Corporation* replaces the *Stipulations* to regulate it. A new law governing firms of partnership is being enacted by the People's Congress. A law governing sole ownership enterprises has been implemented

**Figure 2.2** Share of employment in private sector in national total 1981–97 (%)\*



**Note:** \*Percentage of private employment in the national non-farm labour force. Because of the new categorisation used after 1995, the later has been increased artificially since 1996 and shares of private sector in 1996 and 1997 were not comparable with those of the earlier years. Before 1991, only *getihu* are included; starting in 1991, both *getihu* and private firms are included.

**Sources:** *Yearbook of China Industrial and Commerce Administrative Management*, 1992–98, and *China Statistical Yearbook*, 1982–98. Gregory et al., 2000, *IFC Report*, , Figure 2.5 p.17

from 1 January 2000. There is more detailed discussion on firm registration in Chapter 10.

Although the existence of private firms was not formally acknowledged and sanctioned by the government until 1988 when the TSPE was issued, many *getihu* were qualified as private firms in terms of the number of employees even before 1988. According to a 300-village survey conducted by a research branch of the State Council in 1987, 0.2 per cent of farm households hired more than 8 people in 1986. Taking the survey as a representative sample, it was estimated that at the end of 1988, there were 500 thousand *getihu* in the country that could be called private firms (Zhang and Liu 1995:55).

In addition, many firms were registered as having collective ownership when they were actually privately owned. Such a firm was called a 'red hat' firm: the private owner put on a collective ownership hat to evade the government prohibition of private firms, ideological harassment and to qualify for favourable regulatory treatment. This kind of firm continued to exist even after the TSPE was issued in 1988. Although no national figure for this type of firm is available, it was found by our research team that almost all the collective firms at the village level in Shunde were red hat firms before the privatisation program took place in 1992. The 'red hat' phenomenon was important in all cities covered by the survey in 1999, and most important in Beijing and the Sichuan provinces where the acceptability of private ownership was still being established.

Finally, many collective firms were rented out to private operation. In 1984, the percentage of such firms in the total number of collective firms was, respectively, 19 per cent, 30 per cent, 40 per cent and 50 per cent in Hebei, Tianjin, Liaoning, and Ningxia (Zhang and Liu 1995:29). Private entrepreneurs operated such firms as if they were their own, paying the collective a fixed rent and in many cases accumulating considerable capital assets. As a result, the share of the collective assets diminished and the firm was gradually transformed into a solely privately-owned firm. At the end of 1989, the number of registered private firms reached 90,600 in total.

The development of the private sector suffered a setback with the sudden shift in the political atmosphere after the 1989 fracture in Beijing. The number of registered *getihu* declined from 23.1 million at the end of 1988 to 19.4 million at the end of 1989 (Figure 2.1). The number of registered private firms declined from 90,600 at the end of 1989 to 88,000 in June 1990. Amongst firms being closed down, a considerable number were transferred into collectives or reduced their number of employees to under 8 people. For example, in a survey conducted on 286 private firms closed in the period of January to April 1991, 22.7 per cent were transferred to collective ownership, and 20.3 per cent reduced their number of employees to under 8 (Zhang and Liu 1995:50–1).

The setback was not fully reversed until Deng Xiaoping in 1992 paid his famous visit to the south and called for continuing the reform effort. At the end of 1992, the number of registered *getihu* and private firms reached 27 million and 140 thousand, respectively. The period 1992 to 1994 saw the most rapid increase in the number of private firms, employment and output in recent times (Table 2.2). Attitudes toward private firms were changed as a result of Deng Xiaoping's call for further market-oriented reforms, providing private entrepreneurs with a supportive social and psychological environment. In addition, the national economy was in a new round of expansion providing rapidly expanding market opportunities for privately produced products.

The development of the private sector was enhanced by the privatisation programs starting in various parts of the country soon after Deng's visit to the south. The private sector has served as an appropriate model for the SOEs by demonstrating attainable efficiencies in operations. Examples of this will be given in the next section.

The Fifteenth Congress of the CCP held at the end of 1997 elevated the role of the private sector to one of parity with the state sector. Subsequently, this new move was recognised in China's Constitution by a new amendment in the spring of 1999. While it is a legal milestone, the amendment was an endorsement of what had already happened, rather than a new development. The amendment did not include a clause that provided private property with full protection of rights.

The above review has shown that the rate of development of the private sector in China since 1949 has shifted from being governed primarily by government ideology and associated policies, to depending on domestic and international macroeconomic conditions and the regulatory framework. This change started with Deng Xiaoping's visit to the south. With the constitutional amendment in place, the de-linking of the private sector and government ideology can be expected to continue in the future.

## **Contributions of the private sector to the national economy**

The private sector has been playing an increasingly important role in China's national economy as shown by rapid increases in employment and output shares of private sector in the national total (Figures 2.2 and 2.4). Before 1985, the share of private sector industrial output in the national total was negligible although it had already accounted for around 2 per cent of the national non-agricultural labour force in 1981. By 1997, its share in national industrial employment exceeded 18 per cent. In 1985, its share of national industrial output reached nearly 2 per cent. By 1993, that figure had climbed to 12.2 per cent. In 1997, it reached 34.3 per cent (Figure 2.4).

In absolute terms, private sector industrial output has experienced substantial and rapid growth in the last two decades to reach 3.8 trillion yuan in 1997 (Figure 2.3). The expansion of employment experienced a major down turn in the period 1989 to 1991, but has since grown rapidly. By 1997, the total number of workers reached 67.9 million (Figure 2.1).

Including agriculture in GDP but not in the private sector, the private sector's share in GDP reached 33 per cent in 1998 (Figure 2.5 and Table 2.1).<sup>7</sup> In 1998, the private sector was still smaller than the state sector whose share of national GDP was 37 per cent. If agriculture—a sector comprises mainly individual farmers—is regarded as private as seems more appropriate, the share of the private sector rises to 50 per cent (Figure 2.6).<sup>8</sup> The private sector and collectives together contributed a non-state sector share of 62 per cent in 1998.<sup>9</sup>

The fast growth of the private sector in the 1990s was mainly within private firms, as distinct from non-incorporated enterprises. In 1991, the output share of firms in the private sector's total was only about 17 per cent. In 1997, it reached 47 per cent. In the period 1991 to 1997, for which data are available, the annual growth rates for the number of private firms, employment, and output were 46 per cent, 41 per cent and 71 per cent, respectively (Table 2.2). According to the statistics provided by SETC, by 1998, the total number of registered private firms was 1.2 million, employing 17.1 million employees with total registered capital of 719.8 billion yuan, total output value of 585 billion yuan and total sales of 305.9 billion yuan.

It is noteworthy that the private sector's share of output and employment has been achieved using far fewer resources than other sectors. In the period 1991 to 1997, the share of the private sector's investment in the national total was in the range of 15 per cent to 27 per cent. In addition, the sector took a negligible portion of formal bank loans: at the highest, only 0.87 per cent of formal bank loans in 1997. The disproportion between its contributions to output and employment and its utilisation of capital and other non-labour inputs is a major feature of China's private sector development in the 1990s.

Statistics released by the State Bureau of Industry and Commerce Management (BICM)<sup>10</sup> show that by June 1999 the total number of private firms in China reached 1.3 million, with registered capital of 817.7 billion yuan, and employing 17.8 million workers. All three indicators increased by about 25 per cent over 1998. Private enterprises have also been making rapid progress in their transformation towards a modern enterprise system. For example, by June 1999, there were altogether 700,000 private corporations with limited liability, an increase of 33.7 per cent over the same period in 1998, accounting for about 55 per cent of total private enterprise in China.

The rapid development of the private sector in the 1990s has been a major catalyst for SOE reform. A major SOE reform in the 1990s was the privatisation of small SOEs. Currently, about 80 per cent of firms that had been owned by

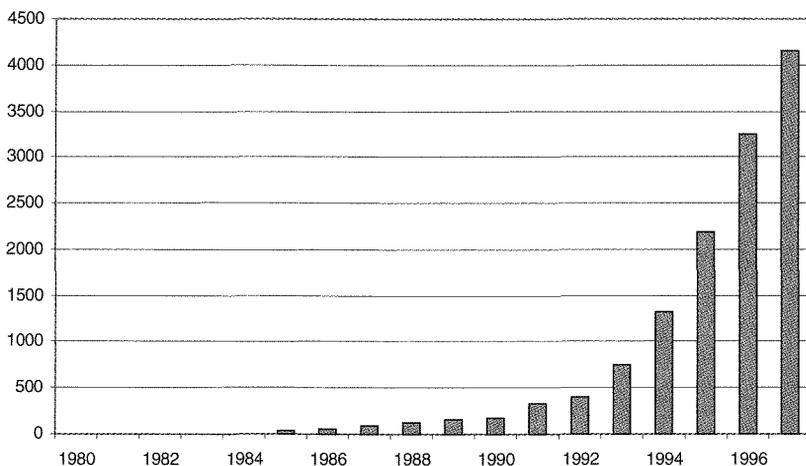
**Table 2.1** Composition of China's GDP, 1998 (%)

	(I)	(II)	(III)	(IV)	(V)
State sector	37	State sector	37	State sector	37
Agriculture	18	Agriculture	18	Agriculture	18
Collective (official)	23	Collective (true)	12	Non-state sector	45
Share holding	3	Share holding	3		
Foreign share	6	Foreign share	6		
Domestic private sector	13	Domestic private sector	24		
	100		100	100	100

**Notes:** Calculated according to a sector-based approach, which derives ownership shares in GDP based on their shares in each of the following sectors, agriculture, industry, construction, transportation, post and telecommunication, wholesale and retail trade and others. Various assumptions on the relative shares of each ownership type in each sector have been made based on relevant data. (I) Official collectives include 'red hat' firms as well as *gaizhi* firms which are actually private firms. Domestic private enterprises consist of formally registered private firms and *getihu*. (II) Domestic private enterprises now include those firms that are under collective titles but truly private assuming they accounted for about half of the official collective firms. In some areas and sectors, the proportion of this type firm in total collective is more than half. (III) Private sector consists of share-holding firms, foreign firms and domestic private firms excluding share-holding firms. (IV) Non-state sector without including agriculture consists of true collective and private sector as defined in (III). (V) Non-state sector with inclusion of agriculture in which state-owned share accounts for about one percentage point which has been added up to the state sector.

**Source:** All the original data are from *Statistical Yearbook of China, 1998*, State Statistical Bureau; *China Statistical Abstract, 1999*, State Statistical Bureau. The shares of all these sectors in GDP are provided by the State Statistical Bureau (1999:13). Gregory et al., 2000, *IFC Report*, Table 2.3 p.18

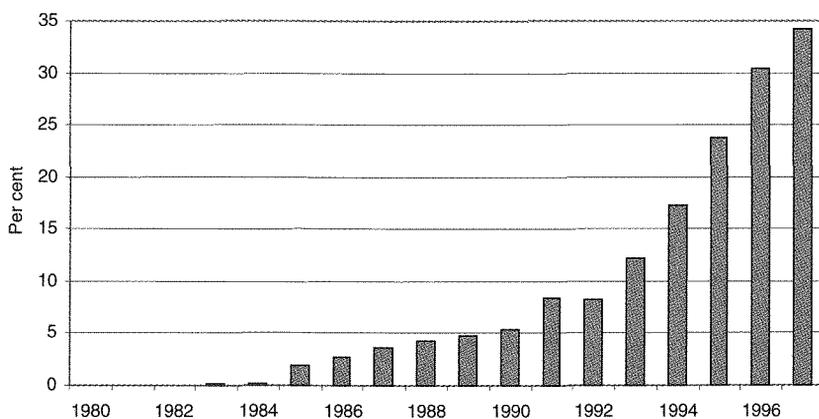
**Figure 2.3** Industrial output of private sector 1980–97 (billion yuan: 1995 constant prices)



**Notes:** Data on private firms are added beginning in 1991.

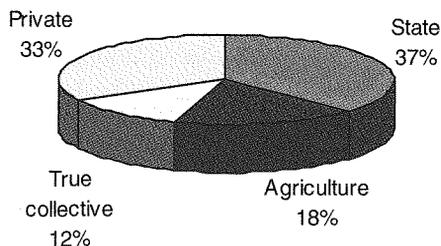
**Sources:** *Yearbook of China Industrial and Commerce Administrative Management*, 1992–98, and *China Statistical Yearbook*, 1982–98, State Statistical Bureau, Beijing. Gregory et al., 2000, *IFC Report*, Figure 1.3, p.2.

**Figure 2.4** Share of private sector industrial output in national total 1980–97 (%)

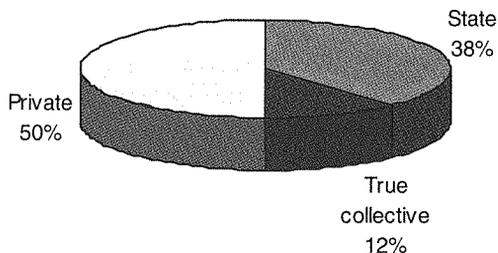


**Notes:** Data on private firms are added starting in 1991.

**Sources:** *Yearbook of China Industrial and Commerce Administrative Management*, 1992–98, and *China Statistical Yearbook*, 1982–98, State Statistical Bureau, Beijing. Gregory et al., 2000, *IFC Report*, Figure 2.4, p.17.

**Figure 2.5** Ownership shares in China's GDP: 1998 (%)

Source: Table 2.1 (III). Gregory et al., 2000, *IFC Report*, Table 2.3, p.18.

**Figure 2.6** Private sector including agriculture in total GDP: 1998 (%)

Source: Table 2.1 (III) assuming one percentage point of state-owned agriculture. Gregory et al., 2000, *IFC Report*, Table 2.3, p.18.

**Table 2.2** Private firm development since 1991

Year	Firms		Workforce		Output*	
	Number (1,000)	Growth (%)	Number (1,000)	Growth (%)	Value (billion yuan)	Growth (%)
1991	107.8	n.a.	1839.0	n.a.	93.7	n.a.
1992	139.6	29.5	2318.4	26.1	116.0	23.8
1993	237.9	70.4	3726.3	60.7	260.1	124.2
1994	432.2	81.7	6483.4	74.0	551.7	112.1
1995	654.5	51.4	9559.7	47.4	1,005.3	82.2
1996	819.3	25.2	11711.3	22.5	1,592.3	58.4
1997	960.7	17.3	13492.6	15.2	1,983.7	24.6
Average		45.9		41.0		70.9

Note: \*In 1995 constant prices. n.a. = not available as this is the starting year.

Sources: *Yearbook of China Industrial and Commerce Administrative Management*, 1992-98; *China Statistical Yearbook*, 1992-98, State Statistical Bureau, Beijing. Gregory et al., 2000, *IFC Report*, Table 2.1, p.11.

governments at the county or lower administrative units have been privatised. By any standard, this is a major transformation. It has totally changed China's economic makeup by bringing private ownership to the vast majority of firms and workforce in the country. As in any other country, small firms account for the vast majority of firms in China. There is no doubt that the record of the private sector's performance has been a major catalyst for this great transformation.

The privatisation programs were initiated at the local level. The most important impetus for local privatisation was the large amount of debt accumulated in the state sector. This was a more pressing problem in small cities because of the smaller size of their economies. For example, in Zhucheng city, Shandong province, amongst the 150 city government-owned enterprises, 103 were making losses, and the total amount of loss was 147 million, equivalent to the city government's revenue over 1.5 years. Shunde met the same problem when it first started its privatisation program in 1992. The solution reached at the local level was to privatise small firms, but the measures adopted in Shunde and Zhucheng were a more radical selling off of almost all its state and collective firms (Box 2.1).

In 1995, the central government, after several rounds of investigation and discussion, formed a policy called '*zhuada fangxiao*' (keep the large ones and let go the smaller ones). The policy allowed the state to focus on retention and improvement of performance in 500 to 1000 large state firms and allowed smaller firms to be leased or sold.<sup>11</sup> The government had good reason for this policy. In 1997, the 500 largest state firms had 37 per cent of the assets held by state industrial firms, contributed 46 per cent of the tax collected from all state firms, and 63 per cent of total profits in the state sector. The government believes that control of the (500) largest firms means it has control of the larger and better chunk of the state economy. By contrast, smaller firms owned by local governments performed even worse than those owned by the central government. In 1995, 24.3 per cent of the centrally owned firms were in the red, compared with 72.5 per cent of locally owned firms.

From the 'let go the smaller ones' part of the policy came a word '*gaizhi*', meaning, 'changing the ownership structure'. Starting in 1994, *gaizhi* began to spread to the whole country. The content of *gaizhi* included contracting and leasing, the two methods used previously, as well as new methods of selling the firm or transforming it into an employee-held company or cooperative. Therefore, *gaizhi* did not necessarily imply privatisation. Yet the government was determined to get rid of the 'red hat' firms. In March 1998, it issued a directive requiring all red hat firms to 'take off the hat', that is, to show their private ownership, by November 1998.

Not all the localities had been fully prepared for *gaizhi*. Many firms changed their names, but nothing else substantial (see Box 2.2 for a description of *gaizhi* in Sichuan province). This is particularly true for firms taking up the

ownership category of employee shareholding. These firms are still regarded as collective firms, and local governments still interfere in their operations. This is a problem in the transformation of local governments' functions. Yao and Zhaohua (2000) have shown that privatisation is not sufficient to improve economic efficiency if the role of the government does not change.

In particular, if the government tolerates its employees' rent-seeking behaviour in relation to privatised firms, the contributions of private entrepreneurs will be held back. In this regard, the municipal government of Shunde has performed well. In the course of its privatisation program, the Shunde government undertook a radical reform by cutting one third of its employees and 40 per cent of its functional units. This reform has served as a signal to the private sector that the government is committed to curbing rent-seeking behaviour and micro-level interference more generally. To a large extent, the smooth and successful transformation in the city should be attributed to government reform.

### **Evolution of private firms' ownership**

Before 1988, private firms with more than 5 employees were not officially acknowledged. Private entrepreneurs who wanted to expand their operations to more than 5 people had to find a disguise although quite a few dared to ignore government restrictions and operated without any disguise. This created many 'red hat' firms that were registered as collectives, but were actually run by private entrepreneurs. This was more common in the countryside.

The extraordinary performance of China's rural industrialization was attributed by some observers to the combination of private entrepreneurship and collective ownership. These authors' main argument was that the combination was a second best response to imperfections in China's market and policy environments (for example Che and Yingyi 1998; Li 1996, 1997).

While the combination of private entrepreneurship and public ownership was one solution to market and policy failures, the argument missed the point that many private entrepreneurs put on the 'red hat' just to evade ideological bias and government regulations. This tendency was clearest in the period 1989–91. From the perspective of the local government, in many cases it suffered rather than benefited from the presence of a 'red hat' firm.

In Shunde, for example, the most important reason for privatisation by the local government was to get rid of the burden of 'red hat' and other government-owned firms. A 'red hat' firm created an asymmetry to an entrepreneur's incentive. If the firm made a profit, it was appropriated privately. If it made a loss, it was shouldered by the government. As a result, a considerable amount of debt was accumulated by village and township governments. Government officials in Shunde called this 'bleeding', and the privatisation program the 'stopping bleeding project'.

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**Box 2.1 Shunde's privatisation**

When Shunde first began its privatisation program in 1992, it tried to maintain a form of collective ownership and adopted employee shareholding as the only form of privatisation. However, several problems were encountered with this form of privatisation. Employees might not purchase shares either because they did not have enough money or faith in the factory's future. The manager in an employee-held firm still played the role of an agent, and state and collective firms still faced a monitoring problem. Free-riding was still a problem as workers' dividends from shares were independent of their work contributions. Uniform shareholding did not help establish authority within a firm. Therefore, Shunde shifted to other forms of privatisation after this initial experience. These forms included listing in the stock market, management leasing and management buy-out (MBO).

Because China has a policy severely restricting the number of firms to be listed in its two stock markets in Shanghai and Shenzhen (usually in the form of quotas to each province), only two Shunde firms, MD and Kelong, have been listed in the stock market (Shenzhen). To get around the government restriction, some firms were sold or partly sold to a listed firm in another city, so their shares could be listed in the stock market. This form of privatisation is called 'to borrow the shell for the egg'.

Management leasing was used for firms that had a large amount of net assets or in circumstances where management could not mobilise enough funds to buy the firm. In this form of privatisation, management purchased the equipment and leased the land and buildings from the local government that previously owned the firm. This was used more often in retail and wholesale businesses.

MBO was the most important means of privatisation. Many firms that were initially privatised by employee shareholding were transformed into MBO through the concentration of shares in the hands of management. This has been encouraged by the Shunde government.

Before it was sold to management, a firm's assets and debts were valued by an outside accounting firm, usually from Guangzhou, the provincial capital. It is noteworthy that land was included in the evaluation. When management bought the firm, it purchased the use rights of the land occupied by the firm. The term of the use rights ranged from 50 years to 70 years, and the price of land ranged from the current 30,000 yuan/mu (one mu = 1/15 hectares) to 50,000 yuan/mu in the mid 1990s. The inclusion of land in the deal has a significant implication for a firm in terms of its ability to provide collateral for loans. To protect workers' employment, no more than 5 per cent of the workforce could be fired in three years. Competitive bidding was allowed, but the incumbent had priority if it had the same qualifications as its competitors. As a result, it was usually the case that the firm was purchased by the original management. To handle the problems emerging in the transitional period (including debt issues and ownership transfers), the government usually asked management to register a new firm that owned the old firm together with the government. After the transition was finished, the management could decide which name it would use for its firm.

For a firm with positive net assets, the top management was asked to pay for the price of the net assets and shoulder the firm's debts. The payment could be made within five years. For some firms that had large net assets, the local government retained a large proportion of the shares. For a firm with a net debt, the local government that previously owned the firm would take over the net debt. The management had to purchase 15 per cent of the firm's gross assets with the payment being made within five years. However, its share of the debts was also reduced by the same amount, and the local government took the reduced amount. For example, for a firm with 20 million gross assets and 22 million debts, the local government would first take over the 2 million net debts, and the management would pay 3 million cash within five years to buy 15 per cent of the 20 million assets. The firm's net assets were kept at zero when it was handed over to management, and in the long run, the management would get the firm free of debt, although it had to pay a considerable amount of cash in a short period.

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**Box 2.2**     *Gaizhi* in Sichuan province

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Sichuan is a province dominated by small firms. In 1994, the provincial government began to implement *gaizhi*, starting from county-owned enterprises. By the end of 1998, the province completed *gaizhi* for 68.6 per cent of the 42,681 firms planned to be transformed. Among those transformed, 35.1 per cent became employee-owned companies, 11 per cent employee-owned cooperatives, 14.3 per cent were sold out, 7 per cent were contracted out to individuals, 8.5 per cent were leased out, 7 per cent entered bankruptcy, and 5 per cent were absorbed by other firms. There were regional differences. In Yibin county, *gaizhi* was predominantly employee shareholding. In Jintang county, selling was more common. In Shehong county, mergers were encouraged.

Since *gaizhi* was enforced by the provincial government, some local governments did not have sufficient preparation for it. One problem was that local officials treated *gaizhi* as an administrative task, putting emphasis only on the speed of *gaizhi*, but not its real content. The consequence was that many firms changed their names, but not their management. In many cases, managers were still appointed by local governments. In addition, the provincial government did not have a good solution to the debts accumulated by firms, hindering the effectiveness of *gaizhi*. Neither did it have a solution to the unemployment problem accompanying *gaizhi*. In short shortshort, the government did not provide proper institutional capital to support *gaizhi*.

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Before 1988, the existence of 'red hat' firms was more a result of the ideological restriction and government prohibition than a rational choice made jointly by private entrepreneurs and the local government. The influence of ideology was never more obvious than in the period 1989–91 when many private owners transferred their factories to collective ownership under pressure of the conservative ideology prevailing in that period. After Deng Xiaoping paid his visit to the south in the spring of 1992, however, private firms flourished again, showing yet another example of the consequences of ideological change in China.

Currently, three kinds of ownership are defined for private firms by the Chinese laws governing firm registration. They are sole ownership, partnership, and a limited liability company.<sup>12</sup> Owners of the first two kinds of firms accept unlimited liability, and the owners of the last only accept limited liability in their firms' fortunes. Table 2.3 shows the ownership structure of the private firms in 1991, 1994 and 1997. From 1991 to 1997, the number of private firms increased 7.9 times. The number of limited liability companies grew most rapidly reaching 65.3 times. Sole ownership showed the second largest increase, 5.4 times. Partnership was the least, at 2.2 times during the period.

As a result, the relative importance of the three kinds of firms changed dramatically. Limited liability companies had the smallest share in 1991, but became the predominant form of ownership in 1997. A limited liability company offers a firm several advantages to owners, including protection of personal wealth, a better firm image, and better internal governance.

In terms of registered capital, limited liability companies are the largest, partnerships are second, and sole ownership firms the smallest (Table 2.4). The sizes of all three kinds of firms increased from 1991 to 1994, but from 1994 to 1997, the sizes of partnership and sole ownership firms declined significantly while those of limited liability firms remained almost unchanged. These trends owed something to China's macroeconomic fluctuations in general and government anti-inflationary measures in particular. They also reflect influence from the rapid increase in numbers of new private firms, which tend to be small at the beginning.

### **Sectoral and regional distributions of private firms**

The number and growth rates of private enterprises vary across sectors of the economy. By the first half of 1999, there were 30,000 private firms in primary industry (mainly agriculture), an increase of 20 per cent from the end of 1998. There were 530,000 firms in secondary industry (manufacturing), up about 5 per cent from half a year earlier.

The majority of private firms are in tertiary industry (services). The number of firms in this sector had reached 722,000 by June 1999, accounting for about 56 per cent of the total number of private firms in China. According to statistics released by BICM in late 1999, private enterprises hired a total of 8.0 million workers, accounting for about 45 per cent of total employment in the tertiary industry. Their registered capital reached 504.8 billion yuan, accounting for about 62 per cent of the total registered capital in the same industry.

Tables 2.5 and 2.6 show the sectoral distribution of private firms in terms of employment and output from 1992–97. Industry is the largest sector, occupying more than half of the employment and output in the private sector in 1997. Trading is the second largest sector, accounting for more than 30 per cent of employment and output. From 1992 to 1997, the shares of industrial employment and output declined by about 10 percentage points. During the same period, the shares of trading companies' employment and output increased by 15 and 7 percentage points. The shares of other sectors didn't have such significant changes.

Table 2.7 provides information on the regional distribution of private firms. In the table, the provincial units are divided into three groups, coast, central, and west. There is a ladder of development of private enterprise (in terms of numbers of private firms) coming down from the coast to the west. In 1992, the numbers of firms in the west, central and coast had a ratio of 21:26:100; in 1997, the ratio became 23:34:100.

In terms of employment, the central and west caught up even faster. In 1992, the ratio among the three regions was 22:26:100; in 1997, it had become 25:39:100. In terms of both the numbers of firms and employment, the central provinces caught up with the coastal provinces faster than western provinces.

**Table 2.3** Ownership structure of private firms

	1991		1994		1997	
	Firms	Share (%)	Firms	Share (%)	Firms	Share (%)
Sole ownership	60,613	56.2	100,621	47.6	387,534	40.3
Partnership	40,552	37.6	37,532	17.8	130,668	13.6
Limited liability	6,678	6.2	103,235	48.8	442,554	46.1
Total	107,843	100.0	211,388	100.0	960,726	100.0

**Sources:** *Yearbook of China Industrial and Commerce Administrative Management*, 1992-98.

**Table 2.4** Capital size distribution of private firms (1,000 yuan)

	1991	1994	1997
Sole ownership	87.0	335.5	199.9
Partnership	100.5	474.3	276.2
Limited liability	445.1	903.1	904.8
Total	11.4	684.9	535.0

**Sources:** *Yearbook of China Industrial and Commerce Administrative Management*, 1992-98.

**Table 2.5** Sectoral distribution of private firms: workers

Sector	1992		1993		1996		1997	
	Workers ('000)	Ratio (%)						
Agriculture	n.a.	n.a.	n.a.	n.a.	166.4	1.4	237.3	1.8
Industry	1611.5	69.5	2296.6	61.7	6396.4	54.6	7000.8	51.9
Construction	102.0	4.4	156.1	4.2	425.1	3.7	475.2	3.5
Transportation	34.8	1.5	49.7	1.3	117.7	1.0	141.3	1.0
Trading	389.5	16.8	845.8	22.7	3545.1	30.3	4362.3	32.3
Catering services	40.7	1.7	65.7	1.7	211.1	1.8	249.8	1.9
Social services	51.9	2.3	144.5	3.9	590.4	5.0	729.6	5.4
Repairing services	29.7	1.3	38.7	1.0	44.6	0.4	4.38	0.3
Others	58.3	2.5	129.2	3.5	214.6	1.8	252.5	1.9
Total	2318.4	100	3726.3	100	11711.3	100	13492.6	100

**Source:** *Yearbook of China Industrial and Commerce Administrative Management*, 1992-98.

**Table 2.6** Sectoral distribution of private firms: output

Sector	1992		1993		1996		1997	
	Output	Ratio (%)						
Agriculture	n.a.	n.a.	n.a.	n.a.	10.37	1.88	14.69	2.09
Industry	18.94	59.44	38.00	51.99	294.73	53.56	355.94	50.71
Construction	0.86	2.69	2.60	3.56	20.54	3.73	25.94	3.70
Transportation	0.71	2.23	1.57	2.15	8.44	1.53	10.40	1.48
Trading	8.83	27.71	24.89	34.05	181.11	32.91	243.36	34.67
Catering services	0.86	2.70	1.59	2.18	9.77	1.77	12.28	1.75
Social services	0.57	1.77	2.00	2.73	18.30	3.33	26.81	3.82
Repairing services	0.43	1.34	0.55	0.75	1.54	0.28	1.78	0.25
Others	0.68	2.13	1.90	2.60	5.52	1.00	10.71	1.53
Total	31.87	100	73.10	100	550.33	100	701.92	100

n.a. = not available

**Notes:** Billion yuan in current prices.

**Sources:** *Yearbook of China Industrial and Commerce Administrative Management*, 1992–98.

**Table 2.7** Regional distribution of private firms: number of firms and workers ('000)

Year	Coast		Central		West	
	Firms	Workers	Firms	Workers	Firms	Workers
1992	95.4	1754.5	24.5	453.4	19.7	380.5
1993	159.3	2351.3	44.6	768.9	34.1	600.6
1996	529.2	7232.8	178.6	2741.2	111.4	1737.4
1997	610.1	8235.5	211.1	3189.7	139.5	2067.4

**Notes:** Coast: Liaoning, Hebei, Beijing, Tianjin, Shandong, Jiangsu, Shanghai, Zhejiang, Fujian, Guangdong. Central: Heilongjiang, Jilin, Shanxi, Henan, Hubei, Anhui, Jiangxi, Hunan, Hainan. West: Inner Mongolia, Shanxi, Ningxia, Gansu, Qinghai, Xinjiang, Tibet, Sichuan, Guizhou, Yunnan, Guangxi.

**Source:** *Yearbook of China Industrial and Commerce Administrative Management*, 1992–98. Gregory et al., 2000, *IFC Report*, Table 2.2, p.12.

The Chinese government is making efforts to shift its investment to the central and western provinces. While this project will speed up the development of the inland provinces, it is questionable whether it is optimal for the whole country. The regional disparities in economic growth may simply reflect the different capacity for economic growth of different regions (Lin and Yao 1998). Over-investment in the inland provinces may well conflict with the distribution of opportunities for economic growth and be economically

inefficient. More market-oriented policies may generate better outcomes for people currently resident in western provinces. For example, improved education to facilitate the migration of inland people to higher income employment in the coastal provinces may achieve more efficiently the objective of the government, to increase the income of people living in the inland provinces. The alternative strategy would also help the development of the coastal provinces.

## Notes

1. All the figures in the 1950s, if not otherwise indicated, are from Chapters 17 and 18 in Bo (1991).
2. Directives on Several Issues of the Agricultural Production Responsibility System, the Central Committee of CCP, 27 September 1980.
3. Directives on Issues Related to Land Used by Urban Collective and Individual Economy, Bureau of Labor, Bureau of Urban Construction, Ministry of Public Security, and Bureau of Industry and Commerce Management, 6 May 1981; Directives on Issues of Material Supplies to Urban Individual Businesses, Bureau of Industry and Commerce Management, Ministry of Commerce, Ministry of Grains, National Cooperative of Supply and Sales, Bureau of Materials, and Bureau of Labor, 22 June 1981; Policies on Urban Non-agricultural Individual Business, the State Council, 7 July 1981; and Several Directives on How to Use New Channels and New Methods to Solve Urban Employment, the Central Committee of CCP and the State Council, 17 October 1981.
4. The State Council, 15 June 1988.
5. Tentative Stipulations on Private Enterprises, Article 2.
6. We will discuss the implications of this distinction in Chapter 6.
7. See Table 2.1 for definitions of true private sector.
8. Assuming state-owned agriculture accounts for one percentage point of the total agricultural GDP.
9. It is done by taking one percentage point of state-owned share from agriculture sector.
10. *The People's Daily*, Overseas Edition, 7 October 1999:2.
11. In 1994, as the ministry in charge of the government's economic affairs, the SETC sent a report *Suggestions on Revitalizing Small State-owned Enterprises* to Vice Premier Wu Bangguo who was in charge of enterprise reforms. In September 1995 the policy was formally announced by the central committee of the CCP in one of its plenary sessions and was put into the suggestions to the ninth five-year plan.
12. In the *Law of Incorporation*, two kinds of limited liability companies are defined. One is ordinary limited liability companies, the other is limited liability shareholding companies. The distinction is purely for registration purpose and ignored in most statistical publications. For a discussion of the registration of different types of ownership, see Chapter 10.

**Government documents**

1. *Directives on Several Issues of the Agricultural Production Responsibility System*, the Central Committee of CCP, September 27 1980.
2. *Directives on Issues Related to Land Used by Urban Collective and Individual Economy*, Bureau of Labour, Bureau of Urban Construction, Ministry of Public Security, and Bureau of Industry and Commerce Management, May 6 1981
3. *Directives on Issues of Material Supplies to Urban Individual Businesses*, Bureau of Industry and Commerce Management, Ministry of Commerce, Ministry of Grains, National Cooperative of Supply and Sales, Bureau of Materials, and Bureau of Labour, June 22 1981.
4. *Policies on Urban Non-agricultural Individual Business*, the State Council, July 7 1981.
5. *Several Directives on How to Use New Channels and New Methods to Solve Urban Employment*, the Central Committee of CCP and the State Council, October 17 1981.