

# 10

## Laws and government administrative regulations

The role of law and regulation in the development of the private sector has emerged in a number of earlier chapters. This chapter provides a synthesis and highlights critical issues of legal reform. It also discusses the role of institutions for dissemination of business information.

### Laws and regulations related to private firms and their impact

In China, regulations issued by the State Council and laws passed by the National People's Congress (the legislator) effectively have the same power although the latter has a higher hierarchic place than the former. Currently, there is one law and one regulation governing the registration and operation of a private firm, that is the *Law of Incorporation*, and the regulation, *Tentative Stipulations on the Registration of Individual and Private Enterprises* (TSRIPE). The TSRIPE was issued in 1988. Although it is called tentative stipulations, it has been in effect for more than ten years. It governs the registration of *getihu* and private firms of sole ownership and partnership. The *Law of Incorporation* governs the registration and operation of limited liability companies.

A new law governing the registration and operation of partnership firms, the *Law of Partnership Firms*, is in the process of obtaining approval from People's Congress. Another law governing the registration and operation of private firms with sole ownership is the *Law of Private Sole Ownership Firms* which became effective in 2000. In addition, a law aimed at protecting small and medium-size firms, the *Law of Protections on Small and Medium-size Firms*, is also under discussion and will have effects on private firms because many of them are small and medium-size firms.

In addition to the major laws and regulations, there are smaller regulations issued by the State Council which affected private firms during specific periods. Some local governments also issue local regulations that are related to private firms. For example, the Guangdong government in 1998 passed a resolution through the local legislature, *Stipulations on the Protection of Private Firms*.

Other general laws and regulations also affect the operation of private firms. For example, the current tax collection procedure has a stronger effect on private firms than on SOEs (Chapter 6). Since many of the issues have been discussed in the previous chapters, we concentrate in what follows on the impact of the TSRIPE, and the *Law of Incorporation* and *Law of Private Sole Ownership*. The several issues related to the four laws and regulations, are discussed in turn.

First, firm registration is a process of application that requires the approval of the BICM. Normally, there are requirements for minimum registered capital for a company (manufacturing and wholesale sectors: 500,000 yuan; retail: 300,000 yuan). In industrial countries, firm registration is only a filing process and no restrictions are placed on minimum capital. The requirements of application and minimum registered capital constitute a major source of rent-seeking behaviour by government agencies or officials.

For example, a local BICM branch usually has a consulting office that provides advice to firms and even takes their cases and runs through the registration process for them. Of course, firms need to pay for the services. If such an office is forbidden, the privilege of opening a consulting firm will be granted to people that have special links with the branch. In addition, the entry barriers could also exclude potentially good firms from entering the market. Last, the process of approval can take a long period of time and many people are exhausted even before their firms are open for business.

Second, the *Law of Incorporation* does not allow a single individual to register his firm as a limited liability company. As discussed in Chapter 7, a company has several important advantages over other kinds of firms. In addition to the protection of personal wealth, being a company also has a positive effect on the firm's reputation. Because information asymmetry is a big issue in the market, even having the word 'company' in its name will help a firm's establishment in the market.

The exclusion of firms with a single owner from registration as companies has a strong effect on limiting development of private firms. Limited liability offers strong protection to entrepreneurs when their firm fails. It is the insurance for an entrepreneur's risk-taking activities. Without this insurance, entrepreneurs' personal wealth is at stake, so their desire to undertake risky but potentially profitable activities is lowered. This is more important when the firm becomes large and the stakes become very high. Therefore, it was observed in the Survey that almost all the larger firms registered as companies even when they had only one effective owner. They circumvent the restriction by inviting a friend to be a nominal owner. As discussed in Chapter 7, in some cases this arrangement created legal problems for the firm when the friendship ended.

On the other hand, the exclusion of a single individual's registration of a firm as a limited liability company also has a rationale under weak government

regulatory capacities. When government regulatory capacities are weak, granting a single owner company status may increase the incidents of cheating in the economy because of the moral hazard problem. It is often observed in industrial countries that bankruptcy is used as a way to evade debt repayment although at the cost of not being able to participate in other companies. With two or more people in the company, however, a balancing mechanism can be planted in the firm so cheating by one shareholder becomes a bit more difficult.

Third, there is still a division between *getihu* and private firms, and the dividing line is still whether the employer hires more than 8 people. The *Law of Private Sole Ownership Firms* is likely to inherit this division although there have been constant calls to eliminate it and treat a *getihu* the same as a private firm. One major impediment to the elimination of the division is related to the income of local BICMs. Local BICMs collected management fees on both private firms and *getihu* in the past. Recently, private firms have been exempted from the fee, but *getihu* have continued to pay it. If *getihu* were treated the same as private firms, the fees collected on them would be eliminated.

The truth is that the management fee collected on *getihu* constitutes a large portion of local BICMs' budgets. For example, in Beijing, a *getihu* needs to pay a management fee equivalent to 5 per cent of its sales. The total income contributed by the fee constitutes half of Beijing BICM's budget. Therefore, the operation of local BICMs would be paralysed if they were not allowed to collect the management fees and there were no new budget allocations or authorisation of new revenue sources from the government.

If the division between a private firm and a *getihu* is retained, the TSRIFE has to remain in place to govern the registration of *getihu*, and China's laws for business operation will remain incomplete. In addition, the existence of the management fee creates ample room for rent-seeking behaviour because the amount of fee a *getihu* pays, to a large extent, depends on his personal relationship with the BICM official in charge. Last, *getihu* was created under a special background that averted private ownership. Since this background no longer exists, the justification for its existence is not warranted. Therefore, it is meaningless to retain the division between a private firm and a *getihu*. The central and local governments should provide new budgets to local BICMs so they do not need to rely on the management fees.

Last, the new *Law of Partnership Firms* does not provide a firm with the flexibility of having a mixture of unlimited liability and limited liability capital. This flexibility allows one or more parties of the firm to shoulder unlimited liability and other parties to shoulder only limited liability. The former parties are usually insiders of the firm, and the latter parties may be outside investors. This kind of arrangement is very helpful for high-risk industries such as the





been eliminated in Shunde, the predictability and regularity brought by the government reform has provided the economy a stable business environment.

In terms of government services, the results are more diverse. Table 10.1 shows some statistics on the power supply in the six cities based on the questions directed to the price of electricity and the power cuts in the last five years. Although Shunde had high electricity prices, it also had the lowest number of power cuts and lowest average loss. Wenzhou had the highest number of power cuts, so it is not surprising to find that it had the highest percentage of firms that had their own generators. Shunde was also the fastest city in installing telephones, taking only 6.3 days on average. Wenzhou was only slightly slower at 6.4 days. Beijing, where it took 22.5 days to install a telephone, was the slowest city.

In terms of the installation fee for a telephone, Mianyang was the highest, 3,709 yuan; Beijing was second, 2,645 yuan. The lowest was Deyang, 1,184 yuan. None of the firms in Shunde complained about the quality of the phone services, Wenzhou again took the second place, with only 5 per cent of its firms making complaints. In Beijing, the percentage was also low (8 per cent). The three cities in Sichuan province were the worst, with the percentages of firms making a complaint in Chengdu, Mianyang and Deyang, 22, 31, and 23 per cent respectively.

For roads, Beijing and Chengdu had the lowest satisfactory rate of 75 per cent, with the highest Mianyang at 96 per cent. Shunde had the most expensive road system in terms of taxes and tolls. In 1998, a truck on average paid 16,083 yuan for taxes and toll. Beijing had the cheapest road system. In 1998, a truck's taxes and tolls expenses were 8,526 yuan. For the other cities, Chengdu was 9,885 yuan, Wenzhou 10,350 yuan, Mianyang 12,787 yuan, and Deyang 13,895 yuan. Therefore, it seems that there is an inverse relationship between city size and transportation costs. Large cities like Beijing and Chengdu have a higher concentration of industries and also provide more free roads. In contrast,

**Table 10.1** Power supply by city

City	Elec. price (yuan/kwhr)	Power cuts per year	Ave. length (hrs)	Ave. loss (yuan)	Firms with generator (%)
Beijing	0.91	8.4	4.6	17,754	1.6
Shunde	1.02	7.4	7.7	15,000	42.9
Chengdu	0.76	9.6	13.4	38,743	40.0
Wenzhou	1.08	24.1	9.9	28,911	87.2
Mianyang	0.72	12.0	7.6	44,022	36.4
Deyang	0.59	14.7	5.0	16,446	38.6
Total	0.84	12.4	7.8	36,886	37.4

**Source:** From the survey results.

smaller cities do not have high industrial concentration so firms' transportation costs outside the city and on toll roads and highways are increased.

In the area of water supply, Wenzhou was the worst. On average, firms experienced 27 water cuts in a year. Chengdu was the best, with only three. Shunde and Deyang experienced 9 and 5 cuts, respectively. In terms of the influence on production, 68 per cent of the firms in Wenzhou said water cuts had negative effects on production and Mianyang 62 per cent. Other cities had much lower percentages (in the thirties).

For the drainage system, Wenzhou was perceived as being the worst. Only 65 per cent of firms in Wenzhou said that the drainage system worked properly while the approval rates in other cities were much higher. In particular, the rate reached 100 per cent in Mianyang.

### **Business intermediaries and government services as a bridge for information dissemination**

The CEO questionnaire asked whether it was difficult for a private firm to get various kinds of information. In terms of business infrastructure, four types of information were regarded by a significant number of firms as highly difficult to obtain. There was information about financial sources (46 per cent, 230)<sup>2</sup>, information on investment opportunities (43 per cent, 223), information on markets (32 per cent, 265), and information on technologies (36 per cent, 233). The perception of government services was better, but far from favourable. Only 20 per cent (263) said it was difficult to get information on licensing and general government regulations. The percentages of firms saying it was difficult to get information on tax and accounting, foreign trade, and other policies were, respectively, 21 per cent (262), 28 per cent (201), and 23 per cent (189).

The high level of difficulty related to obtaining information acquisition shows that business infrastructure and government services could not adequately meet the demand of the private firms. Dissatisfaction was not evenly distributed across region. Generally, firms in Beijing were more dissatisfied. Their dissatisfaction rates were all above the average for all the kinds of information listed above. For example, 28 per cent of them (nearly 10 per cent above the average) said they felt it was difficult to get information on licensing and general government regulations. Sixty-four per cent (nearly 20 per cent above the average) said it was difficult get information on financial sources.

The rate of dissatisfaction was also high in Deyang for several kinds of information. The city that fared the best was Shunde where the dissatisfaction rates were in most cases below 20 per cent. In particular, only 6 per cent said it was difficult to get information on financial sources. Chengdu and Wenzhou followed Shunde in terms of general performance. Wenzhou scored higher also in financial information, with only 17 per cent expressing dissatisfaction.

As for the reasons for the difficulties, a high proportion of CEOs indicated that the lack of intermediaries is the major obstacle. This may be more prominent in the financial sector about which the CEOs expressed the highest rates of dissatisfaction. China has a limited number of sources for a firm to finance its investment. Since the banks are very cautious in lending to private firms, and the stock market is almost exclusively reserved for SOEs, private firms have to turn to informal borrowing. For a large amount of borrowing, friends or relatives may be of limited help, and the search costs for a large lender are high.

On the other hand, investment tools are also limited to private choices. Bank savings and government bonds are not attractive in the current period because of low interest rates, and the stock market is too risky for many private entrepreneurs to try. To match effective projects and investors, investment intermediaries such as investment banks are indispensable. Yet China lacks these intermediaries and the government does not encourage their establishment.<sup>3</sup>

For the sources of information, it is interesting to find that firms rely heavily on non-government, non-commercial sources such as self-searching, mass media, and industrial associations. When asked how they obtained necessary information, 219 (65 per cent of the total) checked self-searching, 166 (49 per cent) mass media, and 142 (42 per cent) industrial associations. Only 85 (25 per cent) of CEOs checked government publications. However, 92 (27 per cent) CEOs pointing to the Internet as a source of information, indicating that the Internet's coverage in the six cities is relatively high.

The high reliance on non-government, non-commercial sources was found in firms' searching for specific information. When asked where they obtained information on their competitors, 179 (53 per cent) CEOs checked personal contacts, 127 (38 per cent) checked industrial associations, and 124 (37 per cent) checked mass media. In contrast, only 40 (12 per cent) CEOs regarded commercial information providers as a source of information about competitors. On a question of where the firms obtained business consultants, 138 (41 per cent) CEOs checked industrial associations and 98 (29 per cent) checked business networks.

However, 93 (27 per cent) also pointed to government as a source of advice. In contrast, only 46 (14 per cent) said local commercial consulting agencies were a source. Finally, when asked where they obtained training information, 131 (39 per cent) CEOs pointed to industrial associations again. Other significant sources included government 78, (23 per cent), educational and training publications 74, (22 per cent), personal contacts 70, (21 per cent), and mass media 68, (20 per cent).

Among the above findings, three are most interesting and relevant to the topic in this section. The first is that the government has played a significant role in providing consultation and training related information to firms, but has not done equally well in providing general information. In terms of the

functions of the government, this may not be a bad thing. We do not expect a limited government to provide firms with their competitors' information or information on where to sell their products. The Survey question did not specify what kinds of consultation a firm gets from a certain source. Therefore, we do not know the kinds of consultation firms got from the government. Many CEOs expressed their appreciation to government-organised training classes.

The second interesting finding is that commercial providers have not begun to play a significant role in providing firms with information and consultations. One explanation to this finding is that specialisation is still low in the economy and the number of consulting agencies is limited. This explanation matches the fact that 44 per cent of the sample firms indicated that the lack of intermediaries was a major obstacle to acquiring information. Another explanation is that private firms cannot afford paying commercial providers because 17 per cent of the sample firms said that price was an obstacle to obtaining information.

The third interesting finding is that industrial associations have played a significant role in providing firms a whole range of information and consultation. From one perspective, industrial associations are a substitute for commercial information providers. From another perspective, the importance of industrial associations indicates that commercial networks are emerging and becoming a significant player in the Chinese private sector. We will devote the next section to the study of the types and functions of the business associations observed in the Survey.

## **Business associations**

China has long maintained national industrial associations. These associations have played a significant role in helping firms exchange technical information and obtain technology-related consultations as well as setting national technical standards. This was clearly demonstrated in the description presented in the last section. In addition, some sample firms also pointed out that the industrial associations served as a vehicle for them to establish business relations. Because most of the associations are dominated by state firms, it is also helpful for a private firm to join the industrial association if it produces intermediate products that are used by state firms. However, entrepreneurs need localised organisations to coordinate amongst themselves as well as to handle their relationship with the local government. The Survey has revealed that such localised business organisations are emerging.

At the national level, there is an official Chamber of Commerce called *All China Federation of Industry and Commerce* (ACFIC). It has an extensive organisational network that covers all the government jurisdictions at or above the county level. It was first created in the 1950s as a part of the Chinese Communist Party united fronts to accommodate private firm owners. During

the Cultural Revolution, its activities were suspended. After it started again in the late 1970s, it gradually shifted its weight from old private owners to newly emerged entrepreneurs and gained popularity in many localities. Its main mission, especially for its national headquarters, is still to work for the Chinese Communist Party's united fronts and gain support from the private sector. Its presidents at various levels are appointed by the Party. However, it has also been engaged in providing more concrete services to its members. One of them is to work with Minsheng Bank to identify qualified private firms for unsecured loans.

Some local offices of ACFIC play a significant role in organising private entrepreneurs. In Sichuan Province, the provincial office of ACFIC is also called Sichuan Chamber of Commerce. The name change has meaningful implications because it has diluted the political colour of ACFIC. The new Chamber of Commerce provides a wide range of services to its members. It serves as a bridge between the private sector and the government by informing the former of government policies and regulations and by informing the latter of the suggestions of the private sector. It helps the private sector in several ways.

For example, it recommends good firms to banks with a view of reducing the efficiency losses associated with information asymmetry. It works with the government to grant technical titles to technicians working in the private sector, recommends promising firms to apply for funds issued by the national 'Star Plan' and 'Torch Plan',<sup>4</sup> and helps private firms in obtaining passports and visas to facilitate their businesses abroad. It also has three specialised centres providing consulting services to members in the areas of firm management, legal affairs, and public relations.

In Shunde, townships that did not have an ACFIC office in the past have organised their own chambers of commerce. Those chambers are officially affiliated with the city ACFIC office, but the link is only nominal. Most chambers are established and run by private entrepreneurs themselves, but not without substantial government support. Box 10.2 shows the operation of the chamber of commerce in Guizhou township of Shunde. Interviews with private entrepreneurs in the township showed that they saw the chamber as a place to interact with each other and were quite pleased with the facilities and services it provided. The problem with the chamber is that it has restrictive conditions for entry, excluding smaller firms.

Interviews with local CEOs found that they formed different interactive circles by firm size. Smaller firms were in a disadvantageous position. They had the incentive to interact with larger firms to find opportunities for subcontracting from the latter, but larger firms had less incentive to reciprocate because there were enough small firms coming to their factories to ask for subcontracting. The interaction amongst smaller firms also was not commercial as many of them got together only to play *majiang*.

Another official organisation for private entrepreneurs is the Association of Private Firms. It does not have a national headquarters and is organised by the

local BICM. Any private firm is eventually forced to join this association because the BICM collects the membership fee whenever a private firm is registered. The fee is also included in the annual firm examination. Although in some localities the president of the association is a private entrepreneur, more often, the president is a deputy director-general of BICM. Most private entrepreneurs interviewed regarded the association as useless to them and only a way of collecting fees from them.

In Wenzhou, industry-specific business associations are emerging. This happens because Wenzhou has several specialised national markets, such as small electronic parts in Hongqiao, low voltage electric products in Liushi, and buttons in Qiaotou. The longer history of Wenzhou's private sector also helps. Box 10.3 introduces the largest industrial association in Wenzhou, Wenzhou Garment Chamber of Commerce. This chamber has been very effective in providing services and interactions for its members. It has also done quite well in promoting Wenzhou's garment industry.

However, it has accomplished more than is normal for a chamber of commerce, and perhaps more than is desirable by promoting mergers amongst its members. Although it is in the members' interests, there is a problem of violating the nation's anti-trust law.<sup>5</sup> Nevertheless, in an environment short of law enforcement, this behaviour is tolerated and even promoted by the local government because it is also in its interest to have a stronger local economy.

The promotion of industrial mergers is no more evident than in the case of the Qiaotou Button Chamber of Commerce in Yongjia county. Qiaotou is a town specialising in button production and wholesaling. It has 750 firms producing buttons. When the chamber of commerce was founded in 1996, its main purpose was to reduce the fierce competition amongst small button producers. Buttons are easy to produce, and new styles can be easily imitated. To protect firms with innovations, the chamber has enacted and enforced a regulation called *Regulations on Protecting and Managing New Products*. Member firms can apply for protection of new products for two or three months. The fee for two-month protection is 1,500 yuan, and for three month protection, 2,000 yuan. The short period of protection is consistent with the rapid design replacement in the button industry.

The chamber regularly checks the market to find imitations of the products under its protection. The violator is first warned to stop producing and selling the product; if it continues the violation, the chamber informs the township government, and the latter takes on the case and punishes the violator. The township government takes local chambers of commerce seriously. The mayor of the township is the honorary president of the button chamber, and there is a government department coordinating its relationship with the chamber. For members who violate the regulation, the button chamber can itself issue punishment. Since the chamber has gained high popularity, the township government also entrusts the chamber to punish non-member violators.

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**Box 10.2**      **Guizhou Chamber of Commerce**

Guizhou is a town in Shunde. It is completely connected with another town Rongqi. The two towns form the largest industrial site in Shunde. The Guizhou Chamber of Commerce was founded in September 1994. The town did not have a local ACFIC local chapter before the chamber was founded. Membership is restricted to firms above a certain size and has to be recommended by villages. Because of the restriction, the chamber only has some 100 members. The annual membership fee is 360 yuan. The township government provided 80,000 yuan when the chamber was founded. Daily operation relies on the membership fee and member donations.

The president and the board of directors are all private entrepreneurs. The board holds a meeting every month. Daily management is handled by a permanent office of two people. One of them was the principal of the town's high school, and the other worked in several government departments before. As a result, they maintained good relations with the government. They are responsible for inviting government officials, the mayor of the town, the head of the local tax bureau, etc., to participate in the board meetings.

There are two major events for the chamber in a year. One is the all-member meeting, and the other is the Spring Festival. In addition, one major activity of the chamber is to organise members to have tours of other parts of the country and to provide training information to entrepreneurs. The chamber also publishes a monthly newsletter that is mailed to every member free. The newsletter publishes related local and national news, news on government regulations, and articles written by local entrepreneurs. It serves as a bridge between the chamber and its members. The office maintains records of government documents and put a notice in the newsletter when a new document is received.

The chamber also helps individual firms when dealing with the government and legal affairs. For example, one firm did not fill in one bunch of its material receipts in the right way, so the tax official in charge was not willing to take these receipts into the calculation of the firm's value-added tax base. The chamber then talked with the head of the tax bureau and resolved the problem. In another example, the chamber helped another firm win a lawsuit in another province.

The chamber intended to construct its own building when it was founded, and the township government also gave it a piece of land. However, the building has not been constructed because of shortage of funds. The chamber intends to construct the building in the future after the economy improves and its members make more cash income. Two other major tasks the chamber is undertaking are to work with the government to issue technical titles to qualified technicians in private firms and to get multiple-entry visa for private entrepreneurs.

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The button chamber is in effect a semi-government agency. The interesting question, then, is why the township government does not use its own resources to promote new product protection? This question can be answered from two perspectives. First, the current patent law does not provide good protection of style-based new products. This is natural because the enforcement of such a protection is very costly. Therefore, there is not a good reason for a local government to provide the protection. As such, the button chamber's own regulation becomes a substitute for the national law. Although it was intended to govern its own members, it has effectively become a local law after it has been recognised by the local township government (or, the government enacted the regulation itself).

Second, the chamber of commerce may have an advantage over a government agency in enforcing a regulation on numerous small firms. The potential advantage derives from the established business network in the button industry.

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**Box 10.3      Wenzhou Garment Chamber of Commerce**

The garment industry is a 10 billion yuan business in Wenzhou. The garment chamber was founded in March 1994 by a group of private entrepreneurs engaged in the garment business. It has five self-management principles: voluntary participation, democratic election, self-internal management, self-financing, and paying membership fees. Membership fee is between 300 to 500 yuan per year. A member conference is held once a year. It elects the board of directors, and the directors elect the president and vice president. The cost of the conference comes from donations of the directors. It maintains an office for daily operation. Employees of the office are paid by its own funds. The daily operation of the chamber also partly relies on member donations.

The chamber has done quite well in promoting Wenzhou's garment industry. It publishes a journal *Wenzhou Garments*, providing information to its members and also introducing Wenzhou garments to outsiders. It organised its members to participate in several garment exhibitions, and organised two Wenzhou International Garment Exhibitions in 1997 and 1998. It helps its members improve the quality of their products by organising training classes and facilitating members to participate in provincial and national quality examinations. In 1996, 8 firms participated in a quality examination organised by Zhejiang province, and 7 were awarded with 'Quality Brand'. The chamber promotes cooperation and mergers among its member firms. Several mergers have happened and the new companies are enjoying larger market shares in certain product niches. It also helps members when they have unanticipated difficulties. For example, when a member's factory was severely damaged by a hurricane, he used member donations to rebuild his factory. Finally, the chamber maintains regular contacts with the city government. A vice-mayor of the city is the honorary president of the chamber. It cooperates with government branches to enforce technical standards as well as government regulations.

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However, the question can be posed; why does the chamber of commerce itself need the local government's help to enforce its own regulations? One answer to this question is that there is a problem of free riding that cannot be solved by the chamber itself.

In particular, free riding of non-member firms is a serious threat to the sustainability of any regulation that only governs member firms. In this case, it is imperative for the chamber to obtain the government's assistance. Alternatively, the local government's assistance provides authority to the chamber when it tries to enforce its regulations on members. The chamber of commerce is a voluntary organisation, so the existence of free exit reduces members' incentive to abide by its regulations. The recognition by its members of government authority helps pull the chamber together. However, China should prevent such associations from becoming the source of monopoly power favouring a few entrepreneurs to the cost of small businesses and consumers. These possible negative aspects should be emphasised.

Business networks provide public goods to enhance the development of the private sector. They also provide an institutionalised infrastructure that fosters the formation of a proper business culture. Through the above examples, we have seen that the essential element of a business network, business associations, is emerging to respond to the needs of private firms. The interaction between a business association and the local government is the most interesting feature found in the study and can be understood as a choice of both the private firms and the government responding to China's imperfect market and institutional environments.

## **Room for improvement**

The discussion in this chapter suggests several recommendations for improving the laws and regulations related to private firms and the performance of the administrative management.

While several of the shortcomings of Chinese laws related to private firms are derived from the weak law and regulatory enforcement, and are not likely to be remedied in the short-run, two improvements are immediately possible. First, firm registration should be changed from an approval process to a true registration process. At least, the minimum requirements for the initial capital should be dropped. Currently, these requirements are not binding constraints if firms are willing to cheat because they can borrow money from friends and return it immediately after they receive approval. They are only binding for firms that do not want to cheat. Therefore, these requirements lead to adverse selection by promoting cheaters and punishing honest people.

Second, the division between a *getihu* and a private firm should be dropped. The division is arbitrary in the first place, and creates an asymmetric incentive that induces a private owner to remain as *getihu* for the purpose of tax minimisation. In addition, the TSRIPE has to remain in place in order to accommodate the division, so the integrity of the Chinese laws is harmed. Since the only reason for it to remain in place is local BICMs' interests, the division should and can be eliminated.

Administrative performance is closely linked with government size and structure. With excessive public employment and redundant departments (such as the Bureau for TVEs in Wenzhou), rent-seeking behaviour is encouraged. For example, the central government has issued many directives calling for stopping irregular fees and reducing regular fees, but the amount of fees has still ballooned in the country. With tight budget constraints, local governments have to find new income sources to sustain a large government. In many cases, they have to keep silent on their employees' rent-seeking behaviour. Therefore, a thorough government reform is imperative for the restructuring and downsizing of local governments.

The Shunde municipal government has set a good example in this aspect. The current government reform, if implemented properly, would achieve the same effects generally as are present in Shunde. The reform carried out in the central government has radically reduced the number of ministries, by 19, but fallen short in cutting down the number of employees that are covered by the state budget. Many of the employees who lost their positions in a functional department have been relocated to a non-functional unit (such as a research institute) affiliated with a ministry.

Since local governments do not have as many non-functional units as the central government, one possibility is that downsizing will be forced to be real by releasing redundant employees out of the government sector. Yet another possibility is that local governments will have to create more non-functional units to accommodate the laid off employees, or the reform will simply stop. Which direction the reform will take depends on local governments' determination.

Finally, law and regulatory enforcement is the hardest part to change. This is because law and regulatory enforcement not only requires large amounts of resources, but also requires a change of people's attitudes toward the rule of law. However, there is still room for improvement. Law and regulatory enforcement is largely related to the quality of the law enforcement and administrative agencies in the government. For example, the public security bureau asks for a substantial amount of fees for taking a case. Therefore, improving the quality of the public offices is directly linked to the kind of government reform that was implemented in Shunde.

## **Social consciousness and channels for private entrepreneurs' voices**

The orthodox ideology in China still regards private entrepreneurs as exploiters of their employees. Officially, a Communist Party member is forbidden to become an owner of a private firm. Yet in reality, many private owners are members of the CCP. This has caused confusion amongst the private entrepreneurs with party membership and in some cases diminishes their incentives to enlarge their operations. To some extent, the new policy toward the private sector formed in the Fifteenth Congress of the CCP and the subsequent constitutional amendment provided an assurance to these private owners.

However, the risk is still there as the party has not taken back the prohibition and the constitution lacks the clause of unconditional protection of legal private properties. Therefore, although it has been taken as an unarguable fact that private firms have become an indispensable factor for China's economic development, the government is still reluctant to give private owners full recognition.

On the administrative side, the government has been slow in moving from a system comparable with a planned economy to a new system compatible with a market economy. Generally, the government is very effective in management revolving around its current bureaucratic establishments, but much less so in handling issues outside its traditional bureaucratic sphere.

A market economy requires more horizontal co-ordination and arbitration than vertical bureaucratic management, yet the government structure has been largely geared to accomplish the latter task. This is no more obvious in the lack of effective law enforcement for business contracts. Related to the bureaucratic establishments are the explicit and implicit rules governing the behaviour of public servants. Different bureaucratic establishments produce different rules which in turn would influence the performance of the economy. The sum of the bureaucratic establishments and the explicit and implicit rules affiliated with them is the so-called institutional capital that has been used to explain the failure of the privatisation program in Russia (Stiglitz, 1998).

China has been slow in transforming its institutional capital. This has largely to do with its gradualist approach to economic reforms. Because the latter has progressed slowly, the demand for new institutional capital is weak. However, as the private sector emerges as a major player of the economy, the demand for new institutional capital is rising. The role of institutional capital can be illuminated by comparing Shunde and Wenzhou.

In Shunde, the government took an administrative reform hand-in-hand with its privatisation program as early as 1993. The central theme of the reform was to transform the role of the government from the manager of the economy to the arbitrator of the economy. To accomplish this task, it radically cut the

total size of the staff in both the government and the party offices from 1,400 to less than 900. Accordingly, it reduced the number of government and party departments from 49 to only 29. As a result, many departments in charge of managing the economy vanished. For example, there were 14 bureaus in charge of agriculture before the reform. Now there are only 4. In addition, the several bureaus in charge of industry were shrunk into one, and its role has been largely transformed from management to providing services.

After the reform, governments at all levels have adopted a hands-off policy toward the economy. Instead, they have been more focused on law and regulation enforcement that aims at creating a fair business environment for all firms. In the meantime, the morale of government officials has been rectified. A new consensus has been formed regarding the role of public servants. They are not players in the game, but arbitrators and service providers. All these factors have contributed to forming a new kind of institutional capital that is amiable to a private-ownership based market economy.

The success of Shunde's privatisation program had much to do with the government reform. Privatisation allows private entrepreneurs the right to make decisions and gain legal ownership of the firms. However, it does not prevent rent-seeking behaviour by offices of government. In an environment of weak law enforcement, it does it prevent the government from encroaching on private ownership. With radical government reform, the Shunde government sent a strong signal to private entrepreneurs that it was committed to protecting private ownership because, willingly, it had cut its own power and the base for rent-seeking (Yao and Zhi, 1999).

In a broader context, Shunde's government reform sent a message to the general public that the municipal government held the belief that private ownership was the better choice to improve social welfare. Because of the strong role of the government in contemporary China, the opinion of the general public is largely influenced by government's position. Therefore, in the case of Shunde, the message sent by the government reform has also played a role of a catalyst in the formation of social capital that is amiable to the privatisation program and to private ownership in general.

In comparison to Shunde, Wenzhou has a much longer history of a private economy, yet it does not have the proper institutional capital that is comparable with that economy. The research team found that the Wenzhou government still maintains the structure inherited from the past. For example the government department called the Bureau of Township and Village Enterprises whose task is to manage and regulate TVEs. There are very few TVEs. Soon there will be no TVEs in Wenzhou. Although the government also adopts a hands-off policy towards the economy, the existence of the excessive functional departments propels them to find a reason for their existence.

The struggle between different government departments trying to control the same enterprises is a consequence of the old structure. For example, the Bureau of TVEs fights with the city BICM for the control of private enterprises because getting control means obtaining the right to collect the management fees on these enterprises (Chapter 10). To maintain these departments, the government turns a blind eye to arbitrary behaviour in legal enforcement. It is common in Wenzhou to find government employees operating their own businesses under alternative names. The mixing of government employment and personal businesses, if has not brought corruption, has at least ruined the work spirit of the public servants.

It is not surprising to find that more of the sampled private CEOs in Wenzhou complained about the government's arbitrary behaviour than those in Shunde. The research team also found that some firms in Wenzhou moved to Guangdong because of the high land price and unfriendly institutional environment.

While the institutional capital largely defines the institutional environment for a private firm, the social capital defines a private entrepreneur's position in society. The general public's perception of a private entrepreneur has changed over time and varies between regions. Private entrepreneurs were thought to take advantage of employees until recently. However, the general public still perceives private firms as being less trustworthy than state firms. This is partly caused by prejudices, the relatively poorer quality of products (especially consumer products) produced by private firms and their unwillingness to disclose internal information.

It is very interesting to observe that many private entrepreneurs sought to de-emphasise the private nature of ownership of their firms. They argued that private capital is a part of the capital a society owns, and its accumulation is the accumulation of society's capital. However, government officials did not agree. Their logic is simple—capital accumulated by a private firm belongs to the owner itself, but capital accumulated by a state firm belongs to the public. While this logic is correct, it also leads to different treatments for private and state firms. For example, the funds invested by a state firm in technical innovations are exempted from corporate income tax, but a private firm does not have this privilege. When asked by a private owner, a government official defended the policy by exactly the same logic. In light of the different treatments and negative perception of the general public, it is understandable why private entrepreneurs asked that their ownership be 'de-emphasised'.

It is noticeable that people in different regions have different perceptions of private firms. In the coastal areas, people are more tolerant towards private entrepreneurs; but in central and western parts of the country, accumulation of private wealth will cause others envy. This may be more prominent in a village setting where people form a close-knit society and the collective survival mentality implanted by the commune system still has its influences.

There are also differences between the south and the north. When the research team visited the BICM of Beijing, it was clear that private firms included all the three kinds of ownership types, that is, sole ownership, partnership, and limited liability. However, when the team visited the BICM of Shunde, it was told that only a firm of sole ownership was categorised as private. Indeed, according to the published statistical yearbook of Shunde, public firms, state-owned or collectively owned, still dominated even in 1997 whereas in reality there were only a few such firms by that year. The reason for this discrepancy was that partnership and limited liability firms were recorded as public. It was a result of the de-emphasis of private ownership, and consistent with the low profile the Shunde government has maintained for its privatisation program. In effect, it has helped the private firms in Shunde to gain confidence as well as to obtain a shield to potential criticisms.

What is the response of a private entrepreneur to harsh environments? The unfriendly environment has taken a toll on the private sector. Not long ago, it was not hard to find a private entrepreneur engaging in excessive consumption, pouring a fortune into building a mansion, buying luxurious cars, having exotic banquets, or in the extreme case, simply competing to burn more renminbi notes. The state did not provide sufficient protection to privately owned production means, but did protect individual belongings including houses and cars. Therefore, this excessive consumption was, to some extent, a way of moving one's wealth from the sphere without sufficient protection to that with full protection.

Another way for a private entrepreneur to protect business assets was to put a red hat on its head, that is, to *guakao* a collective firm or a local government branch (see Box 4.1 for an example). However, things have gradually changed in recent years. As the state becomes more tolerant of private firms, the social capital also becomes more accommodating. On the other hand, private entrepreneurs have become more mature. In Shunde, it is common for a group of entrepreneurs to order simple meals for dinner while they discuss business.

More and more, private entrepreneurs have begun to voice their concerns by participating in public life. Many of them hold positions in local and national People's Congress or People's Consultative Congress. It was frequently found by the research team that the voice of private entrepreneurs in these two legislative bodies made a difference.

One prominent example involves an entrepreneur of a large software company in Beijing. He is a deputy of the National People's Congress. He proposed in one session of the Congress to cut the value-added tax rate of high-tech firms from 17 per cent to 8 per cent. The proposal was eventually passed. It is noteworthy that the promotion of the national ACFIC and its local chapters should be fully accredited for the engagement of private

entrepreneurs in China's political life. As a private entrepreneur has to be recommended by a local ACFIC chapter in order to take a position in a legislative body, the role of ACFIC in promoting the political stance of the private sector is indispensable. However, despite the official background, the active engagement of private entrepreneurs in public life has reinforced their identity and self-consciousness. A new business class is taking shape in China.

## Notes

1. The central government finished its reform in 1998 and cut 15 per cent of its employees and consolidated a dozen of ministries. The same percentage cut is required for local governments. Therefore, the actual cut in Shunde was more than 2 times the required cut.
2. The numbers in the parenthesis are the percentage and firm numbers with usable entries.
3. The National Bank of Development intended to set up an investment bank, but the idea was put down by the State Council.
4. The 'Star Plan' aims at promoting small firms; and the 'Torch Plan' aims at promoting high-tech industries.
5. China does not have a separate anti-trust law, but the *Anti-Unfair Competition Law* has clauses regarding the issue.