A summary overview of emerging private enterprise in China

The Chinese economy is currently undergoing its third great institutional transformation of the reform period.This transformation is as profound as the replacement of the peoples communes with the household responsibility system in the early 1980s and the emergence of township and village enterprises as the main locus of economic dynamism in the second half of the 1980s. The third transformation is the emergence of the private sector as the main focus of economic growth. Like the two preceeding transformations of the reform era, it has proceeded quietly and swiftly, building upon an emerging reality, with change accelerating once the authorities have recognised the benefits of the reality and given official blessing to continuation of the transformation.

A constitutional amendment acknowledging the importance of the private sector was adopted during the 1999 sessions of the National People's Congress. It

- provides a legal basis for private enterprise in the economy
- makes official recognition of the important emerging reality, that a majority of the growth in non-farm employment and output is in the private sector despite the continued tendencies for capital and government services to be allocated disproportionately to state-owned enterprises
- allows individual enterprises to take off their 'red hats', thus reducing uncertainty in the business environment
- allows the official policy and regulatory environment to be refocused to remove impediments to continued dynamism in a major, and soon the major, part of the economy.

The private sector was suppressed in China during the period of central planning (1957–78). It has re-emerged since reform started in the late 1970s and has grown quickly in the past 20 years. The number of registered private firms and employment in them, as well as their share in total GDP, is growing even more rapidly in the improved policy environment for private business that was established in the late 1990s.

The non-state sector now accounts for 62 per cent of total economic activity. Within this total, there are difficult matters of definition in drawing the dividing line between genuinely private and 'collective' enterprises. On our best estimate, the private sector, including household production in agriculture, accounts for 50 per cent of the total. This proportion will now grow rapidly for two reasons.

First, the component of the 'collective sector' that is in reality private will grow rapidly, as the regulatory and ideological advantages of a real or nominal 'red hat' diminish. Just as the collective sector has effectively disappeared in recent years in the municipality of Shunde, so it will recede in other areas.

Second, the state-owned sector will continue to decline as a proportion of total output, just as it has, despite regulatory advantages, over the past two decades. The non-state sector—at first agricultural households and collectives, and increasingly private enterprises outside agriculture—has used resources more effectively and grown more rapidly than state-owned enterprises.

The success of the private sector in a regulatory environment overwhelmingly geared to the requirements of state-owned enterprises is remarkable. The reform of the regulatory and institutional framework to provide more congenial conditions for the most dynamic and now the larger part of the Chinese economy has the capacity to unleash large, new potential for economic growth.

The development of the private sector at this stage of economic transformation plays an important role in a number of areas.

- It increases employment both by recruiting new workers into the non-farm economy and by absorbing laid-off workers from reformed state-owned enterprises (SOEs).
- It creates competition, nurtures entrepreneurship and instigates innovation.
- It helps channel an increasing part of social funds into more efficient uses and hence increases the overall efficiency of the economy.
- Meeting the demands of the private sector can help build an institutional framework which is more compatible with a market system, thereby facilitating improved performance in state-owned and collective enterprises.
- Private enterprises as a new source for growth can play an important role in achieving the objective of restoring growth momentum after a slowdown during and after the financial crisis elsewhere in East Asia.
- Private firms in China are subject to a hard budget constraint so that their expansion does not carry the same risks to macroeconomic stability as the expansion of state-owned enterprises.

But, in a country whose production and commercial activities have been dominated especially by large SOEs for decades, there is still much discrimination against smaller and private enterprises in areas such as business registration, taxation, financing and the right to engage in foreign trade. Furthermore, public perception of the private sector has not yet changed as much as the economic reality that is reflected in official statistics. A considerable task remains, to allow the participation of private firms in developing China's economy, including its foreign trade, to reach its full potential.

The development of the private sector in a transition economy like China hinges on several things.

- The private sector needs to operate and develop within genuine market conditions. Thus, further market-oriented reform is essential.
- To establish genuine market conditions, the rule of law needs to be established to protect private ownership and contract rights and to clearly define private obligations.
- Development of the private sector also requires adjustments in the functioning of the government.
- The establishment of effective market institutions will guide private enterprises into productive profit-seeking and innovation rather than unproductive rent-seeking activities.
- Development of the private sector needs to be accompanied by social and political measures from government and pressure from the public in order to deal with such associated problems as income disparities and social protection.

China has begun to tackle these issues and some measures aimed at encouraging private sector development have been introduced. Most important has been the simple recognition of the sector in the constitution and state policy. Within this context, a large number of small and medium-size SOEs are currently being restructured based on market conditions in which private firms are allowed to play an important role. This is proceeding so rapidly in some areas that it is called the 'quiet revolution'.

Financial and labour markets are rapidly developing. A new management (governance) structure is taking shape among established and new non-state firms. Social safety nets are being built. State commercial banks have been asked to assist in the development of small firms including private enterprises by introducing flexible lending interest rates, which can be varied in response to market conditions including perceptions of risk. From the beginning of 1999 (for the first time since 1957) some private enterprises were granted licenses to conduct foreign trade. More and more sectors including financial services have been opened to foreign competition.

There are still many problems associated with the development of private enterprises in China. For example

- unwarranted fees and taxes are still being levied on private enterprises by local governments
- private firms still find it difficult to obtain to business finance, particularly from state financial institutions
- there is a need for efficient and transparent bank loan guarantee systems for small and medium-size firms, including private enterprises
- there is a need to improve the skill base of private enterprises, particularly those of medium and small size, at both managerial and employee levels
- there needs to be greater transparency of private enterprises in management and operation, particularly in their accounting and auditing practices
- private enterprise still doesn't have and should be provided with access to efficient government sources related to business registration, land use, finance, market entry and law enforcement
- the legal and regulatory environment needs to be streamlined
- markets need to be developed for inputs into production, especially finance and labour
- a more competitive environment in which all firms compete on an equal footing is yet to be established.

Overall, there is much that could be done to enhance the contribution to development of this dynamic sector of the economy.

Policy recommendations

The Survey results, discussed in this book, and analysis based on the Survey, suggest the following policy recommendations for the development of private enterprise in China.

Reforming the financial system

The uneven distribution of bank loans between the state and non-state sectors is a major constraint on further development of the non-state sector, particularly small-size private enterprises. It results in inefficient uses of bank funds. In 1998, the non-state sector contributed 71 per cent of industrial gross output value. However, its share in total bank loans has been minor (SSB 1999).

According to the Industrial and Commercial Bank of China, a major state bank, by 20 June 1999, only 20.9 per cent of its short-term loans were to non-state enterprises. Most of the non-state recipients of loans were collective and foreign-owned enterprises. Domestic individual and private enterprises shared only 0.5 per cent of total short-term loans[1]. The Survey found that small private enterprises find it difficult to get a bank loan.

It may be, but it is not obviously the case, that loans extended to small enterprises have a higher risk than those to larger enterprises. The appalling record of non-performing loans to large state enterprises makes the opposite suggestion. The financial constraint on small private enterprises seriously restricts their development and growth.

To solve the problem, the following policy changes and steps are recommended.

1. Policies of state banks should be adjusted to treat the state and non-state including private enterprises more even-handedly. Financial institutions particularly state banks should develop policies and plans to overcome non-commercial obstacles to making loans to private enterprises.
2. The current policy of zero risk lending, applied mainly to non-state enterprises, should be replaced by judging performance on the overall management of a portfolio. A bank branch or an employee would be evaluated by the profitability of the resources allocated in a certain period, not simply by whether one or two loans had been lost. They would not be evaluated differently according to whether the borrower was a state or a private enterprise.
3. This outcome would be achieved naturally as a consequence of requiring the state banks to operate competitively and profitably within a rational system of prudential supervision, which systematically discounted non-performing assets independently of the identity of the borrower, and which required maintenance of minimum ratios of capital to assets, all within a transparent accounting framework. The second recommendation is therefore best implemented through completion of the system-wide financial reforms that are in any case required for future economic stability.
4. To give incentives to banks to extend loans to small enterprises, to cover their perceived risk of losses, and to eliminate rent-seeking behaviour, a flexible interest rate is needed. Controls on lending rates can be eased to allow banks to charge different rates according to the risks of loans. The years following the Asian financial crisis extending at least through 2002 are a good time to carry out interest rate reform because the economy is not experiencing inflationary boom conditions, and liberalisation will not lead to the interest rate being pushed too high by demand for funds.[2]
5. To finance small and medium-size enterprises, there is a need to develop new non-state financial institutions. Many local non-state

financial institutions have been eliminated, including those which operated well, as a consequence of new prudential regulations in the late 1990s that were designed to reduce systemic risk to the financial sector. A new policy should allow non-state financial institutions to grow, within reasonable prudential supervision by the state. Rules that effectively apply a total ban on all new financial institutions is inappropriate. In this context, it would be advantageous to allow more private banks to operate.

6. The current quota system for entering the stockmarket has given priority to state enterprises. This has resulted in inefficient use of financial capital and less chances for more efficient private firms to raise investment funds through stockmarkets. It is recommended that state and non-state enterprises should have equal access to finance on stockmarkets on terms that vary only with market-related characteristics.
7. Within the context of allowing the emergence of new non-state institutions, and allowing more equitable access to stockmarket issues, special care should be taken to remove current impediments to the provision of 'venture capital'. By 'venture capital' we mean the provision of capital at a high price to activities that are perceived as having high risk but which carry the possibility of high reward.
8. It is important that the regulations governing the listing of shares in established firms, including state-owned enterprises, allow the sale of 'old' as well as 'new issue' shares to facilitate capitalisation of the fruits of successful efforts in establishing new enterprises.
9. Loan guarantee funds or systems, if appropriately designed, can help to resolve financing problems facing private enterprises. Such systems need to be run efficiently and transparently in order to avoid moral hazard and cronyism. Contributions from the private sector into such funds help to increase available funding, improve efficiency of management, reduce moral hazard and strengthen accountability. From the current study, it seems that guarantee funds, outside the public policy sector, would contribute to a solution to small and medium firms' financing problems.
10. The current asset evaluation system for private enterprises in applying for a bank loan is counter-productive. Complicated procedures and high fees deter potential applicants. The system needs to be reformed by simplifying the assessment procedures and rationalising fees. For example, fees should be progressively lower for firms that have established their credit-worthiness through a good repayment record on loans for which they are seeking refinancing.

Further reforming government taxation and revenue system

The Survey found a number of problems for small and for private firms in the current tax system and the government collection of fees. These problems can be summarised as follows.

- Although the tax burden is low compared with other countries (the government budgetary revenue accounted for only 12 per cent of GDP in 1998), there are massive irregular fees, fines, and involuntary 'donations' collected by various government departments at the different administration levels.
- Some estimates suggest that the amount of non-budgetary government revenue, is no less than the formal budgetary revenue. Our Survey finds that the amount of fees collected from firms was smaller than taxes paid, but nevertheless considerable.
- An important reason for the extent of revenue raising through fees is the conflict between the decentralised government role and the centralised tax legislation. Local governments are not allowed to adjust the rate of local taxes or create new taxes to meet their needs. Instead, they irregularly and arbitrarily collect fees. The absence of democratic monitoring of government behaviour facilitates the continuation of irregularities. Without effective supervision, some fees come to be applied to the personal interests of government officials.
- The heavy collection of fees increased burdens on enterprises, caused unnecessary uncertainty; and distorted market signals and firms' incentives. It was also a source of government corruption.
- The actual tax burden among firms is uneven. The variation is much greater in relation to fee collection.The Survey results indicate that fees are higher as a proportion of sales for smaller than for larger firms. Data from the sample firms show that firms with up to 50, 51–100, 101–500, and above 500 employees pay tax and fees totalling 11, 9.5, 9.3, and 7.6 per cent respectively of total sales. This reflects the fact that large firms have more opportunity for tax privileges. The amount of tax and fees also varies across regions.
- Fees, and in some cases taxes, are often collected arbitrarily depending on government officials' personal judgment. They are not transparent and frequently related to rent-seeking behaviour of government officials.
- The current tax system discourages investment and technical innovation by enterprises. This is mainly because investment in capital assets and R&D does not attract deductions in assessment of value-added tax and income tax.

With consideration of the above problems, some policy changes and reform measures are recommended.

1. There needs to be a systematic effort to place the revenues of lower levels of government on a sound footing. The government is trying to solve the irregular fee collection problem by absorbing some fees into the tax system. However, this is unlikely to satisfy all the needs of local governments in different regions with different levels of development. Some taxation powers and rights to revenue should be decentralised. For this to achieve the desired objectives, a more democratic monitoring system for local governments is needed, partly replacing the role of central supervision.
2. The tax system should be made more transparent and more equitable in its application across firms. Opportunities for arbitrary interpretations of tax laws and regulations need to be eliminated. The tax system should be reformed to allow full deductions for expenditure on investment and innovation in assessment of value added tax and income tax.
3. For fairness and efficiency in tax collection, efforts need to be made to help small enterprises to improve management and accounting systems. This is partly a matter of education and training of personnel, and partly of consciousness-raising for key managers and leaders. The best results are unlikely to be achieved from government initiative alone, although government and such public institutions as All China Federation of Industry and Commerce (ACFIC) have an important role in framing the discussion.
4. Accounting and auditing services should be arranged to meet the increasing needs of private firms especially small firms. The government role is to insist on transparent reporting of financial data according to clearly articulated standards, to support education and training in related fields, and to facilitate the development and operation of professional firms providing these services, including through entry of foreign firms.
5. The taxation system itself must be well disciplined. Rent-seeking behaviour, in all forms, by government officials and departments, should be strictly prohibited. Again, clear rules, capable of simple enforcement, and specialised education and training, are the key ingredients of reform.

Government reform

Two other important reasons for raising the financial burdens in forms of fees on private enterprises is the over-expansion of local governments and rent-seeking behaviour of government officials.

The roles of government departments are not clearly defined. Some old government institution functions that are not compatible with a market system have been becoming obsolete. There is overlap in functions among government departments. In some areas, the heavy government burden on firms has become the major obstruction to economic growth.

Because of the expansion of market elements in the economy, the room for rent-seeking behaviour has been reduced. This rent-seeking behaviour is no longer active in input distribution, fund distribution, price control, and import and export controls. However, such behaviour appears to have become more serious in areas of government administration that cannot be subject to market disciplines. They include taxation, legal/regulatory action, public security and local community administration.

Rent-seeking behaviour is also rampant in those institutions that cannot be fully subject to market disciplines. They include institutions concerned with administration of land use, pollution control, health and safety supervision, technology and quality standard of products. Rent-seeking behaviour has significantly increased the business costs to firms and hampered their development.

Reforms in government itself are necessary. The following are recommended as being important to the development of the private sector

1. re-examining, redefining and clarifying the functions of government departments at different administrative levels according to the requirements of a market economy. Changes must be allowed in the structure of local governments in different regions to meet different needs resulting from different circumstances in those regions
2. reducing the size of governments according to the clarified roles of departments, and eliminating unnecessary government departments or organisations affiliated to governments
3. the discipline of the governments must be emphasised by strengthening both the central supervision and local monitoring system with democratic modalities. Rent-seeking behaviour of all kinds must be prohibited
4. interference by governments at different levels in enterprise operation that has no clear legal basis should be prevented.

Policies on technical innovation

Although private enterprises are active in technical innovation, there are several major constraints for their investment in research and development (R&D) and other activities conducive to development of technological capabilities. These constraints include shortages and weaknesses in human capital, financial resources, information and effective protection of intellectual property rights.

In the past two decades, economic growth in China was accelerated mainly by the effects of market-oriented economic reform in improving resource allocation, efficiency in production and openness to foreign ideas, methods and competition. Government and business alike paid insufficient attention to education and other investments in human capital, partly due to the lack of funds. The growth rate of human capital, measured crudely by numbers of educated workers in the labour force, was slower in the reform period than in the pre-reform period (Wang 1999).

Other countries' experience shows that fast economic growth cannot be sustained without significant acceleration of human capital growth. To meet this condition of sustained rapid growth, the government needs to invest heavily in education and R&D. Government could lessen its financial burden in developing education by allowing investment by the domestic and foreign private sector. Investment in education in relevant business skills is particularly important now to the private sector.

China lacks financial institutions that deal with investments in R&D, and more generally venture capital, which has high risk but high potential returns. The government is embarking on establishing various kinds of funds for the purpose of research and development. Again, non-government institutions should also be allowed and encouraged to participate in these efforts.

It is important for information service systems to be effective, especially for small business. More commercial information and knowledge is required in relation to technology, international and domestic goods and services markets, factor markets and management. This is best achieved by facilitating the emergence of new businesses providing these services on a market basis, especially in the private sector. A more competitive telecommunications system, providing basic services at international prices would help.

Legal protection of property rights

To safeguard technical innovation, an improvement and strengthening of the legal system is warranted. This will strengthen incentives for enterprises to invest in R&D and promote innovation.

The common phenomenon of debt repayment arrears and bad debts between firms for private firms can be traced to the lack of legal protection for private property rights. This results in disorder in the market and high costs to legitimate firms as well as to the economy. Protection of property rights should be legislated more clearly and should be enforced more effectively.

Generally the legal system needs to be further improved, with a strengthening of law enforcement to curb irregularities, and reduced transaction costs.

Education and training

It is a theme of these recommendations that there needs to be considerable investment in human capital with relevance to public and private regulation and governance of a market economy. Relevant areas of education and training include business law, accounting, auditing, business and public administration, as well as specialized areas including finance and economics.

There are private (for the individual who undertakes the education or the firm which contributes to employee education) as well as public benefits from expenditures on business-related education and training. There is therefore a case for partial but not full public subsidy for these activities.

Care needs to be given to the mechanisms through which elements of public provision of business education and training are delivered. Not all established educational institutions are suitable for training in business-related fields directed at the effective operation of a market economy.

What is required is flexibility, competition, and openness to domestic and international concepts and market pressures. This is likely to be achieved by providing additional public subsidy not directly on expansion of existing institutions, but as vouchers allocated competitively to qualified students, and redeemable at any properly credentialled institution, including new, private educational institutions. This would support the expansion of new institutions delivering in business-related education services that are perceived in the market-place as having high value.

Opening up more areas (sectors) for private investment

China's likely accession to the World Trade Organisation (WTO) in 2001 requires new steps in its liberalisation program and adjustments in its regulatory framework. Such changes and adjustments are consistent with the current policy shifts towards accommodating the development of the private sector in the Chinese economy. One area that needs further policy action is to open up more areas for private investment and trade.

- All sectors except those in which the State has predominant control should be open to private investment.
- The Law on Protection Against Unfair Competition (enacted in December 1993) to create a fair and competitive business and investment environment needs to be strictly implemented.
- Preferential policies towards SOEs and foreign investments need

to be gradually phased out and a policy of national treatments to enable domestic private enterprises to compete with SOEs and foreign firms on an equal footing needs to be adopted.

- Foreign trading rights should be extended to all qualified private enterprises to allow direct and wider participation by private enterprises in China's foreign trade.

Implications

Several implications for the Chinese economy, reform program, governments, private enterprises and foreign investors (donors) can be drawn from the study.

For the economy and reform

The development of private enterprise was steady during the early years of the reform then accelerated from the early 1990s. Private businesses have made great contributions to the growth of the Chinese economy. We expect that the private sector will contribute much more than half the increase in China's economic output over the next ten years. Further liberalisation and institutional reform hold the key to utilising fully the private sector's contribution.

For governments

Amongst the many implications for government, one stands above others. Governments at all levels should be more consistent with and less arbitrary in their approach and policies towards private enterprise. The construction of the right policy, legal and regulatory framework will have a large pay-off in terms of more rapid development of private economies.

For private enterprises

Many of the lessons of the study are for private enterprises themselves. The key point is that private business should endeavour to focus more on the market, rather than government bureaucracies. To grow to their full potential, they will need to rely more on external financing, especially financing from equity markets, which will require more transparent accounting and lines of authority, and the provision of more reliable information into the market place.

For International Finance Corporation (IFC)

There is a growing demand from the private sector for expertise and training aimed at enhancing their development. Including areas such as financing, corporate planning and governance, management skills, business strategy, marketing, and technological know-how, etc. The IFC is well placed to provide such services to some enterprises.

Notes

1. Information is obtained from an interview with the Industrial and Commercial Bank of China (ICBC) senior officials.
2. It is reported by the time of writing this report that the Central Bank would move to loosen the tight restriction on interest rates, allowing banks wider discretion in setting lending rates based on credit risk starting from 2000. Chinese banks are now required to offer rates within 20 per cent of the central bank's official level, which means a window of just 0.45 percentage points on the benchmark one-year deposit rate of 2.25 per cent.