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# Entry to the WTO and the domestic private economy

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China's entry to the WTO on 11 December 2001 began a new phase in China's economic transition as the terms of accession require further fundamental change in China's economic system. Existing studies have focused predominantly on the impact of China's WTO entry on different sectors of the economy or the economy as a whole. One area that has not been adequately discussed is how conforming with the WTO requirements will affect the development of the emerging domestic private economy in China.

The challenges facing domestic private enterprises in the wake of the WTO entry are particularly pronounced because domestic private enterprises have historically already faced unequal terms of competition with state-owned enterprises and foreign firms (including joint venture firms). Nevertheless, China's ability to face the challenges of WTO entry will depend to a great extent on whether the domestic private sector can successfully develop and expand. This is largely because the private sector has already played an important role in the economy, and further development of the private sector will influence the reform program in many areas, including reform of SOEs and state-owned banks (SOBs). Most importantly, vibrant development of the domestic private sector will require market-compatible institution building—the most fundamental task in meeting the requirements of the WTO.

Specifically, WTO entry requires transparent and formal procedures in the conduct of business and trade, property rights to enhance incentives and facilitate business transactions, level playing fields to fulfil the obligation for 'national

treatment' and ensure fair competition, and rule of law to provide a legal environment in which businesses can operate. All these requirements have direct implications for the development of domestic private enterprises.

## CONSTRAINTS, GROWTH TREND AND CONTRIBUTIONS

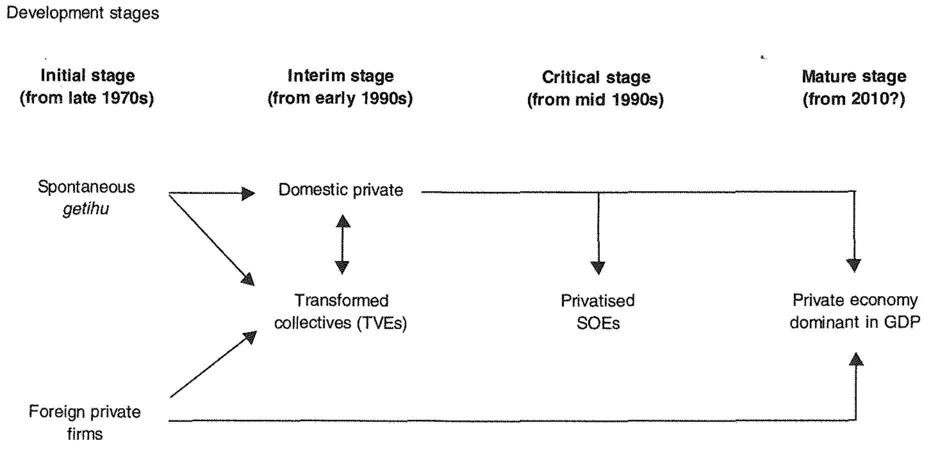
Private firms have emerged in several different ways, reflecting the complexity of a transitional process based on gradualist reform. These include spontaneous eruption of individually operated private businesses in urban and rural areas; the emergence or transformation of private enterprises from urban collectives and township and village enterprises (TVEs) in rural areas; private enterprises transformed from state-owned enterprises; and private foreign enterprises, including joint ventures and wholly foreign-owned firms (Figure 7.1).

In a partially reformed system, private enterprises face enormous difficulties and constraints imposed by various political, institutional, economic and social factors. The following are amongst the more important constraints requiring correction

- arbitrary fees and taxes imposed on private enterprises by local governments
- private firms' access to business finance, particularly from state financial institutions
- the absence of efficient and transparent bank lending systems to small and medium-size enterprises generally, and private enterprises in particular
- the weakness of the skill base in private enterprises, particularly those of medium and small size, at both managerial and employee levels
- the weakness and lack of transparency in accounting and auditing practices
- the weakness of the legal and regulatory environment
- the weakness of markets, particularly financial and labour markets
- the absence of a competitive environment in which all types of firms are competing on an equal footing.

Despite constraints, the private sector is now the most dynamic sector in the economy, and has, since the early 1990s, made important contributions to growth and reform. Growth in the number of formally registered private enterprises, including the *getihu* (individual businesses or enterprises), can be seen from Table 7.1. The average growth rate of formally registered private enterprises far exceeded that of both state and collective enterprises during the period 1989–98 in most respects, including in employment, registered capital, tax revenue, gross value of industrial output and retail sales.

FIGURE 7.1 **TRANSITIONAL PATHS TOWARD THE PRIVATE ECONOMY**




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 workers laid-off by reformed SOEs. It creates competition, nurtures entrepreneurship and instigates innovation. It helps channel an increasing proportion of investment into more efficient uses and hence increases the overall efficiency of the economy. It helps drive the regulatory and institutional framework into becoming more compatible with a market system, thereby facilitating improved performance in state-owned and collective enterprises. It also accelerates growth with less risk to macroeconomic stability than would expansion of state-owned enterprises, since private firms are subject to hard budget constraints.

As a result, there has been a significant shift from the state to the non-state sector in the economy despite various constraints imposed on non-state, especially private, enterprises (Figure 7.2). The share of domestic private enterprises in total GDP, industrial outputs, employment, foreign trade and taxation revenues has increased phenomenally relative to similar shares for SOEs. In line with such a shift, the state has gradually withdrawn from the more competitive sectors of the economy, giving way to non-state enterprises in these industries. The state's share in total industrial output has fallen considerably, accounting for less than one-third

of the total by the end of the 1990s. Given the differences in their respective growth rates, the state's share in the total economy will continue to shrink in the face of private sector expansion.

Facing constraints because of the partially reformed institutional framework, the private sector has induced institutional changes to accommodate its development. In the process, the legitimacy of the private economy (property rights) has gradually come to be accepted ideologically, politically and, more importantly, constitutionally—a fact which has long-term implications for Chinese society. These institutional changes have been vital in enhancing the growth and development of private enterprise but also in prompting state-owned enterprises (SOE) reform. In contributing to progress in two crucial issues in economic transformation—the creation of incentives and the reallocation of resources—private enterprise has become the key for successful restructuring of the SOEs.

Many key reform issues remain. The building of market-compatible institutions is the most important factor for the continued development of private enterprise. Ownership and property rights need to be formalised and made more secure. Regulatory policies that affect, among other things, entry, exit, markets (especially financial markets) and government functions need to be enhanced. Reform in these areas will help overcome the remaining constraints on the development of the private sector, leading it to make an even greater contribution to the reform and growth of

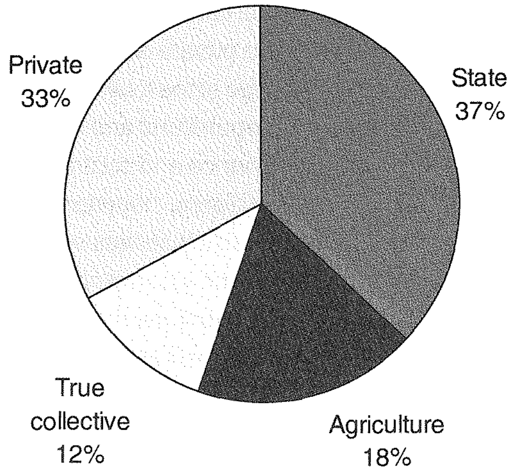
TABLE 7.1 **GROWTH OF PRIVATE AND OTHER ENTERPRISE, 1989–98 (AVERAGE GROWTH RATE)**

| | Average | State | Collective | FDI | *Getihu* | Private[a] |
|---|---|---|---|---|---|---|
| Number of firms | | 5.37 | 0.27 | 34.4 | 8.48 | 33.27 |
| Employment | 2.64 | -0.01 | -0.06 | 22.55 | 13.6 | 29.76 |
| Registered capital | | 12.89 | 11.56 | 36.94 | 27.64 | 63.97 |
| Tax revenue (89–97) | 17.55 | 14.83 | 11.8 | 30.37[b] | 60.79 | 73.15 |
| Fixed capital investment[c] | 24.2 | 21.6 | 28.2 | 11.73[d] | 16.0 | 33.8 |
| Gross value of output | 16.61 | 5.39 | 18.3 | 27.84[c] | 32.95 | 51.85 |
| Retail sales | 13.2 | 5.32 | 4.64 | | 22.35 | 57.24 |

**Notes:** [a]Private here refers to formally registered private enterprises; [b]1994–97; [c]1990–98; [d]1994–98.

**Sources:** Constructed using the figures contained in various tables in Zhang, H. and Ming, L. (eds), 2000. *Development Report on Private Enterprise in China*, Social Sciences Literature Publishing House, Beijing; and Chinese Statistical Agency, *Statistical Yearbooks of China*, (1999).

FIGURE 7.2 **OWNERSHIP SHARES IN CHINA'S GDP, 1998**




**Source:** Garnaut, R., Song, L., Yao, Y., and Wang, X., 2001. *Private Enterprise in China*, Asia Pacific Press, Canberra:19).

the Chinese economy and lay a more solid foundation for China's integration into the world economy.

## INFORMALITY VERSUS FORMALITY

Informality can be defined as variations in social behaviour from formal rules, norms and practice (formality). Informalities are in principle inconsistent with the WTO requirements, which demand formal rules and procedures as the foundation on which member countries apply their policies and conduct business with each other. It is therefore important for the government to facilitate a rapid shift from informality to formality.

Informality, ranging from family-based management and reliance on trust rather than contracts to non-transparency in accounting and taxation systems and informal financial markets, has been a feature of private enterprise development. Informalities associated with the activities of private enterprises stem largely from the imperfect institutional changes resulting from various reform measures and cultural influences. The scale and depth of informality are determined by the extent of the market distortion and progress in reform and institution building. The existence of

informality under certain circumstances brings about gains as well as costs to agencies who attempt to exploit it. A shift that increases the costs and reduces the gains of exploiting informality requires that certain conditions be met.

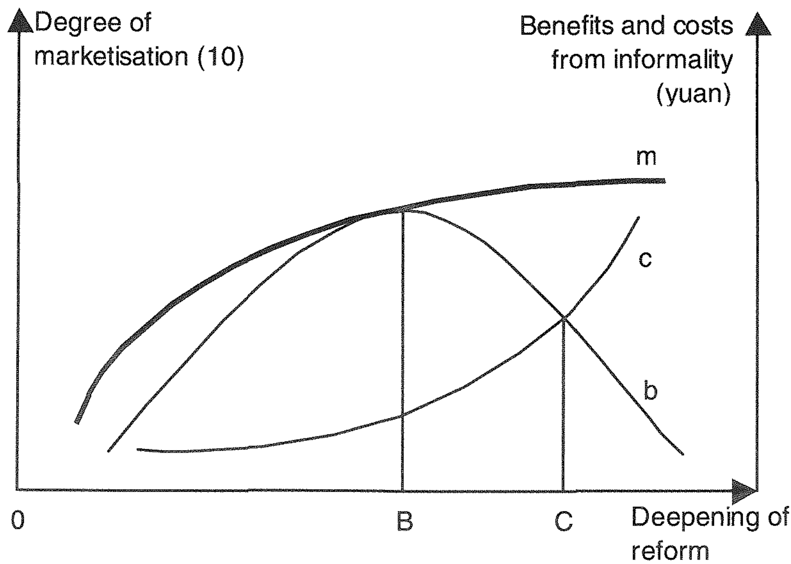
It can be argued that the informality of the private sector was a great strength during a period of uncertainty and rapid change since it allowed private enterprises to respond flexibly to changing policies and regulations and new market opportunities. These private gains, such as obtaining finance and contracts, securing the use of land and material, avoiding taxes, and violating copyright, often help private enterprises survive and expand in an unfavourable business environment. But these private gains are acquired at a cost to the firm and also carry social costs, including the worsening of bureaucratic corruption. For example, the survey of Chief Executive Officers in Chinese private businesses, reported in Garnaut et al. (2001), show that the cost of 'unproductive activities', including expenditure on maintaining and improving *guanxi* (connections), can reach 20 per cent of a firm's total profits, and can take up as much as 80 per cent of a CEOs' time and energy.

Institutional factors can also contribute to the widespread practice of informalities. For example, poorly defined and insecure property rights, burdensome government regulations and lack of law enforcement have seriously hampered private enterprises' adjustment to change and have created ample opportunities for exploiting informalities.

Informality now, however, poses serious obstacles to the further growth and development of private enterprises. Informality has resulted in opaque and unfocused companies with limited management capacity, which find it difficult to attract the finance and skills they need to grow (Gregory et al. 2000). More importantly, exploiting various kinds of informality to acquire private gains incurs costs (penalties) for entrepreneurs. From an economic point of view, entrepreneurs will pursue these activities so long as the gains are larger than the costs. A graphic approach is developed here to explain, (1) how the benefits from exploiting informality change over time with the deepening of reform (marketisation); and (2) how the relative payoff (benefits versus costs) shifts over time for the same reason (Figure 7.3).

Without a competitive market system and well-established market-compatible institutions, there are numerous opportunities, at certain stages of economic transformation, for entrepreneurs to exploit informality for private gain (shown by a precipitously rising *b* curve in Figure 7.3). When marketisation reaches a certain level as a result of a deepening of reform and institution-building, however, entrepreneurs

FIGURE 7.3 **REFORM, MARKETISATION AND CHANGES IN PRIVATE GAINS AND COSTS FROM INFORMALITY**




**Source:** Constructed from Song, 2001b. Behaviour of private enterprises in a partially reformed system—China, Paper presented at the 13th Conference of the Association for Chinese Economic Studies, (Australia), Wollongong University, Wollongong, 14–15 July: Figures 1 and 2.

are forced to change their behaviour. The private gains from exploiting informality reach their peak at point *B*. If economic transformation is to be successful, this peak level of private benefits from exploiting informality must be reached at some point in the process of reform.

After point *B*, even a small dose of reform that could only marginally raise the degree of marketisation (as shown by the shape of the *m* curve), could lead to a substantial (accelerated) fall in the benefits of informality (as shown by a decline of *b*). Another factor contributing to declining net benefit is the steadily rising costs (penalties) (represented by the cost curve *c* in Figure 7.3).

As market institutions are gradually established, the costs associated with unproductive entrepreneurial activities become higher (*c*). Furthermore, the probability of being caught for exploiting informality (for example, conducting unproductive activities illegally) becomes higher than before, causing the two curves to converge after

point B. In response to these changes in the relative pay-off, entrepreneurs will pay more attention to the way they operate in order to minimise the costs associated with exploiting informality. From a dynamic point of view, a quickened reform program will lead to a faster convergence of the two curves as shown in Figure 7.3.

Eventually, the cost curve will intersect with the benefit curve at some point (point *C*). After that point, the costs associated with exploiting informality will surpass the benefits of conducting these activities. Not only that, after the intersection point, costs increase at a higher rate while benefits decelerate sharply (so even a small dose of reform at this stage can have profound effects).

The declining (increasing) trend of private gains (costs) resulting from a shift from informality to formality has become a mechanism in forcing entrepreneurs to direct more entrepreneurial resources away from unproductive to productive activities by changing their behaviour to be more in line with the requirements of a rules-based system. In reality, many enterprises, especially larger ones and those with foreign partners, have recognised the need for more formality to resolve the incentive problems that have plagued private entrepreneurs. A shift from informality to formality will help pave the way for more solid growth of private enterprises.

The evidence from China suggests that the development of private enterprise has exerted the strongest force for institutional changes (such as those to do with property rights, rules and regulations). This has occurred through an interaction between private enterprise development and government (institutional) adjustment, although the government's role has been fairly passive. Informal private enterprises have slowly become more formal as laws and regulations have been established. At the end of the 1990s, this transformation started to go beyond the private sector to affect SOE restructuring, fiscal policy and reforms of the financial and banking systems.

When further institutional changes occurred in response to this private sector development, including laws and regulations and ultimately a constitutional amendment acknowledging the role of private enterprise in the economy, a further burst of activity occurred in response to the changed social and economic environment. Institutional changes brought greater formality, leading to a rapid fall in the number of 'red hat' firms, a substantial increase in the number of private enterprises that has been transformed from collectives, a faster pace of SOE privatisation and increases in the number of private start-up private enterprises, especially in high-tech industries.

## LEVEL PLAYING FIELD

The importance of the domestic private sector in meeting the challenges of WTO entry derives from a principle that is fundamental to the WTO, namely the requirement of 'national treatment'. In many areas, such as taxation treatment and market entry, domestic private enterprises have been treated less favourably than SOEs and foreign firms. One prominent area is bank lending to private enterprises, which requires fundamental reform of SOBs as well as development of the non-state banking sector in order to put private enterprises on an equal footing with others (Song 2001b).

The private sector's access to bank loans has been extremely limited. Table 7.2 shows that in the fourth quarter of 1999 private enterprises received only 0.6 per cent of all bank loans, and less than 0.5 per cent of all loans from state banks. This is despite the fact that private enterprises contributed nearly 35 per cent of industrial output in 1998.[1]

The discrepancy between the private sector's share of output and its share of bank finance suggests the extent of its latent demand for credit. Unable to obtain loans from the state banks and with limited access to equity markets, private enterprises have had to rely on self-finance or informal sources of financing, usually at much higher interest rates. A recent survey suggested that financial constraints may be influencing the investment behaviour of private enterprises—especially small and medium-sized enterprises (SMEs)[2]—in that firms tie investment demand to the availability of internal funds (Gregory et al. 2000; Garnaut et al. 2001).

Another obstacle to obtaining formal finance is that private firms find it difficult to communicate information about themselves to financial intermediaries.[3] Financial institutions, particularly SOBs, have little experience in assessing credit risk or the potential for profitable investment opportunities. And, even if banks do price risk correctly, the controls on interest rates prevent them from charging higher interest rates. Higher transaction costs are involved in lending to private enterprises because there is a need to monitor the competence of entrepreneurs and the return on the investment and there is a greater risk of default. For these and other reasons, long-term loans are not offered to private enterprises.

The distorted interest rate structure and bias toward lending to state enterprises has tended to reduce the net worth of non-state enterprises (which have paid much higher interest rates for informal financing) and has hampered their prospects of becoming creditworthy borrowers. This highlights the importance of developing a

TABLE 7.2 **BANK LENDING TO PRIVATE ENTERPRISES**, 1999 (RMB 100 MILLION, PER CENT)

| Items | Jan–Mar | Apr–Jun | Jul–Sept | Oct–Dec |
|---|---|---|---|---|
| *State banks* | | | | |
| Total loans | 69,409.2 | 71,589.5 | 73,757.3 | 73,695.9 |
| Loans to private sector | 222.8 | 256.5 | 282.7 | 301.0 |
| (per cent) | 0.3 | 0.4 | 0.4 | 0.4 |
| *All banks* | | | | |
| Total loans | 87,825.5 | 90,620.3 | 93,390.4 | 93,734.3 |
| Loans to private sector | 483.5 | 518.1 | 556.0 | 579.1 |
| (per cent) | 0.6 | 0.6 | 0.6 | 0.6 |

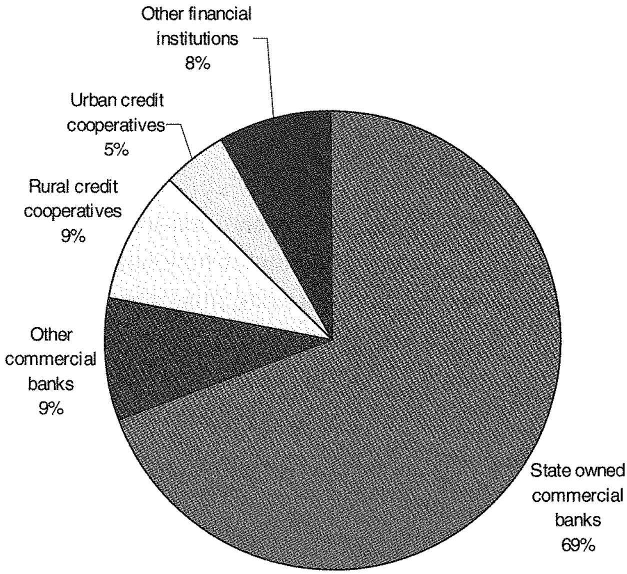
**Notes:** These figures are end-of-quarter balances. Loans made to private enterprises include loans to sole proprietors.
**Source:** Calculated from Tables 3.7 and 3.8 in *Quarterly Statistical Bulletin*, January 2001, Vol. XVII:89–90.

non-state banking sector and increasing competition to meet the needs of the large pool of unsatisfied borrowers. What is required is reform to build a financial system that can transfer the resources currently locked up in the state sector to the emerging private sector, which is better able to generate growth.

There are two main approaches to increasing competition in the financial sector in order to meet the demands of the private sector for funding. One is to privatise the SOBs, and the other is to allow more non-state, including private, financial institutions to enter the financial sector. The latter approach appears to be more feasible in China. The existing non-state banking sector can help resolve the lack of incentives for SOBs to act commercially. In order for this strategy to work, an effective institutional structure must be in place that imposes financial discipline on the decentralised banks. Financial institutions must be subject to tight prudential control by the financial authorities to ensure the safety and stability of the financial system.

The non-state banking sector consists of small and medium-sized banking institutions (joint-equity commercial banks, city commercial banks and the prefecture-level urban credit cooperatives), foreign banks, rural credit cooperatives, trust and investment corporations, and finance and leasing companies. At the end of 1999, there were 10 joint-equity commercial banks, 90 city commercial banks, 836 urban credit cooperatives, 41,755 rural credit cooperatives, 238 trust and investment corporations, 70 finance companies and 15 leasing companies in China (PBC 2000:24–5). China has no true private banks. The non-state financial institutions accounted for 31 per cent of the banking sector's total assets at the end of 1999 (see Figure

FIGURE 7.4 **ASSETS DISTRIBUTION OF FINANCIAL INSTITUTIONS (END OF 1999)**




**Source:** Figure 9, in *Quarterly Statistical Bulletin*, January 2001, Volume XVII:64.

7.4). These institutions have played an important role in fostering more enterprise equality by enhancing competition and providing much-needed investment finance to the non-state sector.

After studying various countries' experiences with financial sector liberalisation, Zank concludes that

> much of the economic activity that should take place in developing countries does not occur because of the constraints placed on private sector activity or the preferences given to SOEs. If these constraints are removed, the playing field will be levelled, and new participants could begin to take part, leading to increased economic growth (1990:37).

China is facing exactly the same problem with market fragmentation, and a shift in the distribution of assets from state to non-state financial institutions is likely to result in a marked increase in bank lending to the private sector.

China has just begun the process of establishing a financial system that will allow borrowing and lending to be undertaken at market-determined interest rates. Price

distortions will be gradually removed through an ordered program of interest rate liberalisation. Only when prices reflect the true economic scarcity of financial resources can resources (including foreign capital after the capital account is liberalised) be channelled into most profitable investment opportunities. The further development of the real economy, especially with regard to the private economy, therefore depends on the reform of the financial sector.

## ROLE OF THE GOVERNMENT

The development of the private economy needs new rules and new roles for government. The old role of the government as a planner is no longer relevant. Realising the importance of the private sector in the economy, the government has adopted various measures to overcome the constraints facing the private sector. For example, it has tried to define and enforce property rights, and put SOEs on level terms with private enterprises in many areas. China's entry to the WTO helps with an understanding of what government should and should not do with regard to the development of the private economy.

In order to define clearly the role of government in supporting the development of private enterprises, especially small and medium-size enterprises (SMEs), Mousley (2001) distinguished three type of firms. Type I firms are small and labour-intensive firms. Government support to those firms should mainly seek to reduce the costs of formalisation in terms of getting permits, licensing and taxation, while increasing the cost of corruption. Type II firms are labour-intensive firms. Government support for these firms should be in the areas of eliminating corruption and anti-competitive behaviour. Type III firms are knowledge-intensive and fast-growing firms. Government support for these firms should be in the areas of the trade and foreign investment regime, removing barriers to entry, providing telecom infrastructure, and guaranteeing intellectual property rights.

Mousley further distinguished three stages of development: entry, operation and exit. At the entry stage, registration, licences and permits, taxation, and unofficial fees and levies are the most important concerns. At the operation stage, financial policies, the legal system and regulation, property rights, trade, exchange rate and labour policies, inspections, government procurement, and unofficial fees and levies are the areas of concern. At the exit stage, when a firm is forced to stop operation, bankruptcy laws, equity markets, the judicial system, and unofficial fees and levies may be the most important areas for reform.

Government intervention is usually justified on the grounds that there are market failures. If market failure is caused by information asymmetry such as in the case of banking lending to private enterprises, however, it can not easily be remedied by government intervention. Evidence shows that there is a tendency for local governments to try to do too much by involving themselves in microeconomic management, resulting in low efficiency and larger government. For example, in response to the need for funding for private enterprises, especially SMEs, many loan guarantee funds have been established by local governments nation-wide. These guarantee funds should be carefully designed to ensure private agents take the central role in bearing risk. It is best if private owners are involved in management, as well as contributing to the funds. Here, the government should be a facilitator, not a substitute for private enterprises themselves.

The government should also avoid giving unequal treatment to different firms through extension of preferential treatment to some firms. The role of the government should be to level the playing field, not to create uneven competition. In proposing a role for government in supporting the development of private enterprises, especially SMEs, it should be kept in mind that the market works better than government most of the time because decentralised individual decision making is generally better informed and more efficient than government decision making (Yao 2001). The government's main job is to build a transparent and enforceable legal and regulatory system to ensure market order.

## CONCLUSIONS

Although tremendous challenges lie ahead in carrying out the main reform, much progress has been made in institutional reform and this appears likely to continue. In recent years, there have been clear signs that the government is serious about implementing deeper institutional reforms to accommodate the development of private enterprise. More private enterprises have been given export and import licenses and access to loans, and have been allowed to invest in a greater number of sectors. Rules and regulations that impede private investment, such as those on taxation, land use, business registration, domestic and overseas listings, and imports and exports, are being phased out.

The reform measures adopted by the government in response to private sector demands have not been radical, but have been sufficient to make a substantial impact on the economic structure of the economy. With the mounting urgency of

SOE reform and the imperatives resulting from China's accession to the WTO, the government now needs to make radical changes to foster private enterprise. There is evidence that reforms have been accelerating.

## Notes

[1] See Figure 5.2 and Figure 2.4 in (Gregory et al. 2000:46, 17).

[2] The latest estimate is that there are now 8 million SMEs in China and that they constitute 99 per cent of all enterprises. SMEs contribute 76 per cent of industrial output, 60 per cent of output, 40 per cent of tax revenue, 60 per cent of exports and 75 per cent of urban employment (*People's Daily*, Overseas Edition, 2 August 2001).

[3] This is partly due to the problems of private enterprises themselves, such as non-transparent reporting systems and lack of creditworthiness.