The Private Sector in China

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Prior to socialism the private sector was the primary economic strength of China. In 1820 it made China the largest economy in the world and by 1860 Shanghai had become the financial and commercial hub of the East. Private enterprise was universal and vigorous and the private sector exercised considerable political power. In fact it was the attempt by Empress Dowager to nationalize the railroads that brought about the fall of the Qing Dynasty and ironically, by way of Sun Yat Sen's popular revolt, the ascent of the Communist Party of China (CPC) in 1949.

At the time there were about half a million private enterprises in China active in a variety of sectors including mining, manufacturing, transportation, finance, and munitions. The private sector continued to drive the Chinese economy even under socialism. It supplied the People's Liberation Army during the Korean War. The initial position of the CPC was that private enterprise was complementary to and could co-exist with socialism. But after the Korean War the CPC reversed itself and began to expropriate private sector assets citing ideological reasons. It is unacceptable in socialism for an individual to profit from the labor of another

During periods of recession and unemployment socialist doctrine was tempered to engage the private sector in job creation; but by 1966 private enterprise had disappeared from China. An industrial structure consisting of state-owned enterprises with centrally planned capital allocation, production targets, wages, and prices was installed in its place.

The system failed. The SOEs grew into giant bureaucracies with social service obligations intermingled with production obligations. They were overstaffed and they used outmoded and polluting technology to produce an excess of inferior goods. As a business enterprise they were grossly inefficient and not competitive in a global context. In 1978 a program of reforms was initiated to overhaul these enterprises.

Enterprise reform is the centerpiece of China's market reform program. Its premise is that the State-owned enterprises will morph into efficient and globally competitive businesses if they are subjected to market forces. Chinese leaders chose to carry out these reforms within the context of State ownership and without a mass privatization plan. It was acknowledged, however, that privatization issues aside, a private sector would be needed in China if only to absorb the excess workers that will be laid off by enterprise reform. Accordingly, the Party formalized the recognition of private enterprise with constitutional amendments in 1988 and again in 1993 in which the private sector is described once again as an acceptable "complement" to socialism.

A third amendment in 1999 elevated the status of the private sector to a "component" of socialism. Although entrepreneurs were still barred from Party membership, it became clear that the CPC (Communist Party of China) wanted to grow a grassroots entrepreneurial sector. Private enterprise responded enthusiastically and grew rapidly from zero to a significant economic force though mostly as self-employed tradesmen and small family businesses such as restaurants, laundries, repair shops, retail stores, manual trades, transport, and light industry. There are only a handful of private businesses with assets of more than 100 million yuan and these are restricted to specific sectors and they are owned for the most part by insiders. Even so, the private sector soon took over as the primary engine of China's economic growth disproportionately to its relative size. Yet, ambiguities remain in regards to the intended role of the private sector in the reform era.

The State's Constitutional responsibility as ally of the private sector is compromised not just by ideological conflicts but by its own vested interest in the State sector that includes obligations to workers, retirees, and an entrenched bureaucracy. The private sector finds itself operating in an

economy where the necessary industrial and economic infrastructure is captured by an inefficient State sector and where the interests of the State sector are the primary concern of the State's regulators and economic planners. Besides, in the absence of the rule of law and without clearly defined property rights, the relatively higher profitability of the private sector provides the incentive and the opportunity for State predation. So the relationship between the private sector and the State is characterized by contradictions. The State simultaneously encourages the private sector and persecutes it.

Discrimination against the private sector is both formal and informal. The tools of formal persecution include entry barriers, excessive fees and permit requirements, sectoral restrictions, and restricted access to capital, raw materials, product markets, and industrial infrastructure. The most severe is the capital constraint. The nation's banks and securities markets are owned by the State and are reserved for the State itself. At stake is a 7 trillion-yuan household savings pool held hostage by the State's banking monopoly.

Informal persecution arises because the reform process functions in a legal vacuum with respect to property rights. The institutional mismatch endows bureaucrats with discretionary power that victimizes both the State and the private sector. In dealing with government officials, entrepreneurs must resort to bribery or rely on *guanxi*, a method of developing a personal relationship with bureaucrats by virtue of mutual friends and relatives.

The capture of the formal capital market by the State squeezes the entrepreneurial sector into niche and informal capital arrangements and a higher cost of capital. Venture capital has flowed in to China sourced mostly in Hong Kong, Singapore, and Taiwan but the venture capital market is still relatively small because of limited exit strategy options. Domestic and foreign venture capital could serve a bigger role but venture capitalists need an IPO exit, an option not available to the private sector in China.

The State's predatory policy towards capital fragments capital markets in China. Asset allocation is distorted, scarce resources are wasted, and the ability of the private sector to generate new wealth and to provide employment is curtailed. Escape from this trap is possible because the savings pool is a zero sum game only in the short term. Given access to capital, the private sector will create new wealth that will increase and not decrease domestic savings in the medium term. There are even benefits in the short term because increased competition for scarce capital will enhance capital allocation efficiency in the State sector too.

It is extremely difficult for private enterprise to operate in the same product market as State enterprises. For example, a private sector domestic airline would need an operating license, approval of its pricing structure, and airport access from the CAAC, a government agency that also owns ten airlines. It would purchase jet fuel from a State-owned monopoly that also supplies the State's airlines. Its business travelers would be largely State personnel.

It would also face capital market constraints. To raise equity capital in the stock market it would retain a state-owned investment banker and a state owned accounting firm to submit a request to the CSRC, a state agency; and a listing application to a state-run stock exchange. To obtain bank credit it would approach one of the four state bank monopolies[1]. These banks give preference to State firms and lend to achieve certain policy targets. The loan officer that reviews the application is held personally liable if a private sector debtor defaults although she will face no such liability

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[1] More than ¾ of the banking industry is controlled directly by the Big-Four State-owned banks. The balance of deposits and loans are accounted for mostly by thousands of small locally run urban credit cooperatives and rural credit collectives and by the so-called Trust and Investment Companies or TICs. The TICs are allowed to enter speculative markets where banks may not go but as an apparent contradiction, are able to pass their bad loans to the banks. All of these financial institutions are public sector enterprises and controlled by the Party-State.

when lending to SOEs. All of the State's financial entities are charged with providing a steady flow of capital for enterprise reform and for a bank rescue program.

In China separation of the State sector from the private sector is complicated by institutional weaknesses and by the terminology itself. The "State" refers to the central government in Beijing. The government hierarchy includes three levels of local government in addition to the State that are both geographically dispersed and functionally distributed with devolution of administrative and fiscal powers. Provincial, township, and village governments, in addition to discharging their administrative functions, also own and operate factories, railways, fishing fleets, mines, and other productive assets. These so-called "township and village enterprises" or TVEs, are normally smaller than SOEs in scale. In some cases, Beijing has turned over small and medium sized SOEs to the province in which they are located and their status has been changed to that of township enterprises. TVEs are not included in the statistics for "state owned enterprises" and are not the concern of the State's enterprise reform project. In fact, their functional category as private or public is often uncertain because of poorly defined property rights.

Not all local government enterprises are clearly in the public sector. Some enterprises are leased to private sector operators for fixed rents and they function more like private than public enterprise. Others are actually sold outright to a shareholding corporation that normally consists of managers and workers and these firms would appear to have been "privatized". However, the lessees and new owners in both cases may choose to pay a fee to local officials and register their business as a TVE to gain favorable access to government controlled markets and infrastructure.

Of the local government assets that are still theoretically in government hands, many are actually operated as if they were private sector enterprises. An informal "privatization" takes place and local officials act more like owners than government agents. Legal institutions have not evolved sufficiently in China to distinguish between ownership structures of these various enterprise forms. It is for this reason that analysts often lump the entire TVE sector with the private sector as simply "non-state".

Significant questions remain, however. Thousands of State-owned SMEs whose control is ceded to provincial governments, but whose exact number is not reported, appear in the data as "growth" of the private sector and an apparent decline in the State sector. There are also complications in the data for large SOEs. Some of these firms have undergone an equity carve-out procedure in which a share-holding corporation is formed that takes over the productive assets of an SOE in exchange for shares issued to the SOE. State statistics treat these corporations as SOE if the government owns more than a given portion of the shares but as "non-state" if government ownership is less. The discriminate level of ownership is set at an apparently arbitrary value between 26% and 51% and revised from year to year. These revisions confound trends in the data. The SOEs are organized in a complex network of pyramidal and cross-holding patterns in which the State and State-owned firms may own 100% of the shares even when "State ownership" *per se* is minor. In cases where the corporation is listed and 30% or so of the shares have been issued to the public, the State uses pyramiding, cross holdings, and an autocratic corporate governance system to shut out minority shareholders. These complexities render the statistics on state ownership impossible to interpret with a reasonable degree of accuracy.

It might appear that we could estimate the real size of the private sector by adjusting the State's numbers downwards to account for these effects; but it's not that simple. First, the incomplete corporate governance system not only victimizes minority shareholders but the State itself. Managers take advantage of institutional weaknesses to seize *de facto* control of State assets. The methods employed normally involve a shell game with equity in a complex cross-ownership network of assets. In some instances funds are removed by managers in hard currency to a shell company in Hong Kong; and these funds often re-appear in the mainland as joint venture foreign direct investment. In all of these cases except for those involving pure capital flight, State sector assets do in fact become transformed into private sector assets. In other words, State assets are

privatized. No estimate for the size of this transformation is available or even possible. Chaos underlies the superficial Confucian orderliness in Chinese corporate governance and presents daunting measurement problems for researchers[2].

Finally, the reported GDP of China refers only to the formal economy and does not account for the production of the informal sector. The informal sector lies entirely in private hands. Analysts and senior executives[3] of international investment banks who have observed private sector business activity first hand in China feel certain that the informal sector in China is at least as large as the formal sector. They cite the extraordinary official savings rate more than 40% of GDP as evidence that China's actual GDP is much larger.

Many researchers have found a middle ground by accepting the State's estimate of the SOE sector and by defining the private sector as the non-state sector. Defined in this way, the private sector appears to have made a remarkable resurgence. In a single decade, from 1989 to 1999, the State and private sector shares of industrial production have flip-flopped. The SOE share is down from ¾ to ¼ with a corresponding rise of the private sector from ¼ to ¾. The pure entrepreneurial sector is smaller but still shows dramatic growth. Its share of industrial production went from 2% to 16% of GDP in the same period.

The pattern of private sector development in China flows mostly from the State's policy decisions. The leaders and bureaucrats of China in charge of its transition are its former central planners; and so it is not surprising that the target economic structure and the transition process itself would contain elements of central planning[4].

A system of geographical preferences is used to set aside "special economic zones" where private and foreign joint venture projects would be allowed. Special consideration is given to coastal regions for private ventures that are most likely to result in exports. There is also a hierarchy of sector designations for private enterprise that run the spectrum from those most encouraged to those that are forbidden. Geographical and sectoral considerations are sometimes combined to encourage private sector development in certain geographical regions only in a pre-determined sector. For example, Hainan Province and Shenzhen in Guandong Province are expected to develop a private sector in the information technology industry. Finally, a timetable is used to set up target production rates by the private enterprise in each sector.

It may turn out that the important characteristic of state owned enterprises that distinguishes them from privatized firms is not the extent of state ownership per se but the extent to which the state is willing and able to exercise control. It is widely recognized that decentralization and devolution of powers in the reform era in China have fostered regional autonomy for local governments and TVEs and has created a "weak center"[5]. The same process has devolved power from the State to SOE managers, particularly in the "unprotected" sectors where the productive assets of SOEs have been carved out into corporations and some have even issued shares to the general public and engaged in joint ventures with foreign firms.

These managers enjoy expanded authority to make both cost center and investment center decisions and a system of incentives and profit sharing within the experimental, innovative, and evolving "responsibility system". The system was initiated at the outset of reforms to break down

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[2] The Confucian ideal is a sense of order even at the expense of truth. For example convicting a suitable scapegoat to regain order after a high profile crime, something that is often observed in China, is a perfectly legitimate course of action for Confucians because social harmony can be achieved without a downside if the scapegoat is either dead or known to be a criminal who deserves punishment anyway.

[3] Richard Margolis, Bill Overholt, and Steven Xu are some of these individuals.

[4] Central planning has not been abandoned and continues in the way of Five-Year Plans. In the reform era, these plans have included such "development targets" as stock market indexes.

[5] Richard Margolis, Vice President, Merrill Lynch Securities, Hong Kong, 2001

central planning and increase the efficiency of SOEs. It has developed considerably over time. The State no longer dictates production levels and prices to these firms. Instead, it subjects them to market forces. In other words, State control is yielding to market control.

The SOEs compete in the commodity and capital markets. It is expected that market forces will determine prices, production, and cost of capital. Therefore, management expertise and worker productivity will determine efficiency and survival. The role of the State in SOE management is greatly diminished consistent with the "weak center" model of regional decentralization.

Whether these efficiency increases have been achieved is a topic of debate among scholars. Initial empirical data do not seem to contain any evidence of increases in SOE efficiency attributable to these organizational enhancements[6]. However, conventional wisdom and anecdotal evidence indicate otherwise. It may be that sufficient time has not elapsed for these efficiency increases to show up in cross sectional statistics. An efficiency time lag of this nature has been observed by Villalonga in Eastern Europe[7].

In China, the mechanism is one of attrition and consolidation. Inefficient firms will not survive and their assets will either be mothballed or acquired by efficient managers. Until this process advances sufficiently the efficiency losses of he losers will match the efficiency gains of the winners and the cross sectional average efficiency will still be "average. We ought to see an increase in the variability of efficiency across the sample and not necessarily an increase in the mean. A statistically detectable efficiency improvement may occur after enough of the bad firms have dropped out of the population.

The dynamics of the household electrical appliance industry is illustrative. The pre-reform emphasis on regional self-sufficiency in conjunction with the government's barriers to inter-regional trade bred a large multiplicity of inefficient producers of household appliances. The reform program removed these barriers, discontinued production quotas and centrally planned pricing policies, and set off an intense competition among these producers in the nationwide market for household electrical appliances. Many firms sought to leverage their competitive position with joint venture agreements with established international firms such as Maytag, Siemens, Electrolux, and Sanyo and by raising new capital in the IPO market. The industry went through a period of rapid growth to one of overproduction. Price wars broke out and profit margins stabilized. Winners and losers became apparent. Regional specializations took root.

Washing machine maker Rongshida Group of Heifi in Anhui Province partnered with Maytag and became an industry leader. Among its acquisitions was Chongqing Washing Machine, a money losing SOE that was returned to profitability by Rongshida's management. The Heifi region emerged organically as a national center for the industry. The city is home to several other industry winners including Meiling Group and Philco. Meiling raised capital by issuing shares in the Shenzhen Stock Exchange and became an industry leader in refrigerators while Philco, like Rongshida, chose the foreign joint venture route to capture market share in air conditioners. Over this period economic growth in Heifei outpaced the national average. Within a decade average household income in Heifei grew from from 500 RMB/month by an order of magnitude in nominal terms.[8]

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[6] Hongbin Li and Scott Rozelle, "Saving or Stripping Rural Industry: An Analysis of Privatization and Efficiency in China", Agricultural Economics, Vol 23, No 3, September 2000

[7] Belen Villalonga, "Privatization and Efficiency: Differentiating Ownership Effects from Political, Organizational, and Dynamic Effects", Journal of Econoomic Behavior and Organization, Vol 42, No 1, May 2000

[8] These examples are drawn from articles in the business section of the South China Morning Post. See for example, "White-goods firms victims of success", South China Morning Post, business section page 16, 27 Feb 2001

The battle among SOEs in the market for television sets played out a similar drama. Winners gained market share and grew rapidly while losers went out of business or were acquired by winners. Changhong capitalized with an IPO in Shanghai and became a market leader with acquisitions and a modernization program. Joint ventures with Japanese and Korean manufacturers were its primary rivals. Total production peaked at above 40 million sets per year. Over-production and price competition weaned out losers. Industry consolidation and regional specialization followed. Dalian arose as an important center of the industry. The winners were efficient enough to compete in international markets. An export market was Chinese sets was born.

It may be argued that this process, that is, state control yielding to market control, is the essence of transition to a market economy. However, there are inconsistencies and complexities in the Chinese implementation. An autocratic party-state unconstrained by the rule of law is still the majority shareholder and market forces can work only as far and as long they are allowed to do so by the benevolent dictator. It is a gray area of privatization but it draws value from the widespread belief that "gray will emerge to white" rather than black. The belief rests on the weak center theory. The State is not able to exercise its theoretical control in the context of reform because real power has been decentralized and devolved. Whether it is willing to do so is moot. It couldn't even if it wanted to.

Another "gray area" is corporate governance. As the State loosens control over listed SOEs it expects that shareholders will discipline managers. Individual shareholders are powerless to do so because the State did not provide legal institutions to protect minority shareholder rights. If no one is monitoring managers, as this scenario suggests, then the firm is subject to very high agency costs that may significantly lower its value. A World Bank study[9] shows that this may be true in China but with gray areas. The study implies that ownership by other government agencies and institutions, so-called "legal persons", is separable from direct State ownership and that firm performance can be related to "legal person" holdings but not to State holdings. Institutional shareholdings provide monitoring services that would otherwise be absent in the corporate governance construct of Chinese SOEs.

These gray areas and their spontaneous resolution demonstrate ways in which "unintended consequences" of the State's incomplete reform policies appear naturally to fill in the gaps. That is, the market is a self-correcting system[10].

The domestic airline industry provides anecdotal evidence of the regressive effect of State control and the beneficial effect of institutional control that are suggested in the World Bank report. The Civil Aviation Administration of China (CAAC) is the government authority that regulates the airline industry and its infrastructure including airports. Oddly it also owns and operates ten airlines. The ten government-controlled airlines have stagnated and most of the growth in the domestic airline industry is being captured by SOEs that are not under direct government control. State-owned but not state-controlled Hainan Airlines is growing faster than any of the CAAC airlines. Hainan is listed in Shanghai. George Soros holds a significant stake. Its rapid growth was mostly fueled by acquisitions of less efficient state owned airlines. The CAAC reacted by regrouping and consolidating its airlines.

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[9] Xiaonian Xu and Yan Wang, "Ownership Structure, Corporate Governance, and Corporate Performance", The World Bank, May 1997

[10] Christopher Lingle,