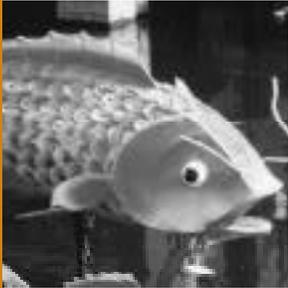


CHINA'S EMERGING PRIVATE ENTERPRISES

PROSPECTS FOR THE NEW CENTURY



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PREFACE

One of the important outcomes of market-oriented reforms in China over the past 20 years or so is the emergence of a significant private sector. Initially allowed only on the fringes of the economy, it now accounts for about a third of gross domestic product and is officially recognized as an important component of the economy. This recognition reflects the new internal and external realities facing China today.

Internally, one of the main challenges is the reform of the state-owned enterprises (SOEs) and the related reform of the financial sector. Restructuring SOEs and recapitalizing the banks are likely to be expensive, both because of short-term employment losses and fiscal costs. The private sector has emerged as an important source of income and employment growth, which can mitigate the social costs of reforms. In addition, China is trying to address the growing regional disparities in growth and incomes. Private sector development in the interior of China could be one way to narrow the gap between the interior and the coast. Externally, China is becoming increasingly exposed to the opportunities and challenges of globalization. The prospect of membership in the World Trade Organization highlights the need for major and rapid adjustments in virtually all sectors of the economy. New private businesses are likely to be the main agents of this rapid change.

These developments make this a good moment to take stock of the evolution of the domestic private sector thus far and to identify constraints and opportunities for its future contribution to China's development.

This study is one of the first systematic attempts to do so. It is based on extensive surveys and interviews carried out in four locations: Beijing, Chengdu, Shunde, and Wenzhou. These were supplemented by additional discussions held by the authors with entrepreneurs, industry associations, government officials, and others in these locations, as well as in Chongqing and Shanghai. The report focuses on three main themes: the structure of private enterprises, the enabling environment for their development, and access to financing. For each of these areas, the report presents an analysis of constraints on private sector development and outlines an agenda for entrepreneurs, the government, and the financial sector for addressing these constraints.

The principal authors are Neil Gregory, Stoyan Tenev, and Dileep Wagle. Extensive guidance and support were provided by Davin Mackenzie and Jianguo Cui from IFC's Beijing office.

The State Economic and Trade Commission (SETC) supported and facilitated the study for its successful implementation. Wei Dong (director general, Small and Medium Enterprise Department), Tian Chuan (deputy director, Small and Medium Enterprise Department), Wang Xu (International Department), and other SETC staff provided valuable guidance and support throughout, and the fieldwork was supported by the Economic and Trade Commissions in each locality. A range of other government and non-government institutions at the central level and in the four localities also contributed information and perspectives. This partnership was supported by the government of Australia, which financed the costs of the study through the IFC Australia-China Trust Fund. Donnelle Wheeler gave encouragement and support to our work at all stages.

The study draws heavily on a technical report by the Asia-Pacific School of Economics and Management (APSEM), Australian National University, which carried out the fieldwork for the study with the assistance of the China Center for Economic Research (CCER), Peking University. Ligang Song (APSEM) and Yang Yao (CCER) were the principal authors of the technical report, under the direction of Ross Garnaut (director, APSEM). The fieldwork team also included Xiaolu Wang (APSEM) and graduate students from CCER.

Additional inputs were provided by Gao Shi-Ji and Xu Gang on sources of equity capital under the supervision of Gary Fine (World Bank) and on the legal framework by Stephen Harder (Clifford Chance).

A draft of the study was presented and discussed at a conference in Beijing in April 2000. Additional presentations and comments were made by Yingyi Qian (University of Maryland), Wu Jinglian (State Council Research and Development Center), and Nicholas Lardy (Brookings Institution), which together with the discussions at the conference enriched the final study. Ed Steinfeld (Massachusetts Institute of Technology) commented extensively on the technical report.

The study also benefited from comments and insights from other IFC and World Bank staff, including Jean-Francois Arvis, Joseph Battat, Joan Bayard, Ravi Bugga, Amanda Carlier, Simeon Djankov, Xiaofeng Hua, Albert Keidel, Klaus Lorch, and Guy Pfeffermann.

Finally, the study depended upon the insights and perspectives of the private entrepreneurs themselves. We are extremely grateful to the hundreds of entrepreneurs who talked at length with interviewers during the fieldwork and to the hundreds more firms that returned survey questionnaires.

The study reflects IFC's and the World Bank's increasing emphasis on improving the business environment as one of the main conditions for sustained growth and poverty reduction. It also reflects the evolution of IFC's strategy in China. The size and the breadth of IFC's program in China are in many ways a function of the development of the private sector in this transition economy. When the private sector was mostly small scale and informal, and the industrial and financial sectors were dominated by SOEs and joint ventures with foreign private investors, IFC's China program consisted largely of industrial projects sponsored by foreign investors. IFC had an important role to play as a provider of long-term project financing, which was not otherwise available for private projects. While this activity and this role will continue, the emergence of the domestic private sector has given us new opportunities to broaden our program to include support for local financial institutions, indigenous industrial and infrastructure enterprises, and small and medium enterprises.

We hope this study will provide all those with an interest in the development of the domestic private sector in China with new insights into its status and new ideas for ways to support and participate in its future growth.

Javed Hamid

Director
East Asia and Pacific Department
International Finance Corporation
September 2000

EXECUTIVE SUMMARY

China's economy has grown rapidly over the past decade. At the same time, it has undergone a fundamental change, from complete reliance on state-owned and collective enterprise to a mixed economy where private enterprise also plays a strong role. By 1998 the private sector had grown to about 33 percent of gross domestic product, making it second to the state enterprise sector in economic importance. A constitutional amendment in 1999 formally recognized this shift, thereby laying the foundation for the private sector to emerge from the shadows and play a prominent role in China's future development.

To date, analysis of China's private sector has concentrated on the dramatic surge in foreign direct investment and has paid little attention to the growth of domestic private enterprise. This study represents a first attempt to understand the domestic private sector: where it has come from, its current status, and its future prospects. But as Marx said, the point is not just to understand the world, but to change it. So the study focuses as much on prescription as on description. It addresses the question, what needs to be done for domestic private enterprise to flourish? This question is directed at the three main players in the story: the private entrepreneurs themselves, the financial institutions that finance them, and the government, which controls the policy and regulatory environment.

To arrive at an answer, it is necessary to go beyond the rather limited statistics on the private sector and talk directly to entrepreneurs, policymakers, and financiers. This study is based on extensive surveys and interviews in four locations: Beijing, Chengdu, Shunde, and Wenzhou. These cities were chosen not as typical examples of the Chinese experience, but as instances of relatively advanced private sector development in different circumstances (capital city, inland province, coastal province, Pearl River delta). They therefore illustrate the constraints and opportunities the private sector is experiencing in its early stages.

China has adopted a unique approach to market-oriented reforms, with extensive local and sectoral experimentation and a "dual-track" reform process. This has influenced the way in which the domestic private sector has developed since its reemergence in the late 1970s. Private enterprise first took hold in the rural sector as an outgrowth of the restructuring of the rural economy. During the 1980s, larger private enterprises grew out of these rural and individual enterprises, and out of collectives and state-owned enterprises, although they were not officially recognized until 1988. In the 1990s, government policy placed increasing emphasis on building a market economy and shifted toward a rules-based framework, which paved the way for rapid growth of private enterprises. This was given further impetus by policy changes that encouraged ownership reform of smaller, nonstrategic state-owned enterprises and that allowed collectives to transform into private enterprises. In many cases, such transfers were merely catching up with the reality of how these enterprises were operating.

Owing to this pattern of development, the domestic private sector exhibits a high degree of informality. Many enterprises possess only the vaguest of property rights, ownership structures, corporate governance mechanisms, financial records, and rights to market access. They are often part of complex groups of companies, spanning many different activities. This gives entrepreneurs great flexibility to respond to an uncertain world composed of unclear and rapidly changing government policies, taxes, and regulations. However, it hampers their ability to raise capital, to reward managers and employees, and to operate efficiently. As a result, even large, mature businesses have many of the strengths and weaknesses more often associated with small start-ups. The challenge for entrepreneurs now is to put their businesses on a firmer footing as the policy and regulatory framework becomes more stable and accommodating.

Up to now, the policy environment has been heavily biased in favor of state-owned enterprises, whether in providing access to markets or to finance. Now that the government recognizes the private sector as a pillar of the economy alongside the state sector, it faces a large agenda of reform if it is to level the playing field between the public and private sectors. A high priority will be to shift from a discretionary, particularistic way of regulating and taxing the private sector toward a rules-based system. Much of this will be a straightforward matter of making the registration of private enterprises simple, cheap, and automatic. But the future growth of private enterprise also depends on progress in more fundamental reforms, such as strengthening property rights and ensuring the judicial system enforces them.

Critically, business cannot grow without access to finance. The domestic private sector is particularly poorly served: a very small portion of bank credit goes to private firms, and only 1 percent of listings on the Shanghai and Shenzhen exchanges are private. As a result, private firms rely very heavily on self-financing for their growth. This will not be sustainable once they

move beyond the start-up, high-growth phase. As with other issues, the solution involves a combination of straightforward regulatory changes (such as allowing private firms greater access to equity markets) and more fundamental reform (such as building a commercial banking system that allocates credit on the basis of commercial decisions rather than government direction). However, access to finance will not improve until private enterprises formalize and their financial position, corporate governance, and beneficial ownership become more transparent.

China's impending accession to the WTO provides new impetus for moving toward a rules-based, nondiscriminatory policy environment. This not only will expose the domestic private sector to new competition from abroad but will also introduce new financial institutions to serve the needs of private business. Hence the environment for domestic private enterprise will continue to evolve rapidly. The challenge for the government and for entrepreneurs alike is to put the domestic private sector on solid ground, so that it will be ready to seize the new opportunities that will arise.

INTRODUCTION

In 1999 China passed a constitutional amendment giving formal recognition to the country's emerging private sector.¹ This step, along with the buildup of foreign direct investment (FDI) and the reform of state-owned enterprises (SOEs), is setting China's economy on a course of major structural change. In a sense, the amendment was propelled by the sector itself, which in the past decade has experienced dynamic growth—in number of enterprises, employment, and output (see figures 1.1, 1.2, and 1.3).

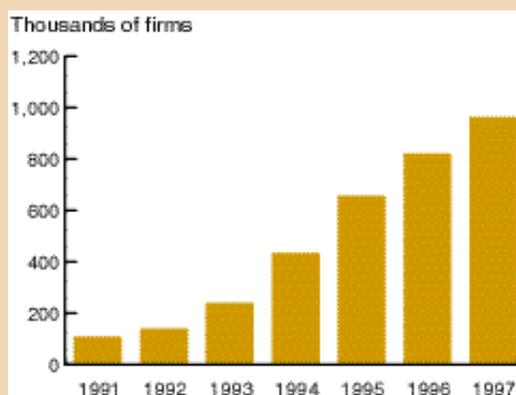
Already more than half of economic activity in China is in the private sector—nearly two-thirds, if agricultural and collective enterprises are counted, too (see chapter 2). While the state-owned sector and foreign direct investment have stagnated, domestic private enterprises continue to grow rapidly. Between 1991 and 1997 the output of domestic private firms grew on average 71 percent a year (figure 1.3) and employment 41 percent on average (figure 1.2). Though much of this growth represents a transfer of activity from the state-owned enterprises and collective sector, many individual enterprises are achieving double-digit growth each year. Importantly, this growth has occurred at the same time that FDI has slowed (see

figure 1.4) and SOE employment is declining. As a result, the domestic private sector is becoming a major engine of growth for the economy as a whole.

A strong domestic private sector takes on additional significance as China prepares for accession to the World Trade Organization (WTO). This will involve phasing out the preferential treatment given to foreign private enterprises to attract FDI and opening up domestic markets to foreign enterprises (see box 1.1). The creation of a level playing field between domestic and foreign enterprises opens new opportunities for the domestic private sector, but also poses the challenge of new competition in domestic markets. During the preparatory period, it is critical for domestic private enterprises to improve their ability to compete under the new framework.

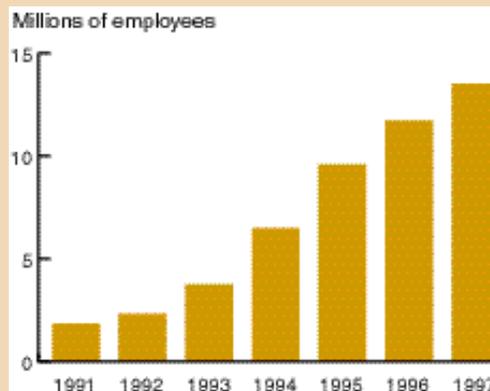
Because of the sector's growing significance for China's future development, this is a good time to take a first look at its evolution thus far and to identify constraints and opportunities for its future contribution to economic growth. With that purpose in mind, this study offers business owners, managers, and policy-makers assistance in identifying an agenda of action

Figure 1.1. Number of Registered Private Firms in China, 1991–97



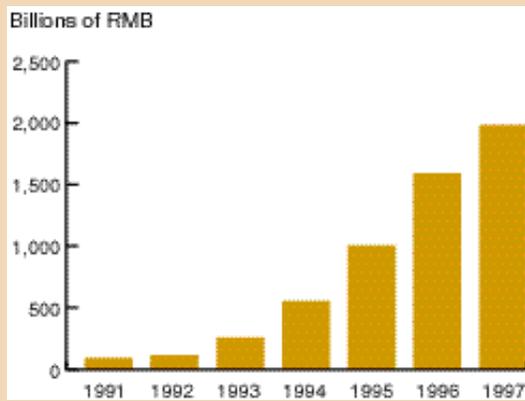
Source: Table 2.1.

Figure 1.2. Employment in Registered Private Firms in China, 1991–97



Source: Table 2.1.

Figure 1.3. Output of Registered Private Firms in China, 1991–97



Source: Table 2.1.

that can help reduce those constraints and enhance the opportunities.

This study was supported and facilitated by the State Economic and Trade Commission (SETC) and draws on fieldwork in China in the summer of 1999, along with discussions at a conference in Beijing in April 2000. It also draws on IFC's and the World Bank Group's global experience in promoting private sector development.

The fieldwork focused on four cities with distinct approaches to private sector development: Beijing,

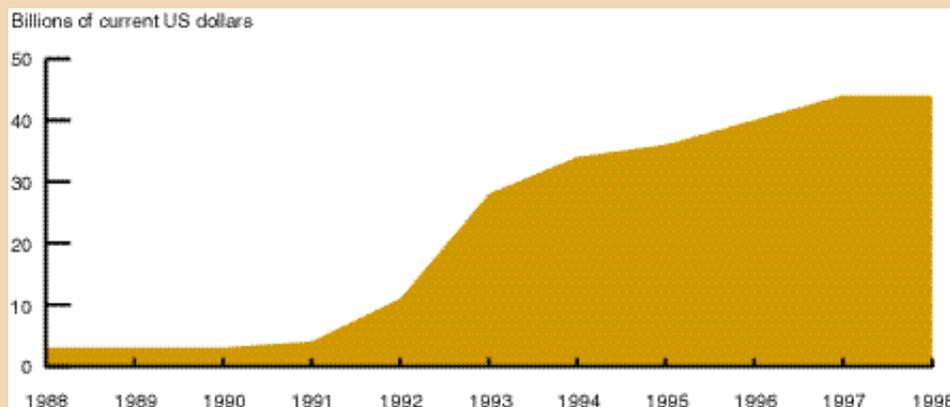
Chengdu, Shunde, and Wenzhou (for a summary of the size of the domestic private sector in each location, see figure 1.5). Beijing provides an opportunity to observe how private enterprises emerge and develop in the national capital and political center. Beijing has also witnessed rapid development of high-tech industries in its non-state sector in recent years. Chengdu is the capital of Sichuan Province and has maintained a good record of private sector development, presenting a case study of private enterprises in inland areas. Shunde is a county-level city in the Pearl River Delta in Guangdong Province and has experienced rapid growth in its private sector following a comprehensive enterprise ownership reform program in the early 1990s. Wenzhou, on the coast of Zhejiang Province, is the first city in modern China in which private enterprises have flourished. These locations are described in further detail in the next section.

Although these locations do not provide a representative sample of private enterprises across the whole of China, they are cities in which such businesses have become an important part of the local economy. Hence their experience reveals much about the constraints and opportunities private enterprises face in China today.

Description of the Fieldwork Locations

Private enterprise has flourished in each of the fieldwork locations. As mentioned earlier, the four cities were chosen for their distinctive approach to private sector development.

Figure 1.4. Net Foreign Direct Investment Flows to China, 1988–98



Source: World Bank.

Box 1.1. China's Accession to the WTO

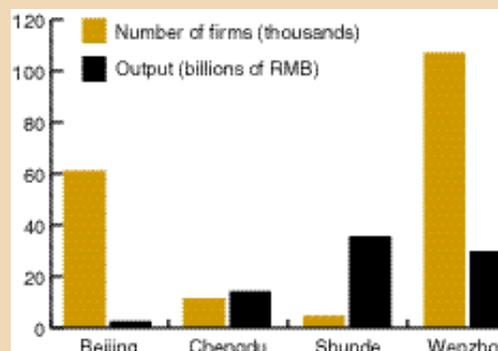
In preparation for accession to the WTO, China recently agreed on a set of trade reforms that will have a far-reaching impact on domestic capital and product markets. These reforms include

- The elimination of import quotas by 2006.
- The elimination of import tariffs on computers, semiconductors and related products by 2005.
- Reduction in import tariffs on agricultural products from 22 percent to 17.5 percent.
- Reduction of import tariffs on industrial products from an average of 24.6 percent to an average of 9.4 percent.
- A reduction in import tariffs on motor vehicles from 80–100 percent to 25 percent by 2006, and 10 percent for parts.
- Permission for up to 50 percent foreign ownership of telecoms and insurance.
- Permission for importers to own domestic distribution networks.
- Full market access for foreign banks within five years of accession; foreign banks will be able to conduct local currency business with Chinese enterprises two years after accession.

Beijing

Beijing, including its suburbs, has a population of 12.4 million. In 1998 its gross domestic product was RMB201 billion (US\$24 billion), or RMB18,423 (US\$2,225) per capita. Industrial output was RMB171.5 billion (US\$20.7 billion). Although Beijing has more private firms than the other cities, they appear to be fairly small because their output and sales volume are the smallest. Even so, the private sector in Beijing has experienced rapid development. Its numbers increased from 1,428 registered private firms in 1992 (each firm on average had registered

Figure 1.5. Numbers and Output of Domestic Private Enterprises in Survey Locations



Source: Bureau of Industry and Commerce Management.

capital of RMB228,000 [US\$27,500]) to 61,113 private firms (*siying qiye*) in 1998 (average size of registered capital is RMB621,000 [US\$75,000]). Recently, the municipal government issued a document calling for a speeding up of private sector development. Concrete policies promoting such development are under consideration.

Chengdu

Chengdu is the provincial capital of Sichuan and has a population of 9.9 million. Its GDP in 1998 was RMB110 billion (US\$13.29 billion), or RMB11,103 (US\$1,341) per capita, and its industrial output was RMB121.9 billion (US\$14.72 billion). The private sector in Chengdu has become a significant contributor to the city's economy. In the first half of 1998, its industrial output was RMB14.1 billion (US\$1.7 billion), or 30.8 percent of the city's total output, and its GDP was RMB10.7 billion (US\$1.3 billion), or 22.3 percent of the city's total. In the period January–November 1998, the private sector contributed RMB607 million (US\$73 million) of tax, or 10.3 percent of the city's total. In some counties, the private sector dominates the local economy. In Xinjin County, for example, the private sector (private firms and *getihu*) contributed 90 percent of the total tax revenue in 1998.

Since 1992 the number of large private firms in Chengdu (firms with registered capital of more than RMB5 million [US\$604,000]) has climbed to 260. One of these, the Hope Group, is the largest private

Table 1.1. Distribution of Enterprises by Industry in Survey Locations (percent)

Industry	Beijing	Chengdu	Shunde	Wenzhou	Overall
Chemicals	12	19	20	8	8
Electronics and apparatus	19	10	18	35	35
Foods and cigarettes	11	18	8	4	4
Garments and other light products	31	18	28	14	14
Machinery	7	11	8	29	29
Metal and nonmetal manufacturing	9	14	10	10	10
Primary industries	3	5	6	0	0
Others	8	5	2	0	—

Source: Bureau of Industry and Commerce Management.

firm in China, with an annual sales volume of more than RMB5 billion (US\$600 million). Of the first 20 private firms to obtain the right of direct export in China, 5 were in Chengdu. In addition, some large private firms began to buy large SOEs, playing an increasingly significant role in the state sector reform. The industrial distribution is quite balanced, as shown in table 1.1.

Shunde

Shunde is a county-level city with a population of only 1.4 million and a gross domestic product of RMB26 billion (US\$3 billion), or RMB24,769 (US\$2,991) per capita. Industrial output is about RMB60.5 billion (US\$7.3 billion). Situated on the west bank of the Pearl River estuary, the city lies outside the enterprise zones on the east bank, which have attracted massive foreign investment, especially from Hong Kong. Shunde's private sector began to take shape largely as a result of its ownership reform program, which started in 1992. Currently, there are almost no purely state-owned firms in Shunde. Its private sector ranks second among the four cities in terms of sales. Before its ownership reform program, Shunde was renowned for its township-village enterprises (TVEs). Its leading industries were small home appliances such as electric fans, rice cookers, and water heaters.

Some large firms have emerged since the early stage of development, and now the city has 72 such firms, each with an annual sales volume of more than RMB100 million (US\$12 million). In particular, it has become the nation's largest industrial base for home electronics, producing every kind of home electronic product except televisions. Several nationally renowned firms have also emerged, notably Kelong (a major national refrigerator producer), MD (the world's largest electric fan producer and a major national producer of air conditioners), Grand (the nation's largest microwave producer), Wanjie (gas heater manufacturer), and Kangbao (the nation's largest kitchen sterilizer producer). Together with Zhongshan, Nanhai, and Dongguan, Shunde is regarded as one of the four "small tigers" in Guangdong Province.

Wenzhou

Wenzhou is a prefecture-level city governing several counties and county-level cities and has a population of about 7.2 million. Its GDP in 1998 was RMB72 billion (US\$9 billion), or RMB9,986 (US\$1,206) per capita. Wenzhou has a long history of private sector development. In 1984 it became one of 14 coastal cities opened to foreign trade, and a national economic development zone was established there. It has a history of pioneering new forms of enterprise. The size of

its private sector is the largest among the four cities in terms of the number of firms and sales volume. Its industries have formed several nationally renowned geographical clusters, such as electronic parts in Hongqiao, low-voltage electrical products in Liushi, and buttons in Qiaotou. In addition, the garment industry is a pillar of the local economy. Overall, the sample enterprises are heavily concentrated in machinery and electronics (table 1.1).

Fieldwork Methodology

In view of the size of the Chinese economy, it is not possible with limited resources to undertake a comprehensive representative survey. Moreover, there is a trade-off between timeliness and thoroughness. Therefore, in order to take a snapshot of the status of the private sector and draw policy conclusions, we adopted a rapid assessment approach in the fieldwork. That is to say, we analyzed specific locations and segments of the private sector that could yield usable information and analytical insights within a limited time frame. This is therefore a preliminary analysis, which could provide further valuable information if extended to cover more locations and other segments of the private sector.

The fieldwork consisted of structured interviews of government officials, banking officials, business associations, and chief executive officers (CEOs) of 338 domestic private enterprises. This was supplemented by a mail-out survey of some 628 domestic private enterprises.

CEO Interviews

Guided by a questionnaire containing both structured and open-ended questions, interviewers met with CEOs in a subset of 338 of the surveyed firms. CEOs filled in the structured questions during interviews, and interviewers posed the open-ended questions. These latter questions elicited CEOs' opinions on the most important and pressing issues private enterprise is facing and the changes that are needed to improve the business and policy environments in which private enterprise operates.

Mail-out Questionnaires

The questionnaire mailed to firms contained structured questions on factual aspects of a firm's operation and development. These questions were to be answered by persons designated by CEOs, such as deputy managers

or chief accountants. A total of 2,400 such questionnaires were posted to randomly selected firms in Beijing, Wenzhou, Shunde, and Chengdu. The number collected amounted to 628, which represents a response rate of 26.2 percent. Because of inaccurate addresses, the response rate from actual recipients was somewhat higher.

Sampling Strategy

We adopted a stratified random sampling strategy, choosing firms from a database constructed and maintained by the Bureau of Industry and Commerce Management in each city. This excludes privately controlled collectives and TVEs.² Very small firms, those with no more than eight employees (known as *geti gongshang hu*, or *getihu*), were also excluded from the sampling because of the difficulty of obtaining accurate information on them. Later, a few joint ventures and firms engaged in commerce and services were also surveyed.

The ratio of rural versus urban firms sampled in each locality was kept roughly the same as the ratio of rural versus urban firms in that locality. This was achieved by the random selection of firms within rural-urban strata in each locality. The share of each type of ownership examined—sole proprietorship, partnership, limited liability company, and so on—were kept roughly the same as their respective share in the population. Finally, a number of newly emerging high-tech enterprises were included in the sample to ensure representation of this group. Firms were selected randomly within each stratum.

The sampling strategy was difficult to apply, however, because in many cases local government agencies did not have the required data, and many firms under the control of private domestic entrepreneurs were not registered as such and so could not be identified. Thus the enterprises covered in the survey do not represent a true cross-section of the domestic private sector. Rather, they are concentrated in the part of the private sector that it is easiest to identify and contact. These tend to be among the larger, more mature private enterprises. Although they certainly offer insight into domestic private enterprises, they do not necessarily reflect all the dimensions of the domestic private sector. More extensive survey work would be required to understand the full range of private sector activity in China today. The distribution of sample enterprises

by industry as a whole and in each city sample is shown in table 1.1.

Other Interviews

To gain a wider perspective on private enterprises, we also interviewed officials of official institutions, financial

institutions, and business associations. The official institutions consisted of the Central Bank, tax/regulatory agencies, and policy agencies. The financial institutions included commercial banks and rural credit unions. In some locations, we also interviewed people at business associations.

EVOLUTION AND STATUS OF THE DOMESTIC PRIVATE SECTOR

China's market-oriented reforms of recent years have produced impressive results. Perhaps the most important is the emergence of a significant private sector. This chapter looks at the evolution and current status of the domestic private sector in the context of China's overall approach to reform.

Reform Approach

One notable feature of China's approach to reform is its emphasis on gradual experimentation at the local and sectoral level (Gelb et al. 1993; Harold 1992). Thus China took its first steps toward reform without a well-defined strategy or a clear blueprint. From the outset, Chinese leaders did not envision the private sector as the driving force of economic growth. Rather, private business was revived in the period after the Cultural Revolution as a quick way to respond to the mounting pressures of unemployment and economic stagnation. It was an experiment in itself and for most of the reform period has evolved through cycles of unpublicized experimentation, followed by general "in principle" approval, then by ratification and specific regulations, only after the reform in question has become well established. Oftentimes, new regulations have been accompanied by "rectification" campaigns, which have set the private sector back in its development. As the term "gradual" suggests, reforms are implemented over time. Several years may elapse from the beginning of a reform experiment in one of the Chinese provinces until it is endorsed from the center or is imitated by other provinces.

Another reform characteristic in China has been the use of partial reforms within sectors, also known as the dual-track approach. The first such tactic was two-tier pricing, introduced in rural areas in 1979 along with the household responsibility system. Later it was applied to other sectors: industry (through the contract management responsibility system), the national budget (through the fiscal contract responsibility system),

external trade and payments (through the sharing of foreign exchange between central and local governments, trade contracting, and foreign exchange trading centers), and labor markets (through the contract system for new hires in the state sector). In a sense, the same dual-track approach was adopted with respect to private sector development because transfer of ownership did not enter political debate until well into the second decade of market reforms. When the reforms began, the prevailing view was that activities in the private sector complemented those of the state sector. They were tolerated and even encouraged in areas where large-scale state enterprises did not exist, such as services, light industry, and agriculture.

This dual-track approach is perhaps the most important aspect of Chinese reforms since it was, at the time, an innovative solution to the political constraints on the direction and speed of reform. One such constraint was the emphasis on "consensus-making," meaning it was imperative to "leave no one worse off than before" (Shirk 1993, pp. 130, 137, 334). As economic analysis has shown, the dual-track approach in China has been both efficiency-enhancing and Pareto-improving, that is, with no one made worse off (Laffont and Qian 1999; Lau, Qian, and Roland 1997). It has allowed economic agents participating in the market track to benefit from liberalization while protecting the vested interests of state-owned enterprises and bureaucrats in different industries and sectors. Although the reforms were controversial, the experimental dual-track way of introducing them enabled reformers to bypass the formal ideological debate usually required for public legislative sanction of reforms and also to use the successful results of the reform as ammunition in the debate.

Several features of China's social and political environment have contributed to this unique transition to market. One is decentralization. Since 1958, the Chinese economy has been organized around a geographical principle known as regional organization. By contrast, organization in the former Soviet Union was

much more centralized, along sectoral lines (Qian 1999). A regional system has the important advantage of flexibility: it can experiment with reforms locally because regional entities are self-contained and different ingredients of reforms can be tested and matched without disrupting the organization as a whole.

Added to this possibility for local experimentation were powerful incentives to promote local economic development. They were in the form of a fiscal contracting system known by the nickname “eating from separate kitchens,” which replaced the previous system of “unified revenue collection and unified spending.” The new system encouraged and rewarded local governments for promoting economic development of their local economies. The nature of local experimentation, however, was heavily influenced by the existing political structure.

The fact that China adopted a new policy course without political liberalization and under the same political structure practically ruled out experiments that would create losers on a large scale within the bureaucracy. Consequently, the experiments had to be of the dual-track type, so as to preserve the vested interests of the bureaucracy and a level of political stability. Despite the lack of political liberalization, China has been able to transform its bureaucratic system substantially with a mandatory retirement program for the revolutionary veterans, a drive for administrative and fiscal decentralization, and the decision to allow bureaucrats to quit the bureaucracy and join businesses (Li 1998). As a result, the bureaucracy tends to function as a “helping hand” for economic development, is intimately involved in promoting private economic activity, supporting some firms and inhibiting others, pursuing industrial policy, and often having close economic and family ties to entrepreneurs (Frye and Shleifer 1997; Walder 1995). Under such incentives, central and local governments have the capacity to act like Olsonian encompassing organizations, exercising self-restraint and not expropriating efficiency gains through ratcheting (Olson 1992). The township and village enterprises, in which local governments have direct ownership and management stakes, were one incarnation of this long-term interest in promoting local development (Jin and Qian 1998).

The political constraints may have also accounted for the choice of agriculture as the starting locus of the changes, a decision that played an important role in

creating the self-reinforcing character of Chinese reforms. There were not many rents for bureaucrats to collect in poor rural areas where the household responsibility system was first introduced. The success of reforms in agriculture brought needed savings, which then had to be channeled into the industrial sectors in rural areas, where they fueled the big boom of the non-state industrial sector, that is, the TVEs. Local governments and new entrepreneurs alike shared in the benefits of growth in this sector. The development of the non-state sector in turn created pressure, but at the same time offered solutions, for the reform of the state sector. This generated a self-reinforcing virtuous cycle of reforms with growth, and the private sector ended up playing a key role in the process.

Major Turning Points in Private Sector Development

The cycles of experimentation discussed in the preceding section make it possible to distinguish three phases in the development of the private sector: the first from 1978 to 1983, the second from 1984 to 1992, and the third from 1993 to the present.

Phase 1: 1978–83

This phase is marked by the official revival of private business. However, the private sector was limited to individual businesses (*getihu*), which developed first in a regulatory vacuum. These businesses had a strong experimental flavor. Regulations came later in the process and were followed by a short “rectification” campaign. The sector was intended to play a marginal, stop-gap role and to act as a “supplement” to the state and collective sectors, “filling the gaps” they left in the economy, particularly in the distribution of consumer goods and services and in employment. Official attention focused on the urban private sector, although perhaps deeper changes were taking place in the rural areas.

The Third Plenum of the Chinese Communist Party’s 11th Central Committee in December 1978 is said to mark the beginning of market-oriented reforms in China. Although the plenum itself made no specific announcements concerning private business, it signified the official adoption of economic modernization and growth as the paramount concern of the Communist Party. It emphasized economic development and individualistic incentives, which gave impetus to the revival of private business.

In fact, the individual economy was already developing by that time, in response to economic pressures to increase employment opportunities and to improve living standards. Once the shift in policy was officially announced at the Third Plenum, local governments began to formulate procedures for the administration of the individual economy. Yet the individual economy still had an experimental flavor and was confirmed only by a set of State Council regulations on the urban, nonagricultural individual economy in July 1981. These regulations defined a new business category, *geti gongshang hu*, or single industrial and commercial proprietor. The government moved with caution in developing the *getihu*. The July 1981 document capped the number of employees a *getihu* could hire at eight. In addition, it specified that individual businesses were only supplements to the state and collective economic units, and could develop only within certain limits.

The private enterprise boom began in rural areas. The contract responsibility system evolved into a fundamental reform in agriculture because economic management devolved to households. Some households then specialized in nonagricultural activities and became “specialized households” (*zhuanyehu*). Many of these were in fact private nonagricultural businesses. Because they originated within the collective agricultural economy, however, their private nature could be ignored for the time being and obviated the need for guidelines or regulations dealing with them as such.

In 1983 China introduced a series of central and local regulations for the licensing and control of individual businesses, taxation, product quality and hygiene, and free markets. These were followed by inspection drives. “Market rectification” drives became an opportunity to attack private business.

Phase 2: 1984–92

This phase is characterized by the rise of the *siying qiye* (privately run enterprises), to be distinguished from the smaller *getihu* (individual enterprises). Such enterprises, defined as privately owned enterprises employing more than eight people, began to develop as early as 1981, but they did not come under regulation until 1988. However, in 1989 the development of the sector suffered a setback. The private sector continued to be regarded as a supplement to the public sector.

Larger private enterprises developed in different ways. Some were *getihu* that grew and took on more employees. According to a 300-village survey conducted by a research branch of the State Council in 1987, 0.2 percent of the farm households hired more than eight people in 1986. Taking the survey as a representative sample, it was estimated that by the end of 1988, China had 500,000 *getihu* that could be called private firms (Zhang and Liu 1995, p. 55).

Some larger private enterprises emerged from the leasing of state or collective enterprises to individuals. By 1984 the share of such firms in the total number of collective firms had reached 50 percent in some localities (Zhang and Liu 1995, p. 29). The private entrepreneur paid the collective a fixed rent and operated the firm as if it was his own and in many cases accumulated considerable assets. These enabled him to reduce the share of collective ownership and gradually transform the enterprise into a solely owned firm.

Yet *siying qiye* were not officially registered as a category until June 1988. Administrative bodies dealt with such enterprises in various ways. First, they could be registered as *getihu* but be given permission to employ more than eight people. This practice was more prevalent in urban areas. In rural areas, larger private enterprises were able to gain at least partial entry into the collective category by one means or another. Second, firms could obtain a collective license by paying an “administration fee” to a state or collective unit or local government organization and thereby receive its stamp on the application for registration. Such firms were called “red hat firms,” meaning that the private owners put on a hat of collective ownership to evade the government’s prohibition of private firms and its ideological harassment. This kind of firm continued to exist even after the regulations on private enterprises were issued in 1988. In Shunde, for example, almost all firms at the village level were red hat firms before the enterprise ownership reform program took place in 1992. The red hat phenomenon remains important even today. Third, in certain cases, distributing shares or profits as bonuses to employees was enough to qualify a private enterprise as a collective.

In June 1988, the State Council issued the so-called Tentative Stipulations on Private Enterprises (TSPE) to govern the registration and management of private firms. This document defined a private firm as “a for-profit organization that is owned by individuals and employs more than eight people.”¹ Firms that hired

eight employees or less could still be registered as *getihu*.² The TSPE identified three types of private firms: those under sole ownership, partnerships, and limited liability companies. *Siying qiye*, defined as enterprises with privately owned assets and employing more than eight people, were recognized as a supplement to the socialist, publicly owned economy and enjoyed the protection of the state. By the end of 1989, the total number of registered private firms had reached 90,600.

The number of registered *getihu* declined from 23.1 million at the end of 1988 to 19.4 million at the end of 1989, and the number of registered private firms declined from 90,600 at the end of 1989 to 88,000 in June 1990. Of the firms closed down, a considerable number were transferred into collective firms or had their employees reduced to fewer than eight people. According to a survey of 286 private firms closed in the period January to April 1991, 22.7 percent of these firms were transferred to collective ownership and 20.3 percent had their employees cut to under eight (Zhang and Liu 1995, pp. 50–51).

Phase 3: 1993 to the Present

This period has been marked by important changes in China's overall approach to reforms and its official attitude to the role of the private sector. While experimentation continued, a coherent strategy of transition to a market system began to emerge. The strategy envisages a market system based on the rule of law, in which the private sector is an important component.

Deng Xiaoping's famous southern tour in September 1992, when he called for a continuing of the reform effort, was a defining moment in China's transition to market. It was followed by the big ideological breakthrough at the Fourteenth Party Congress: for the first time, the socialist market economy was endorsed as China's goal of reform. And in 1993 the government designed the first "grand strategy" of transition to a market economy, with an emphasis on a rule-based system and on the building of market-supporting institutions. This was the turning point for China on the road to markets. The new approach advocated a coherent package of reforms; it called for creating a level playing field through a rule-based market system, as opposed to particularistic contracting; and it addressed the enterprise reform issue in terms of property rights and ownership, thus opening the door for the transformation (*gaizhi*) of SOEs.

Once Deng Xiaoping called for further market-oriented reforms, attitudes toward private firms changed, providing private entrepreneurs with a more hospitable social and psychological environment. By the end of 1992, China had 27 million registered *getihu* and 140,000 private firms. But the most rapid private firm development occurred from 1992 to 1994, not only with respect to the number of private firms and employment but also with respect to output (table 2.1).

Perhaps the greatest change in official attitude toward private ownership came at the Fifteenth Party Congress held in September 1997, when private enterprise was recognized as an important component of the economy. The forum also stressed the rule of law and its crucial role for a modern market economy to work well. Private ownership and the rule of law were incorporated into the Chinese Constitution in March 1999.

Patterns of Private Sector Evolution

For historical and ideological reasons, private businesses first emerged as individual enterprises in rural areas and in sectors such as trade and services, where there were a limited number of large state enterprises, and distortions from central planning created market opportunities for private entrepreneurs. The scope of private sector activities then gradually expanded, as their legal and organizational framework, geographic distribution, and presence in various sectors increased. Comparisons with other transition economies suggest that this pattern is by and large consistent with the normal evolution of private business. For example, one of the most important inroads of private activity in other socialist economies occurred through private farming and in the service, transport, and construction industries (Kornai 1990). Once China allowed some room for private activities to emerge, this was enough to trigger the spontaneous development of the Chinese private sector, despite the remaining plethora of restrictions and biases. When the internal dynamics of this movement ran counter to existing formal restrictions, the system was flexible enough to accommodate the new realities until formal constraints were relaxed and new room was created for the expansion of private sector activities. This flexibility, as explained earlier, was largely due to factors related to decentralization and

Table 2.1. Private Firm Development since 1991

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

Note: "Private" refers to *siying qiye*.

^a In 1995 constant prices.

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

bureaucratic incentives and became a key factor in ensuring the continuity and the cumulative nature of private sector development.

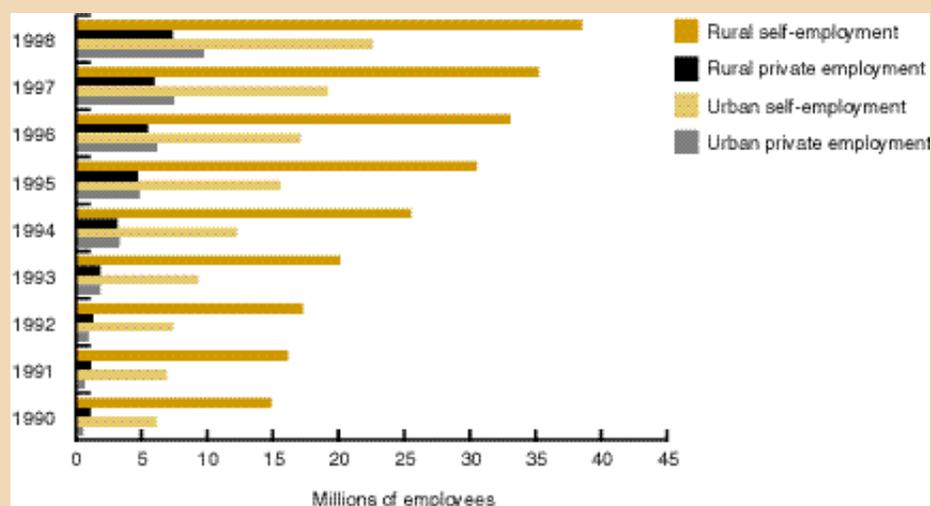
From Rural to Urban

As just mentioned, the rural enterprise played a dominant role in private sector development in China,

especially in the early phase, because major reforms were first tried and proved successful in agriculture. Indeed, until 1993 employment in *siying qiye* was higher in rural areas than in urban areas (figure 2.1).

Self-employment in rural areas continues to exceed urban self-employment by a wide margin. Rural areas,

Figure 2.1. Self-Employment and Private Employment in Rural and Urban Areas in China, 1990–98



Source: China Statistical Yearbook, 1999.

Table 2.2. Distribution of Private Firms by Region

Year	Coast ^a		Central ^b		West ^c	
	Firms	Employment (thousands)	Firms	Employment (thousands)	Firms	Employment (thousands)
1991	95.4	1754.5	24.5	453.4	19.7	380.5
1993	159.3	2351.3	44.6	768.9	34.1	600.6
1996	529.2	7232.8	178.6	2741.2	111.4	1737.4
1997	610.1	8235.5	211.1	3189.7	139.5	2067.4

Note: "Private" refers to *siying qiye*.

^a Liaoning, Hebei, Beijing, Tianjin, Shandong, Jiangsu, Shanghai, Zhejiang, Fujian, Guangdong.

^b Heilongjiang, Jilin, Shanxi, Henan, Hubei, Anhui, Jiangxi, Hunan, Hainan.

^c Inner Mongolia, Shaanxi, Ningxia, Gansu, Qinghai, Xinjiang, Tibet, Sichuan, Guizhou, Yunnan, Guangxi.

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

being somewhat detached from central bureaucratic control, spawned a private sector whose nature and role differed from those of the urban private sector. One notable difference can be seen in the ratio of *getihu* to *siying qiye*, which is much higher in rural than in urban areas. Historically, the industrial structure of the private sector has also differed significantly in rural and urban areas. In the cities, private businesses have clustered in the small-scale retail, service, or food service industries, which have had a disproportionately strong impact on the public perception that private business is interested primarily in "nonproductive" activities. At the same time, largely hidden from the public eye, more than 75 percent of private businesses developed in rural areas, after reforms promoted a surge in the growth of rural enterprises. Of these, nearly 40 percent were engaged in manufacturing or processing (Young 1995).

From East to West

Because of China's emphasis on decentralization and local experimentation with reforms, private sector development was greatly influenced by local conditions, including the attitude of local governments to the role of the market. As a result, the patterns of development differ from region to region. The differences between coastal and interior provinces are especially pronounced.

The regional distribution of *siying qiye* is strikingly different across the country, as shown in table 2.2. The

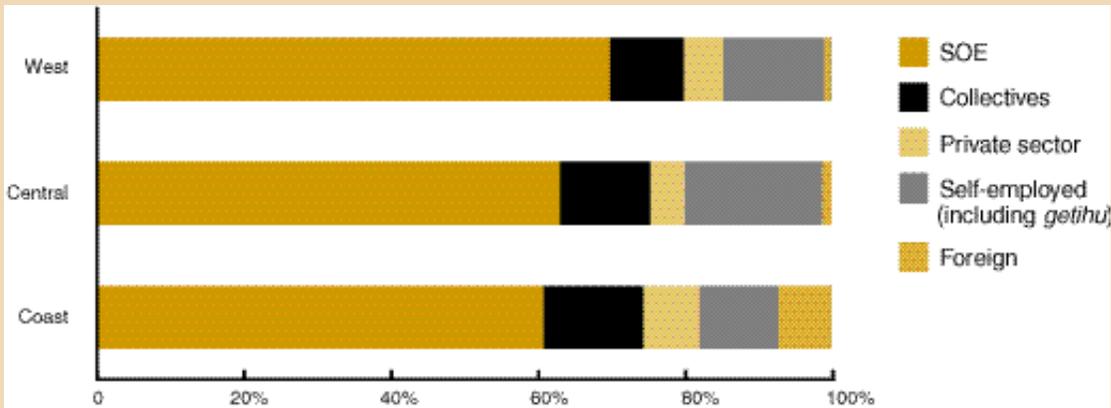
ratio of the number of firms in the western, central, and coastal areas was 21:26:100 in 1992 and 23:34:100 in 1997. In terms of employment, the ratio was 22:26:100 in 1992 and 25:39:100 in 1997. In terms of both numbers of firms and employment, the central provinces were able to catch up with the coast faster than the western provinces.

As figure 2.2 shows, however, the relative shares in urban employment are not that different. The coast has the lowest shares of both SOE and private sector employment (*siying qiye* and *getihu*) but the highest shares of employment in the foreign-invested and collective enterprise sector. The central region had the highest share of domestic private sector employment as of 1998. Within the domestic private sector, however, the coast has the highest share of employment in private enterprises with more than eight employees (*siying qiye*), and the highest ratio of *siying qiye* to self-employed. The latter closely resembles the urban-rural dimension of the relationship between *siying qiye* and *getihu*. Overall, the share of the non-state sector in urban employment is highest in the coastal area and lowest in the western provinces.

From Informality and Particularism to the Rule of Law

Some of the unique features of private business in China derive from the fact that the private sector developed experimentally, in an environment of political, legal, and regulatory uncertainty. The typical

Figure 2.2. Ownership Structure of Urban Employment by Regions in China, 1998



Source: China Statistical Yearbook, 1999.

sequence of development—unpublicized experimentation, followed by general “in principle” approval, then by ratification and specific regulations—implies that for most of the reform period private businesses evolved without clearly defined and secure property rights. Political uncertainty remained substantial as long as activities in the sector were viewed as a temporary solution to some economic problems of the day and as a supplement to state and collective sectors, “filling the gaps” the latter left in the economy.

The Chinese experience therefore seems to suggest that a system of well-defined and secure property rights is not necessarily a precondition for the emergence and initial development of a private sector (McKinnon 1992). Rather, the growth of private enterprise and market institutions over time can create a demand for a clear definition and enforcement of private property rights. Small businesses, which constitute the bulk of the private sector in the initial stage of development, need little in the way of legal protection (Murrell 1992; Rapaczynski 1996). They are typically owned by a single individual or a small group of people who know each other very well; they do not raise capital from the public; and debt capital plays an insignificant role in their financing. What they need most is to have the state eliminate the obstacles that it has been putting in their path. Indeed, local governments in China often interpreted new regulations as a signal allowing them to attack and interfere in private sector activities.

However, unclear property rights have slowed the growth of many firms, and the hybrid forms of ownership that resulted created perverse incentives, which have become a drain on the resources of enterprises and the government alike (see chapter 3). The particularistic approach, as opposed to universally applicable rules, forced local officials and enterprise managers to concentrate on rent-seeking rather than economic returns. It led to collusion between local governments and enterprises, with the local governments acting as patrons rather than regulators. Moreover, the process made private entrepreneurs more susceptible to interference from local bureaucrats. The former reliance on personal connections in the relationship with the government has been transplanted to the marketplace and now dominates exchanges there. The highly particularistic nature of market transactions makes it difficult to gain reliable information about people, commodities, prices, and distribution channels.

The market has therefore become highly fragmented and relies on personal relationships for vital information. In interprovincial market transactions, this particularism has created a high degree of local protectionism. Fiscal decentralization and patronage over local enterprises encourage local officials to protect local markets for their own factories by erecting administrative blockades. Thus perhaps the biggest challenge for the development of the domestic private sector in China today is to establish the rule of law.

SOE Reform: From Stop-Gap to Catalyst

Because China emphasized *de novo* private firms instead of transforming the ownership of existing companies, the private sector emerged on the fringes of the economy and during most of the reform period was viewed as a supplement to the state sector. China delayed ownership reform of SOEs, and, in fact, did not divest any state-owned assets or lay off any state workers before 1992. It took the first of these steps on a large scale in 1995.

The rapid development of the private sector and its impressive performance in the 1990s have been a catalyst for SOE reform, with major progress occurring in the transformation of small SOEs. According to some estimates, ownership changes have taken place in about 80 percent of firms owned by governments at the county or lower administrative level have been restructured. This has put the vast majority of firms and workforce in the private sector and thus has totally changed China's economic makeup.

Ownership reform programs were initiated at the local level in part because the large amount of debt accumulated in the state sector was a drain on local budgets, especially in the smaller cities. That was certainly the case in Shunde when it started its program in 1992 and took the radical step of selling off almost all its state and collective firms (box 2.1).

In 1995, the central government formulated a policy called *zhuada fangxiao*, meaning “keep the large ones and let the smaller ones go.” It decided to keep under its ownership 500 to 1,000 large state firms and to reform the smaller SOEs through a package of policy measures including reorganizations, mergers, acquisitions, leasing, and sales. In 1997 the 500 largest state firms had 37 percent of all assets held by state industrial firms, and contributed 46 percent of tax revenues collected from all state firms and 63 percent of total profit in the state sector. By contrast, smaller firms owned by local governments were performing poorly: in 1995, 72 percent of the firms owned by local governments were in the red, compared with only 24 percent of the centrally owned firms.

From the “let the smaller ones go” policy came the word *gaizhi*, meaning “changing the ownership structure.” Starting in 1994, *gaizhi* began to spread throughout the country. *Gaizhi* consisted of contracting and leasing, two methods used before, as well as

new methods of selling the firm or transforming it into an employee-held company or cooperative. Therefore, *gaizhi* did not necessarily imply privatization. The policy had a direct impact on the so-called red hat firms. In March 1998, the government issued a directive requiring all the red hat firms to “take off the hat” or show their private ownership by November 1998.

Not all localities were fully prepared for *gaizhi*. Many firms just changed their name without going through any form of restructuring (see box 2.2 for a description of *gaizhi* in Sichuan Province). This was particularly true for firms introducing ownership in the form of employee shareholding. These are still regarded as collective firms, and local governments still interfere in their operations. Ownership reform, it has been argued (Yao and Zhi 1999), is not sufficient to improve economic efficiency if the role of the government does not change. Shunde provides an example of combining transfer of ownership with government reform. In the course of its program, the Shunde government undertook a radical reform by cutting one-third of its employees and 40 percent of its functional units. This reform has served as a signal to the private sector that the government has a credible commitment to curbing rent-seeking behavior as well as microlevel interference. To a large extent, the smooth and successful transformation in the city should be attributed to government reform.

Contributions of the Private Sector to the National Economy

The private sector is the most dynamic component of the domestic economy. Between 1991 and 1997, the number of *siying qiye* grew at an average annual rate of 46 percent, employment in *siying qiye* grew at 41 percent, and output grew at 71 percent (table 2.1). During the period 1990–97, new jobs created in the private sector accounted for 38 percent of all new formal employment, or 56 percent of new formal employment in urban areas. In recent years, new employment in the private sector has exceeded the combined total for state, collective, and township and village enterprises (Rawski 1999). This explosive development is in sharp contrast to the stagnation of the SOE and collective sectors (figure 2.3). The private sector has, therefore, become an important source of job creation, absorbing a significant number of workers laid off from the SOE sector.

Box 2.1. Shunde's Ownership Reform Program

When Shunde began its ownership reform program in 1992, it tried to maintain collective ownership and adopted employee shareholding as the main form of ownership. However, it encountered several problems with this strategy. First, employees could not be counted on to purchase shares, either because they did not have enough money or because they did not have enough faith in the factory's future. Second, the manager in an employee-held firm still played the role of an agent, and the firm continued to experience the monitoring problem faced by state and collective firms. Third, free-riding was a major concern because irrespective of performance an employee could still receive dividends from shares. Fourth, uniform shareholding did not help establish authority in a firm.

As a result, Shunde shifted to other forms of ownership change after this initial experience. These forms included listing in the stock market, management leasing, and management buyout (MBO). Because China had a very restrictive policy regarding listing on its two stock markets in Shanghai and Shenzhen (usually in the form of quotas to each province), only two Shunde firms, MD and Kelong, have been listed in the stock market in Shenzhen. To get around government restrictions, some firms were sold or partly sold to a listed firm in another city. This form of ownership change is called "borrowing the shell for the egg."

Management leasing was used for firms that had a large amount of net assets or firms whose management did not have enough funds to buy it. In such cases, management purchased the equipment and leased the land and buildings from the local government.

MBO was the most important and most interesting form of transformation. Many firms that were initially restructured as employee shareholding were transformed by MBO through the concentration of shares in the hands of management. This has been encouraged by the Shunde government.

Before it was sold to management, a firm's assets and debts were valued by an outside accounting firm, usually from Guangzhou, the provincial capital. To protect workers' employment, no more than 5 percent of the workforce could be fired in three years. Competitive bidding was allowed, but the incumbent had priority if it had the same qualifications as its competitors. As a result, the firm was usually purchased by the original management. To handle problems emerging in the transitional period such as debt issues or ownership transfers, the government usually asked the management to register a new firm that owned the old firm together with the government.

For a firm with positive net assets, the top management was asked to pay for the price of the net assets and shoulder the firm's debts. The payment could be made within five years. For some firms that had a large amount of net assets, the local government retained a large proportion of the shares. For a firm with a net debt, the local government that previously owned the firm would take over the net debt. The management had to purchase 15 percent of the firm's gross assets, with the payment being made within five years.

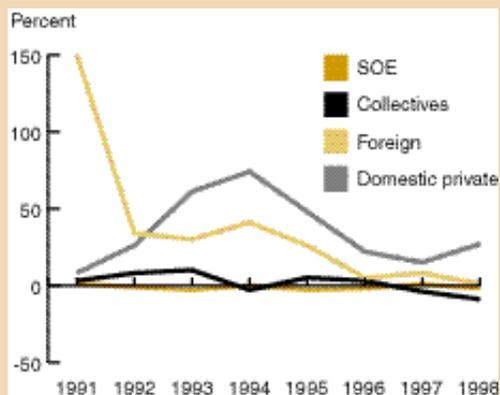
Box 2.2. *Gaizhi* in Sichuan Province

Sichuan is a province dominated by small firms. In 1994 the provincial government began to implement *gaizhi*, starting from county-owned enterprises. By the end of 1998, the province finished *gaizhi* for 68 percent of the 42,681 firms planned to be transformed. Half of the firms (46 percent) were transformed into employee-owned companies or cooperatives, 19 percent were sold to other firms, 15 percent were contracted out or leased out, and 7 percent were liquidated (for 13 percent the outcome is unknown). Regional differences existed. In Yibin County, *gaizhi* was predominantly employee shareholding; in Jintang County, selling and large shareholders controlling were more common; and in Shehong County, mergers were encouraged. Since *gaizhi* was initiated by the provincial government, some local governments did not have sufficient preparation for it. One problem was that local officials treated *gaizhi* as an administrative task, putting emphasis only on the speed of *gaizhi* but not on its real contents.

The increasingly important role of the private sector is reflected in the rapid increases in its share of employment and output in the national total.³ Between 1985 and 1997, the share in national industrial output rose from 2 percent to more than 34 percent (figure 2.4). The employment picture also shows impressive growth (figure 2.5). The private sector's share was already around 2 percent of the national nonagricultural labor force in 1981. By 1997, its share in industrial employment had reached more than 18 percent of the national total. Between 1989 and 1991, the expansion of employment experienced a major downturn, but since then it has grown rapidly. By 1997, the total number of workers had reached 67.9 million.

Although the private sector appears to have become the most dynamic portion of the Chinese economy, it is difficult to measure its size and performance with any confidence, in large part because the classification system for the components of the economy mixes the concepts of ownership, sectors, and corporate organizing methods. This makes it difficult to arrive at an accurate view of the country's economic ownership structure. Furthermore, it has become difficult to separate out what portion of the increasing employment and output of the sector is due to "indigenous growth" within the sector, on the one hand, and to the transformation of enterprises from other types of ownership, on the other. The difficulty of measuring the performance of private firms is further compounded by the lack of adequate financial data on the sector's profits, fixed assets, and working capital. Data on these financial variables published by the National Statistics Bureau do not separately identify subtotals for private firms. The lack of accurate financial data on pretax profits, fixed capital, and working capital makes systematic comparisons of the rate of return on private firms' assets with those of other forms of ownership, notably state-owned firms and foreign invested firms, a difficult task.

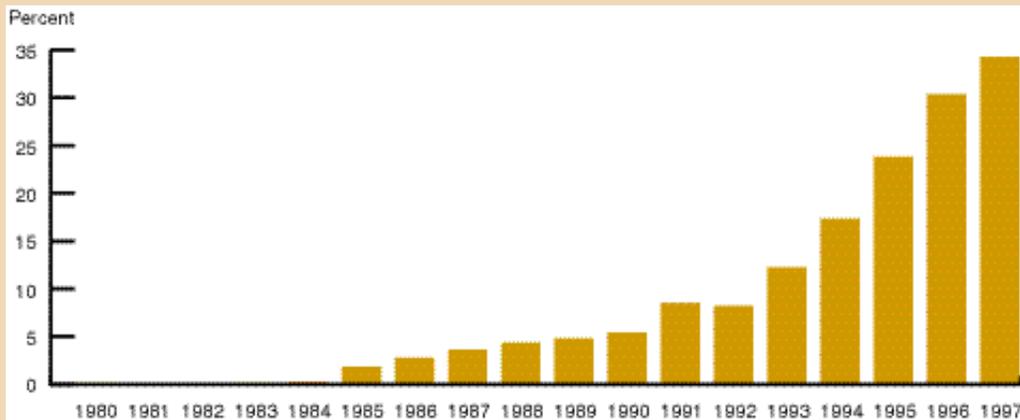
Figure 2.3 Employment Growth Rates by Type of Employment, 1991–98



Source: China Statistical Yearbook, 1999.

To estimate the private sector's share of GDP, we take a sector-based approach, which derives ownership shares in GDP by sectors using plausible assumptions based on official data. In 1998 the true private sector's share of GDP was approximately 33 percent

Figure 2.4. Share of Private Sector in Total Industrial Output in China, 1980–97



Note: Data include getihu and, from 1991 onward, siying qiye.
 Sources: Yearbook of China Industrial and Commerce Administrative Management, 1992–98; and China Statistical Yearbook, 1982–98.

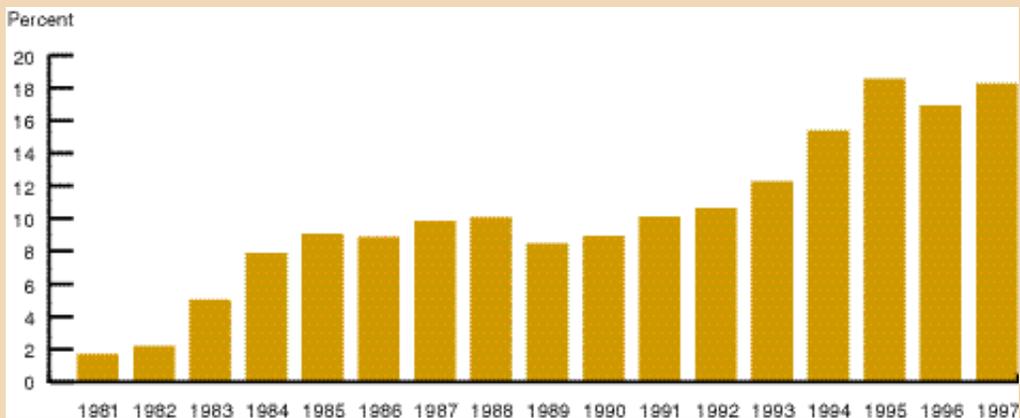
(table 2.3),⁴ which was still smaller than the state sector’s share of 37 percent. If agriculture is regarded as mostly private, however (inasmuch as it consists mostly of individual farmers), the share of the private sector would increase to 51 percent. Adding the GDP contribution of collectives would bring the share of the non-state sector to 62 percent of GDP in 1998.

From official data, it appears that the private sector has achieved this impressive growth with relatively few resources. In the period 1991 to 1997, the share

of private sector investment in the national total was in the range of 15 to 27 percent. In addition, the sector took only a negligible portion of the formal bank loans: according to official statistics, less than 1 percent of working capital loans went to the private sector. The disproportion between performance and resource absorption is a major feature of China’s private sector development in the 1990s.

Private enterprises have in general made more efficient use of capital. Figure 2.6 shows that the average capital-

Figure 2.5. Share of Private Sector in Total National Employment in China, 1981–97



Note: Non-farm labor force. Private sector includes getihu and siying qiye. Because new categorization was adopted after 1995, data for 1996 and 1997 are not strictly comparable with those of earlier years. Prior to 1991, only getihu are included.
 Sources: Yearbook of China Industrial and Commerce Administrative Management, 1992–98; China Statistical Yearbook, 1982–98.

Table 2.3. Composition of China's GDP by Percent, 1998

Official Private Sector ^a		True Domestic Private Sector ^b (excluding agriculture)		True Private Sector ^c (excluding agriculture)		True Non-state Sector ^d (excluding agriculture)		True Non-state Sector ^e (including private agriculture)	
State sector	37	State sector	37	State sector	37	State sector	37	State sector	38
Agriculture	18	Agriculture	18	Agriculture	18	Agriculture	18	Non-state sector	62
Collective (official)	23	Collective (true)	12	Collective (true)	12	Non-state sector	45		
Share holding	3	Share holding	3	Private sector	33				
Foreign share	6	Foreign share	6						
Domestic private sector	13	Domestic private sector	27						

^a Official collective includes "red hat" firms as well as gaizhi firms that are actually private firms. Domestic private enterprises consist of formally registered private firms and getihu.

^b Domestic private enterprises now include shareholding firms and those firms under collective titles but truly private, assuming they accounted for about half of the official collective firms. In some areas and sectors, the proportion of this type in the total collective is more than half.

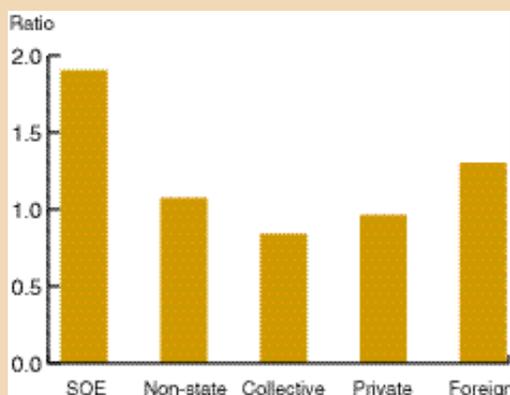
^c Private sector consists of foreign firms and domestic private enterprises.

^d Non-state sector excluding agriculture consists of true collective and private sector as defined in c.

^e In non-state sector including agriculture, state-owned share accounts for about 1 percentage point, which has been added to the state sector.

Source: Calculated according to a sector-based approach, which derives ownership shares in GDP based on their shares in each of the following sectors: agriculture, industry, construction, transportation, post and telecommunication, wholesale and retail trade, and others. Various assumptions on the relative shares of each ownership type in each sector have been made from relevant data. All the original data are from Statistical Yearbook of China, 1998 (SSB); China Statistical Abstract, 1999 (SSB). The shares of all these sectors in GDP are provided by State Statistical Bureau (1999, p. 13).

Figure 2.6. Capital-Output Ratio, 1996



Note: Capital-output ratio is calculated by dividing gross industrial output by total assets.

Source: China Statistical Yearbook, 1997, 424-25.

to-output ratio for private and individual enterprises is only about half of that of SOEs, which suggests that investment in the private sector is more efficient than in the state sector.⁵

The latest statistics released by the State Bureau of Industry and Commerce Management (BICM) show that by June 1999 the total number of *siying qiye* in China had reached 1.3 million, employed 17.8 million workers, and had registered capital of RMB817.7 billion (US\$98.8 billion).⁶ All three indicators increased by about 25 percent over 1998.

The numbers and growth rates of private enterprises vary across sectors of the economy. By the first half of 1999, there were 30,000 private firms (*siying qiye*)

in primary industry (mainly agriculture), which represented an increase of 20 percent from the end of 1998. There were 530,000 firms in secondary industry (manufacturing), up about 5 percent from half a year earlier. The majority of private firms are in tertiary industry (services); their number had reached 722,000 by June 1999, and they accounted for about 56 percent of the total number of private firms in China.

In terms of employment and output, however, industry is still the largest sector, occupying more than half of the employment and output in the private sector in 1997. Trading is the second largest sector, accounting for more than 30 percent of employment and output. From 1992 to 1997, the shares of industrial employment and output declined by about 10 percentage points. During the same period, the shares of employment and output at trading companies increased by 15 and 7 percentage points, respectively. The shares of other sectors did not post such significant changes.

Conclusion

The emergence of a dynamic private sector was the most important result of the reform process in China. Private business was revived in the period after the

Cultural Revolution as a quick way to respond to the mounting pressures of unemployment and economic stagnation. It was first allowed on the fringes of the economy and was initially regarded as a supplement to the state and collective sectors. Private entrepreneurs did not yet enjoy a clear identity, their property rights lacked protection, and they had to function in an environment of significant legal and political uncertainties. Faced with a plethora of restrictions and biases, they had to establish close links with the local bureaucracy and operate under a high degree of informality. Because of China's marked decentralization and strong bureaucratic incentives to promote local development, however, the system was flexible enough and reasonably responsive to demands for legislative measures to allow the cumulative development of the domestic private sector. Thus decentralization, experimentation, and informality have served the evolution of the private sector well in the past. But this evolution constantly brings new problems, some of which require new approaches. Areas of strength in the past are now turning into liabilities for the dynamic growth of the private sector. Today the private sector accounts for about one-third of China's GDP and is officially recognized as an important component of the economy. Perhaps the biggest challenge for its continued development is to establish the rule of law and address the related problem of informality.

INFORMAL STATUS OF DOMESTIC PRIVATE ENTERPRISES

For most of the period from the establishment of the Peoples' Republic in 1949 until the Constitutional Amendment of 1999, private enterprise lacked legitimacy in the eyes of the state. This led to a “withering away” of the private sector in the 1950s. Although private enterprises began to reemerge in the late 1970s, they remained under a veil of informality, which had important consequences for the way in which the private sector has developed since then.

Companies typically go through a “life cycle” of formation, growth, and maturity. Their legal structure, financial structure, corporate governance, and market relationships all change during the life cycle. However, firms in China's private sector have a limited ability to evolve beyond the first, informal stages of life and tend to become “stuck” in a framework of legal, financial, governance, and market structures that they have outgrown in terms of the size and complexity of their business. Thus the informality of the private sector is particularly problematic for larger, more mature enterprises. It is becoming an even more serious constraint now that the private sector is beginning to play a larger role in the Chinese economy.

Establishment

At first, only sole proprietorships employing up to eight people could be registered as *geti gongshang hu*. In 1988 larger private enterprises were permitted to register, either as sole proprietorships, partnerships, or limited liability corporations. Even then, their status as private enterprises kept them at a disadvantage compared with SOEs and collectives, owing to the heavy restrictions on their freedom to operate (see chapter 4) and limited access to finance (see chapter 5).

As a result, many private enterprises registered in other ways that gave them the freedom to run a larger enterprise, with fewer regulatory restrictions and greater access to finance. The following were the most popular alternatives:

- **Red hat firms (including TVEs).** Many firms were registered as having collective ownership when they were actually privately owned. This was more common in the countryside. As explained in chapter 2, such a firm was said to be wearing a “red hat,” which enabled it to evade the prohibition of private firms and ideological harassment by the government. Collective or TVE status brings with it a degree of local government involvement in the enterprise. This can be helpful in securing access to land, assets, finance, and markets. Local governments also often subsidize collectives and TVEs, through tax breaks, favorable contracts, or loans on preferential terms. On the other hand, government involvement interferes with truly commercial management and can lead these firms to operate more like SOEs. Red hat firms continued to exist even after private ownership forms were created in 1988, owing to the continuing advantages of government involvement. Although an estimate of these firms is not available, the prevalence of this practice can be illustrated in Shunde, where we found that almost all the firms at the village level were red hat firms before 1992. Furthermore, most of these have since been transformed into private enterprises with the encouragement of the municipal government, partly because of its concern about the budgetary cost of supporting them. The red hat phenomenon remains important in all the cities covered by the survey.
- **Rented collectives.** Many collective firms were rented out for private operation. According to one estimate, in 1984 such firms made up 19 percent of all collectives in Hebei, 30 percent in Tianjin, 40 percent in Liaoning, and 50 percent in Ningxia (Zhang and Liu 1995). A private entrepreneur would pay the collective a fixed rent and operate the firm as though it was his own. Many such entrepreneurs accumulated considerable capital assets, thereby reducing the share of the collective assets. Hence the operation was gradually transformed into a solely privately owned firm.

■ **Foreign investors.** Since foreign private enterprises were permitted to operate as joint ventures with local collectives or SOEs and obtained significant tax advantages, many domestic entrepreneurs invested through offshore companies so as to qualify as foreign investors. Hong Kong has been an important source of foreign direct investment in China, and it is widely believed that a significant proportion of this has been “roundtripping” by domestic entrepreneurs.

In addition, many *getihu* grew beyond the formal limits on their size (see chapter 2). Private firms also attached themselves to existing state-owned and collective firms in various ways to obtain representation, solve procurement problems, and obtain access to markets and financial services. Many coinvested with state and collective firms to overcome entry barriers in particular sectors, thus creating a variety of mixed-ownership forms. Some covered themselves in a cloak of ambiguity, referring to themselves in terms associated with public enterprises, such as “business department” and “service department,” to suggest a public status. Another practice designed to create ambiguity was to give local government cadres enterprise shares, paid positions as advisers, and positions as board members.

The firms we surveyed were all registered as private enterprises and therefore did not include red hat firms. Of these, 40 percent were sole proprietorships, 30 percent partnerships, and 29 percent limited liability companies. Sole proprietorship has the disadvantage of taking unlimited liability, but it has the advantage of not being liable to establish a standard corporate account and put it under the state’s supervision. This provides certain attractions, including scope for tax evasion. Many of the sole-ownership firms surveyed were large (the average of net fixed capital stock of these firms was RMB15 million [US\$1.8 million]).

The current law prohibits a firm with a single owner from registering as a limited liability company. Where firms do want the protection of limited liability, sole proprietors may form partnerships with sleeping partners, such as a family member, who have no effective control or role in the enterprise while formally owning a share of it. Although the law does not set a minimum share for the second owner, in implementation the share is set at between 5 and 20 percent in the four cities covered in the first phase of our survey.

In some cities such as Shunde, a spouse is permitted to act as a partner, so a firm can obtain corporate status without necessarily having the sole owner’s family lose control of the firm. In other cities, such as Beijing, a spouse is not permitted as a partner. In this case, some firms just give a nominal partner a nominal share, but both parties agree between themselves that the share is not real. This discrepancy between personal agreement and legal protection has already brought cases in which the second owner has sued the first owner to get his share out of the company. Such disputes can obviously be devastating for the firm.

The mismatch between the formal structure of the firms and the reality on the ground has important consequences for their operation. While it confers on the enterprise the rights and privileges of the form adopted (say, a collective or a foreign joint venture), it also weakens the structure, especially as the firm grows in size.

The success of China’s rural industrialization led many people to argue that the combination of private entrepreneurship and collective ownership helped attain that success. It was seen as a second-best response to China’s imperfect market and policy environments. State subsidies and allocations of land, assets, and credit contributed substantially to the initial financing of many private enterprises.

Although this may be one way to address China’s market and policy failures, the fact remains that many private entrepreneurs put on a red hat just to evade the ideological bias and government regulations. In many cases, local governments suffered fiscal losses rather than benefited from the presence of a red hat firm. At the same time, the private firm suffered from political interference in its operations.

In Shunde, for example, the most important reason for the local government to transfer collectives to private ownership was to get rid of the burden of red hat and other government-owned firms. A red hat firm made an entrepreneur’s incentive asymmetric. If the firm made a profit, it was his. If it incurred a loss, the government had to shoulder the burden. As a result, village and township governments accumulated a considerable amount of debt. Government officials in Shunde called this “bleeding” and the transformation program the “project for stopping the bleeding.”

Corporate Governance

A key characteristic of the informality of the private sector is its opaque organization (for types of corporate governance, see box 3.1). That is to say, because of their artificial status, firms operate quite differently from what their formal status would suggest. Many collective firms, for example, are effectively under the control of an individual proprietor; some foreign companies are effectively owned by domestic companies.

Managers appear to make most of the important decisions in the firm: in those surveyed, managers did so in 69 percent of the cases, the board of directors in 23 percent, and others in 8 percent. This is typical of early-stage companies or family businesses in which owners and managers are the same people. Similarly, most of the CEOs interviewed were themselves owners.

This structure becomes problematic as companies grow beyond the span of control of the owner-manager. Once he or she needs to delegate to managerial staff, formal corporate governance structures are required to tackle the principal-agent problem of ensuring that staff act in the interests of the owners. In the absence of formal structures, owners often hire family members, trading off trust for competence. The competence of managerial staff then becomes a constraint on enterprise performance. As might be expected, larger enterprises that have taken the legal form of corporations make greater use of boards of directors to take important decisions.

Legally barred from maturing into publicly traded companies, large private firms have had to adopt alternative approaches to corporate governance. Some have tried to mimic the structure of state-owned enterprises, with both a board of directors and a supervisory board representing shareholder interests. These boards tend to include political appointees and may lack business or sectoral expertise. This situation has contributed to the poor performance of some large enterprises, which lack effective managerial control and take excessive account of political considerations in their decisionmaking.

A large problem for family businesses everywhere is how to manage a smooth transition once the original owner-manager is no longer able or no longer wishes to run the business. Because businesses often fail at this point, any means of overcoming this problem

Box 3.1. Corporate Governance and the Corporate Life Cycle

Sole proprietorship or family business. This is how most private firms start. The owners are the managers, so there are few principal-agent problems, and little formal governance structure is needed. Financial disclosure is limited to that required to comply with tax laws and to raise external finance, which can be rather limited. It usually takes the form of turnover, collateral value, credit history, indebtedness.

Closely held corporations. Most small and medium enterprises (SMEs) take this form at maturity. They may be large enough to have divided ownership from management, so formal corporate governance structures are required for the owners to supervise the managers. Some information transparency is needed as part of this supervision, but external disclosure is still limited, as most investors are closely related to the company.

Publicly traded corporations. Many large enterprises take this form at maturity, as it offers the greatest scope for raising external finance. Since they typically have large numbers of shareholders who have no direct contact with the corporation, governments and stock exchanges require complex systems of corporate governance and information disclosure to ensure that investor interests are protected. Owing to the high cost of compliance with these requirements, public listing is rarely cost-effective for smaller companies. However, growing sophistication of equity markets in developed countries is allowing high-growth firms to list at an earlier stage of their life cycle.

would help increase the survival rate of enterprises. Many private enterprises in China are still relatively young, however, so this has not yet emerged as a major constraint, but it is likely to do so over time.

Management Capacity

Except in the smallest firms, owners are not able to provide all the management skills themselves. Among the surveyed firms, many owners have hired managers to bring in additional managerial and other specific skills. This leads to principal-agent problems, which firms address either by hiring family members (whose interests are expected to be closely aligned with those of the owner) or by giving the managers shares in the ownership.

According to a 1999 study of 1,900 medium and large enterprises by the China Academy of Social Sciences (CASS) and the National Association of Industry and Commerce (NAIC), 48 percent of the relatives of the entrepreneur were employed in management of the enterprise, including 51 percent of the spouses and 20 percent of the adult children. Another study by the All China Federation of Industry and Commerce (ACFIC) found that 98 percent of private enterprises were family-managed. One such enterprise is a medium-size firm in Wenzhou with a turnover of RMB300 million (US\$36 million) per year, which makes analytical devices for the chemical industry. The father is the chairman of the board, the mother is the office manager, the eldest daughter is the general manager, the son is the vice-general manager, the second daughter is the financial manager, the second son-in-law is the sales manager, the sister-in-law is in charge of general affairs in the office, and the nephew is the purchasing manager.

Even if employees are given the option of buying the firm's shares, the problem is not fully resolved because the shares are not transferable unless listed in a stock market. They thus have reduced value for the employees and must be cashed out for an employee who wants to leave the firm. Moreover, the lack of financial transparency and clear asset ownership makes it difficult to value the shares or to realize their value when the manager leaves the firm. For owners of large firms, public listing of their shares would help to make the allocation of shares or share options to managers more effective. In fact, a major reason for Stone Group, one of the largest high-tech firms in China (see box 3.2), to go public was to solve its internal incentive problem. The software industry is knowledge-intensive, and the incentive problem is more acute here.

Background information culled from our surveys indicates that top managers¹ in the sample firms have a reasonably high education: 35 percent have gone to junior high school, 25 percent have gone to senior high school, and 28 percent have been to college.² However, educational attainment may not be a good indicator of business skills. According to the CASS/NAIC study just mentioned, only 40 percent of entrepreneurs could read a balance sheet. Among the smallest firms, the education attained by managers is concentrated at the junior high school level (34 percent), while it jumps to the college level for the larger firms: in firms of 100 to 500 employees, nearly 50 percent of the managers have a college diploma.

When broken down by location, 45 percent of the managers in Shunde and 34 percent in Beijing have a junior high school education, while 28 percent in Beijing are college graduates. In the four cities as a whole, more than 40 percent of the managers are college graduates. In Beijing and Chengdu, 5 percent of the managers have a Ph.D. degree, while there are almost none with this degree in the other cities. This makes sense because those two cities have many top universities, while the others have none.³ The proportion of managers with a foreign education is highest in Wenzhou at 2.3 percent.

Overall, 75 percent of CEOs had management experience before they had taken their current job. Their past sectoral experience breaks down as follows: 74 percent worked in the industrial sector, 43 percent in private firms, 33 percent in state-owned firms, and 13 percent in collective firms. Thus both the private and the state sectors train and foster entrepreneurs. With the further reform of SOEs, more entrepreneurs can be expected to emerge from the state sector. However, the figures show that the private sector itself is becoming a significant source of human capital accumulation.

At the same time, private firms have difficulty obtaining and retaining skilled workers. For one thing, state firms are able to offer greater job security and social benefits (including residence rights, housing, and health and education benefits). Thus many college graduates do not want to work in a Chinese private firm even if it pays a higher wage than a state firm. This situation is more prevalent in Beijing and Chengdu, where the first choices of university graduates are foreign companies, joint ventures, and government institutions.

Box 3.2. From Collective to Private Ownership

The Stone Group is the most famous of China's private high-tech firms. It was founded in 1984 by four scientists from the Chinese Academy of Sciences and Beijing's No. 3 Computer Factory. It obtained its original premises and capital from Sijiqing township in Haidan. It wore a red hat, registering as a collective, but unlike most collectives it did not receive any government investment or have an administrative "parent unit" to oversee it. By 1986, the owners had formed three other related companies, all legally separate collectives. They turned these into subsidiaries of a holding company and in 1987 formed a joint venture with Mitsui of Japan to manufacture word processors.

In 1992, Stone obtained government approval to corporatize one of its subsidiaries, SET, and list it on the Hong Kong stock exchange. In effect, SET became the holding company, with 52 subsidiaries within and outside China and a turnover of HK\$1.5 billion by 1996. A large number of shares in SET were given to managers and employees via stock options, so that by 1994 two-thirds of employees held shares in SET. Though Stone remained formally a collective, its functional ownership rested increasingly with its management and employees. However, 51 percent of SET shares remained in the hands of the collective, Stone Group Corporation, and this remained an impediment to true private ownership. All parties believed that this portion of the shares belonged to the management and the employees, but the real challenge was to legally clarify it both in form and in substance.

IFC was mandated in September 1998 to advise on a restructuring to transfer the 51 percent ownership of SET collectively owned by Stone Group Corporation to the management and employees. An Employee Share Ownership Committee was created to be a special-purpose vehicle capitalized by management and employees with their own personal funds to purchase shares from the Stone Group. By mid-1999, the transaction had been completed with the approval of the Hong Kong Securities and Futures Commission and authorities in Beijing. Today, SET is majority owned by employees, management, and the public. The clarification of the ownership of Stone has become a model for how a private firm wearing the red hat of a collective can become a true private enterprise through a market-driven transaction with transparency.

Sources: Kennedy (1997) and IFC staff

Again reflecting the economic uncertainties they face, private firms tend to recruit managers in an informal way, with an eye on reducing their risks. For example, one surveyed firm pays a master's graduate only RMB3,000 (US\$360) per month in the tryout period, whereas a low-level office manager can get more than RMB8,000 (US\$970) per month. The tryout period may help the firm identify qualified people, but it also discourages highly talented people. Offers of such a wage and uncertain career prospects make it almost impossible to get qualified people.

Labor Relations

Employees in a typical private firm can be divided into two groups: local people and outside university graduates, on one hand, and rural migrants on the other. The first group generally occupy better positions in the firm and enjoy better wages and benefits. For example, many cities require firms to purchase retirement and health insurance for urban residents. Firms need the expertise of outside graduates, so they tend to treat them as locals. Because rural migrants have a high

turnover rate and have accrued few skills that cannot be acquired quickly by readily available new workers, firms do see much sense in purchasing retirement or health insurance for them.

In the private workforce, then, a clear distinction is made between the locals (and outside graduates) and the rural migrants. The latter group not only have less favorable jobs and lower wages but also poorer accommodations. Rural workers usually live in firm-provided dormitories within the factory, often 8 to 12 people in one small room. In contrast, local people live in their own houses, and outside college graduates enjoy much better housing provided by the firm (two persons in a room, the firm buys commercial apartments for employees with higher positions, and so on).

Only 27 percent of the surveyed firms responded to a question about worker unions. Of these, 60 percent had a unionized workforce. This may overstate the prevalence of unions, however, because those firms that did not provide an answer to the question might not have any. All the same, unions appear to play a significant role in representing the interests of the workers: among the chief executive officers interviewed, 41 percent reported using unions to help resolve workplace disputes, whereas only 11 percent relied on direct negotiation.⁴ In addition, the courts and the government played an important role: 21 percent used courts in labor disputes; 25 percent turned to the government.

Note, too, that a few firms consciously used unions and Communist party organizations to strengthen their management. This is particularly significant in Beijing. Although conforming to the law or public relations may be one aim of setting up a party organization, employees may also see it as beneficial in that it allows employees who are party members to justify working for a “capitalist” firm.⁵

As the reform of state-owned enterprises has deepened, many urban workers have lost their jobs. These unemployed workers are willing to lower their asking wages and benefits in order to find new jobs. As a result, they have become competitive in the labor market. Consider the case of a Beijing garment company that in the past hired rural migrants. These rural workers had a high turnover rate and went on strike twice.

Beginning last year, the firm began to hire unemployed local workers. Because they had already lost jobs once, these local workers valued the work opportunity and worked hard. Apart from being more disciplined, their previous working experience also reduced the cost of training for the owner.

Financial Disclosure

To preserve their chosen formal status, firms often need to keep their financial structure opaque. Most do not maintain transparent, audited financial records. Even where audited accounts are required, they may misrepresent the true financial position of the firm. Restrictions on registration under different categories of incorporation give firms an incentive to underreport and misreport financial flows, numbers of employees, stocks of assets, and the like. This is exacerbated by the burdens of the tax system, which also encourages underrecording.

Enterprises are commonly said to keep three sets of books: one for the government, one for the banks, and one for themselves.⁶ This means it is difficult for outsiders to ascertain who owns the assets, who controls the firm, and how management decisions are made. This lack of clarity in corporate governance has allowed companies to respond with agility to shifting regulatory and policy constraints.

Only 37 percent of the sample firms provided shareholders an annual report certified by an outside accounting agency (and only 1.2 percent of the firms used an international accounting firm; see box 3.3). Since the law requires only corporations to provide such a report and 70 percent of the sample firms are not incorporated, this constitutes legal compliance. Furthermore, since many firms are closely held by the owner, there is little immediate reason to publish audited financial statements. Unless audited financial statements are disclosed, however, it is difficult to demonstrate creditworthiness, and thus to enter contracts and attract investment.

When asked why they did not produce audited financial statements, 25 percent of the firms that did not said they never considered it, 41 percent thought it was not required, 14 percent said it was too expensive, and 5 percent thought the report was of no use. Again, this is typical of less mature, smaller enterprises.

Box 3.3. Toward International Accounting Standards in China

In the early 1980s, the government inaugurated changes to the Chinese accounting profession, which are continuing. The first Chinese certified public accountant firm was formed in 1981, at which time international accounting firms received permission to open representative offices in China. The Chinese accounting system continued into the 1990s. Early in the decade, an accounting system was developed and implemented for Sino-foreign joint ventures, marking the country's first step away from the fund accounting concept. To enable Chinese enterprises to attract foreign investment or list stocks on overseas markets, the Ministry of Finance in January 1992 issued a separate set of accounting regulations for selected joint stock companies that conform more closely to international accounting and disclosure practices than the general Chinese standards.

In 1994 the Company Law took effect, providing a regulatory framework on which new accounting and auditing standards could be based. In the last five years, the Ministry of Finance has issued or revised three sets of accounting regulations applicable to all enterprises in China, including joint-stock limited companies and foreign-invested enterprises. These regulations are prescriptive in nature, however, setting out specific accounting treatments for different types of enterprises in different industries and therefore are still rigid compared with international accounting standards (IAS). The Accounting Law was revised in October 1999 to tighten the requirements for transparent accounting and unbiased auditing, and to introduce new penalties for misleading accounting practices.

In addition to passing new accounting laws and regulations, China joined the International Accounting Standards Committee in July 1997. The joint-stock limited company is perhaps the only type of enterprise in China that typically uses accounting standards approximating international accounting standards. However, there remain important distinctions between IAS and Chinese accounting standards in the areas of method and choice of accounting policies, the treatment of provisions for accounts receivables and contingencies, income taxes, and asset valuation.

To understand the financial position of domestic private firms, it is important to look at the handling of related-party transactions, which can include loans, loan guarantees, and raw material purchases. In June 1997 the Ministry of Finance released the Accounting Standard for Business Enterprises: Disclosure of Related Party Relationships and Transactions. Based on IAS, the standard requires listed companies, and encouraged unlisted firms, to disclose related-party relationships and transactions. Nonetheless, it is still difficult to gain a thorough understanding of significant related-party transactions and the processes and internal controls over such transactions. This is particularly problematic because of the triangular debt situation that has resulted from companies' obtaining loan guarantees from third parties to cover their debt obligations. Until recently, the fact that companies were not required to disclose such information in their financial statements made it difficult for financial institutions and investors to assess the risk of investing debt or capital in a company. Under the Ministry of Finance's June 1997 pronouncement, however, companies are now required to disclose information about loan guarantees obtained through third parties.

Subsidiaries and Conglomerates

An important feature of China's domestic private sector is the prevalence of conglomerates consisting of related and unrelated businesses. Private businesses have moved in this direction owing to four factors:

- Economic and regulatory risk.** With economic conditions, government policies, and regulations changing rapidly and unpredictably, businesses are exposed to different risks in each sector in which they operate. Since these risks are not completely correlated, firms can reduce risk by diversifying their operations among different sectors. The more unrelated they are, the lower the risk covariance. Hence the observed pattern of diversification into unrelated businesses. This seems to be more prevalent in locations such as Chengdu, where the climate for private enterprise has been less certain. By contrast, where private enterprise has a more stable policy framework, as in Wenzhou, private enterprises are typically concentrated into narrow market niches. To cite one example, an entrepreneur in Chongqing started with a small foundry producing parts for local engineering companies. A chance meeting at a trade fair with an American company selling horse-riding equipment led to a contract to manufacture bridles and stirrups for export to the United States. This became the main line of business. Using the cash flow from this business, the entrepreneur is sponsoring the development of a resort complex outside Chongqing. Most recently, he has acquired a contract to construct and operate a toll road.

- Market failure.** Where labor and financial markets do not work well, existing enterprises find it advantageous to enter new businesses, because they can obtain capital and management skills from within the existing business. This leads them into unrelated businesses as opportunities arise. This pattern can be seen in a number of other Asian countries. Keiretsu in Japan and chaebol in Korea, for instance, make it possible to share capital and human resources across unrelated sectors. In addition, to balance their overall operations, entrepreneurs may deliberately match a business experiencing uneven cash flow with another having even cash flow. In one case, a real estate developer in Beijing operates a department store and a

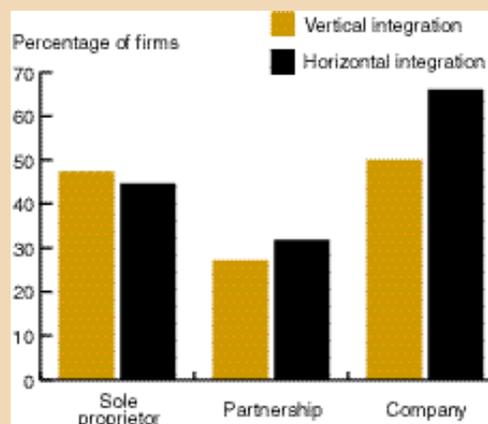
hotel to generate steady cash flow to support the volatile real estate business.

- Principal-agent problems.** If a firm has weak corporate governance, its shareholders may have little control over the managers of the enterprise. This allows managers to reinvest profits in the business, rather than return them to the shareholders. Where profit opportunities are limited in the existing business, managers may have the freedom to invest in unrelated businesses.
- Opaqueness.** Diversification also serves to increase the opaqueness of the enterprise, which may help to disguise the true ownership or tax liabilities.

Among the firms in the survey, 28 percent had one subsidiary, 22 percent had two, 27 percent had three to five, and 24 percent had more than five. In addition, 5 percent had subsidiaries outside China. Furthermore, 33 firms reported that they belonged to enterprise conglomerates; 38 percent of the firms also said there was no specific industrial connections between themselves and their subsidiaries. The average size of the conglomerates in 1998 was 1,127 employees, with a sales volume of RMB150 million (US\$18 million) and a profit of RMB20 million (US\$2.4 million). This would make the average conglomerate equivalent to a medium-size SOE.

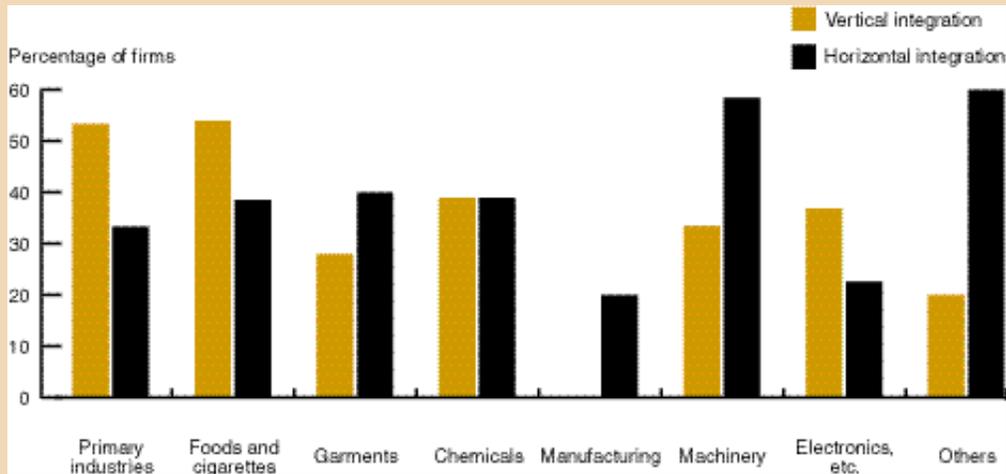
One Beijing group ran the gamut from construction to pharmaceuticals. Founded in 1983, this firm's first

Figure 3.1. Prevalence of Vertical and Horizontal Integration in Surveyed Firms



Source: Survey.

Figure 3.2. Vertical and Horizontal Integration by Industry among Surveyed Firms



Source: Survey.

line of business was the construction of computer rooms. Since the early 1990s, it has used the profits from this business to expand into other businesses and is now active in more than a dozen industries. First, it plowed profits from construction into real estate ownership and management, such as office blocks in Beijing. Second, its contacts with a Japanese manufacturer of refrigeration equipment led it to enter refrigeration manufacturing. Later, it established manufacturing facilities for pharmaceuticals and health products, which are now its main line of business.

This pattern of conglomeration among unrelated companies has been a rational response to the economic environment facing private enterprises. However, it confers weaknesses on the companies, which will become exposed as capital and labor markets improve and economic uncertainty declines. This has been the experience of keiretsu in Japan and chaebol in Korea, whose performance has deteriorated following economic liberalization. Managers of highly diversified groups face an enormous challenge, because they are required to understand many different businesses in different markets. Many are tempted to run such companies in their interests rather than shareholder interests, because the use of intercompany transactions rather than the market obscures the economic performance of each constituent enterprise. There are only a few conglomerates in the world, such

as GE, with strong enough management structures to perform well across a wide range of industries.

Where there was an industrial connection, firms in our sample were fairly evenly balanced between vertical (within the supply chain) and horizontal (cross-chain) integration (figure 3.1).

Another feature of conglomerates in China is that the different activities tend to be organized as separate legal entities, rather than formal subsidiary companies or divisions of the parent company. This serves to obscure financial and control relationships between companies, which depend more on family relations than legal control. This also makes it more difficult for companies to be taken over, as the parent company does not formally control its subsidiaries. On the other hand, financial separation allows the managers of each activity to be rewarded according to the performance of their company, and legal separation makes unbundling of activities easier.

Supplier and Customer Relationships

Conglomeration can also be a way to reduce transaction risk, through vertical integration. In our sample, 37 percent of the firms had subsidiaries they described as vertically integrated (figure 3.2). It

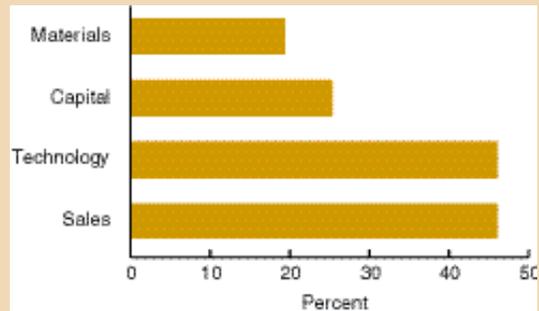
seems that the firms with longer years in operation tend to be more vertically integrated, although the level varies across industries. For example, foods and cigarettes and primary industries have a high level of vertical integration. To address the problems arising in market transactions, some firms invite their customers and suppliers to invest in the firm. In the sample, 24 firms had suppliers as shareholders, 39 had customers, and 8 had financial institutions.

Such integration practices may be a response to another feature of informality: operating in an informal environment, private enterprises have difficulty forming relationships with third parties such as banks (discussed below) or suppliers and customers. Thus many private enterprises are reluctant to advance trade credit to other private enterprises (for example, by filling an order in advance of payment) because they cannot assess the creditworthiness of the other enterprise or easily sue for the recovery of losses. This constrains the growth of business. As one entrepreneur told the researchers: “No one ever went bankrupt by turning down an order, but many have gone bankrupt by accepting orders that were never paid for.”

This puts a premium on stable, long-term trading relationships, as reflected in the survey results: 84 percent of the companies in the CEO survey had stable suppliers, and 85 percent had stable customers. When asked about buyers, 26 percent of the firms indicated they buy mainly from government agencies, 46 percent from state-owned firms, 50 percent from private firms, and 42 percent from foreign companies. In the case of main suppliers, 45 percent of firms are supplied by SOEs, 58 percent by private firms, and 39 percent by foreign firms.

Because of its informality, the relationship also relies greatly on trust, especially where payment for sales is concerned. Among the firms in the survey, 21 percent reported that their customers were introduced by friends or family members, 19 percent said their partners were friends, and 3 percent said that their partners were family members. In other words, about 43 percent had some prior direct or indirect connection. As for suppliers, 24 percent said they were introduced by friends and family members and 10 percent said the partners were their friends. That is to say, about 34 percent had some connection. In addition, 30 percent of CEOs said family and friends were important in material supply, and 46 percent said they were important in sales.

Figure 3.3. Areas in Which Links to Overseas Chinese Are Important



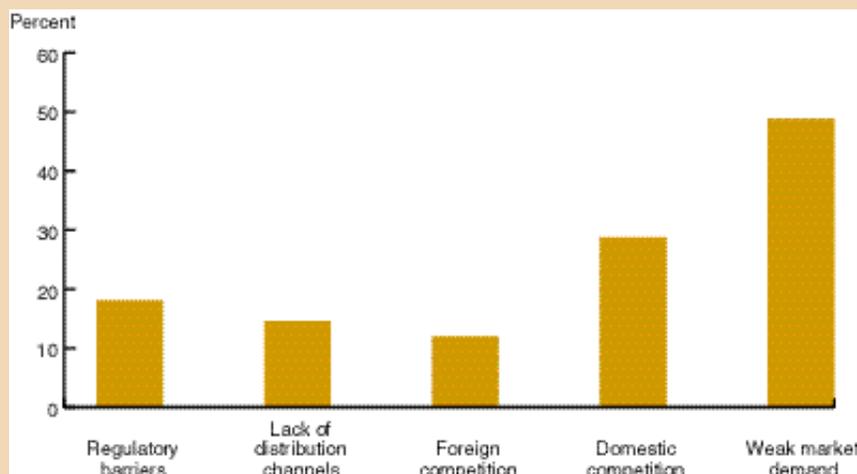
Source: Survey.

These figures provide considerable insight into the role of networks in a private firm’s market operations. Private entrepreneurs seldom ask family members to be a business partner, but quite a few of them do business with friends, and a lot of them do business with people introduced by friends or family members. Therefore, networks help make up for the informational deficiencies of informality. Overseas Chinese are important members of networks, especially in the areas of marketing and technology acquisition (figure 3.3). However, private firms also rely heavily on the “faceless” market to find customers and suppliers.

Some sample firms also establish business relations through industrial associations. Because most such associations are dominated by state firms, private firms that produce intermediate products used by state firms find it particularly helpful to join these associations. According to interviews with CEOs, entrepreneurs form different interactive circles by firm size: owners of smaller firms had one circle, larger firms another circle. Smaller firms were at a disadvantage, however. Through association contacts, they hoped to find opportunities for subcontracting from the larger firms, whereas the larger firms already had enough small firms coming to their factories to ask for subcontracting work.

In view of the current economic slowdown and widespread enterprise arrears, firms are becoming more cautious about selecting their customers.⁷ Because firms operate under conditions of tight liquidity, losing one payment may bankrupt them. Many of the surveyed firms had reduced their business volumes in order to avoid deferred or dead payments. A common sentiment was, “If you do not have a deal, you are not going to die

Figure 3.4. Major Constraints to Market Entry Cited by Surveyed Firms



Source: Survey.

immediately; but if you have done a deal without payment, you are going to die quickly.” To get the information on the payment ability of a customer, a private firm relies on contacts with firms that have done business with that customer. Only if the customer has a good record of payment will the firm do a deal with it.

Market Entry and Competition

Because until recently private enterprise lacked recognition, many areas of economic activity were reserved for state-owned and collective firms. Hence private firms were excluded from many domestic markets and, until recently, were excluded from direct exporting. Even now, only a limited list of private firms have direct export rights, and a number of sectors continue to be reserved for SOEs (see chapter 4). Of the firms surveyed, 18 percent cited legal restrictions and 15 percent cited the lack of distribution channels as barriers to entering new markets (figure 3.4).

Formal exclusion is not the only means of keeping private enterprises out of the markets dominated by state-owned enterprises and foreign joint ventures. Another is the fact that SOEs, TVEs, and collectives have preferential access to bank credit. As a result, they are able to invest without full market discipline, which in turn allows overexpansion and excess capacity to develop in many sectors. Not surprisingly, 48 percent of the enterprises surveyed reported that “weak market demand” in

relation to existing capacity was a constraint to market entry. Similarly, the tax breaks, subsidies, and preferential access to resources and markets available to joint ventures make it very difficult for private enterprises to compete and remain viable. Of the firms surveyed, 12 percent cited foreign competition as a barrier to entry. In addition, SOEs and collectives have been able to exploit their political patronage to obtain contracts, access to land and resources, credit, and other sources of competitive advantage not available to private enterprises. As a result, private entrepreneurs have tended to put on the red hat to obtain market advantages (see box 3.4) or to seek niches where SOE competition is a limited threat, such as new products (software) or rapidly changing markets (fashions, toys) where SOEs find it difficult to compete. This has severely limited their range of markets. Hence the survey found little head-to-head competition between registered private enterprises and SOEs. Only 12 percent of the CEOs interviewed thought state firms were their competitors; 81 percent saw other domestic private firms as their main competitors.

Competition among private firms themselves is high because their numbers are increasing in all categories, whether newly restructured SOEs, *gaizhi* firms, or red hat firms. The competition is especially keen in the several industries where private firms tend to be concentrated. In rural areas, for instance, many small private firms are producing similar low-grade products and competing with each other and with other TVEs.

Box 3.4. *Guakao* and a Beijing Taxi Company

Private taxi companies are not allowed to operate in Beijing. To get around this restriction, one entrepreneur established his taxi company as a subsidiary of a collective firm. In Chinese, this arrangement is called *guakao*, literally meaning “get backing”: the private firm is called a *guakao* firm and the state or collective firm or government agency providing the backing is called a *guakao* unit.

In 1996 this entrepreneur's *guakao* unit (that is, the collective firm), was transformed into a shareholding company, but the taxi company was excluded from the transformation. As a result, the company became a purely private company without *guakao* and was thus disqualified from the taxi business. To continue the business, the entrepreneur approached the district government for help. Since the taxi business provides considerable local tax revenues, the district government decided to set up a new company, partly owned by the district government and counted as a collective firm, to be the new *guakao* unit for the taxi company. As a result, the private taxi business could continue. The new company was registered as a trade company specializing in jewelry and arts articles, but its owner does not put much effort into these activities.

The same entrepreneur also owns another trading firm with a state firm as its *guakao* unit. This allows him to operate on three fronts: as a private business, as a collective firm, and as a state firm. He told the researchers that he made this arrangement purely to avoid political risks and to get around government restrictions. He said he thought that by this arrangement, he was fully prepared for any policy changes. Although the Constitutional Amendment and the Fifteenth Congress of the CCP gave the private sector the same status as the state sector, thereby increasing his confidence, he was not yet ready to get rid of this arrangement.

Many of the private firms surveyed also formed clusters in terms of both location and industry. Such clusters tend to deepen industrial specialization, increase economies of scale, enhance efficiency, and widen the scope for development of private enterprises. Local governments' policy of developing hi-tech areas, as in Beijing and Chengdu, fosters the formation of industrial clusters. Such clusters can be highly competitive or, as in some industries in Wenzhou, can engage in practices that reduce competition (see box 3.5).

According to the CEOs interviewed, entrepreneurs see the lack of access to market information as a key internal constraint. One of the biggest differences between a planned and a market economy is that the latter recognizes the need to respond to market conditions and consumer preferences. Chinese enterprises lack these skills, and the private ones are anxious to acquire them.

Financing

As chapter 5 points out, the financial system has until recently been entirely under the direct control of the state. As a result, private enterprises have been bound by government policies toward them: before private enterprises were formally recognized, they found it very difficult to obtain credit without a red hat. Even as restrictions on private enterprise were eased, the government continued to direct credit toward SOEs, crowding out private enterprises. Similarly, access to public equity markets has been closely controlled by the Securities Commission, which has given preference to SOEs.

Aside from the particular constraints of the Chinese financial markets, the informal nature of China's private enterprises makes it difficult for them to attract external financing, particularly bank loans. Private borrowers lack clear title to assets, and few have transparent financial statements with which to assess repayment ability. In the past, some got around this barrier by wearing a red hat, which gave them preferential access to credit from state banks. However, recent reforms of the banking system are phasing out the preferential treatment of state-owned and collective enterprises. At the same time, the prospect of entry into the banking sector by private banks (including, under the WTO agreement, foreign banks) increases the pressure on banks to abide by market disciplines.

Box 3.5. Qiaotou Button Chamber Of Commerce

Qiaotou is a town in Zhejiang Province specializing 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 among small button producers. Buttons are easy to produce, and new styles can easily be copied. 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 their new products for a period of two or three months. The fee for two months of protection is RMB1,500 (US\$180); for three months it is RMB2,000 (US\$240). The short period of protection is consistent with the rapid design replacement in the button industry.

The chamber regularly checks the market to find copies of the products under its protection. A violator is first warned to stop producing and selling the product; if it continues to do so, the chamber informs the township government, and the latter takes on the case and punishes the violator. The township government takes the local chamber 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. Moreover, since the chamber has become highly popular, the township government also entrusts the chamber with punishing nonmember violators.

The button chamber is in effect a semigovernment 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 for style-based new products. This is natural, because the enforcement of such protection is very costly. Therefore there is no good reason for a local government to provide the protection. Hence 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 since being recognized by the local township government.

Informality also makes it difficult to attract equity investment. For unlisted, private equity, investors are deterred by the lack of clear asset title and lack of clear corporate governance. This leaves them with little means of safeguarding their investment and little prospect of exiting the investment. Exit is made more difficult by stock exchange listing rules that give preference to state-owned enterprises. Even by wearing the red hat, few private enterprises have been able to obtain permission to list. Without a transparent financial track record, clear asset ownership, and clear corporate governance, private firms have little hope of gaining such permission.

Hence equity investors tend to be limited to close family and associates of the firm, who can directly supervise their investments and who hold some kind of leverage over the enterprise managers. Again, this is typical of small, early-stage enterprises, but in China even large, mature private enterprises are stuck at this stage of financial development. Among the firms surveyed, more than 90 percent relied on self-financing for their initial capital.

Most firms continue to rely heavily on investments by their owners and on internal cash generation as they grow. This is sustainable only under conditions of rapid

growth. Since many private enterprises have experienced explosive growth, finance has not always been an obstacle. However, these conditions are unlikely to persist. As companies adjust to more normal rates of growth, the need for external finance will become more pressing (see chapter 5).

Government Relations

A final consequence of the private sector's informality has been an awkward relationship with government. Up to now, private enterprises have spent much time, effort, and resources either hiding their activities from government scrutiny or negotiating special treatment. Furthermore, they have had little influence over the policies and regulations that affect them. SOEs and collectives have sponsoring ministries that represent their interests at the provincial and national level, for example, by ensuring that credit is available from the banking system. Not having such state support, private enterprises operate at a disadvantage in coping with the regulatory framework and with the financial system.

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 set national technical standards. However, these are dominated by SOEs.

At the national level, ACFIC, China's official chamber of commerce, has an extensive organizational 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 CCP's united fronts to accommodate private firm owners. During the Cultural Revolution, its activities were suspended. After it started up again in the late 1970s, it gradually shifted its weight from old private owners to new entrepreneurs and gained in popularity in many localities.

Some local offices of the All China Federation of Industry and Commerce play a significant role in organizing private entrepreneurs. Its office in Sichuan Province is also called the Sichuan Chamber of Commerce, a name with significant overtones: it softens the political color of ACFIC. The new Chamber of Commerce provides a wide range of services to its members and acts 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.

The chamber assists the private sector in several ways. For example, it recommends good firms to banks with a view to reducing the efficiency losses associated with information asymmetry. It works with the government to grant technical titles to technicians in the private sector, recommends promising firms for funds issued by the national "Star Plan" and "Torch Plan," and helps private firms obtain passports and visas to facilitate the conduct of business abroad.⁸ It also operates three centers offering consulting services in firm management, legal affairs, and public relations.

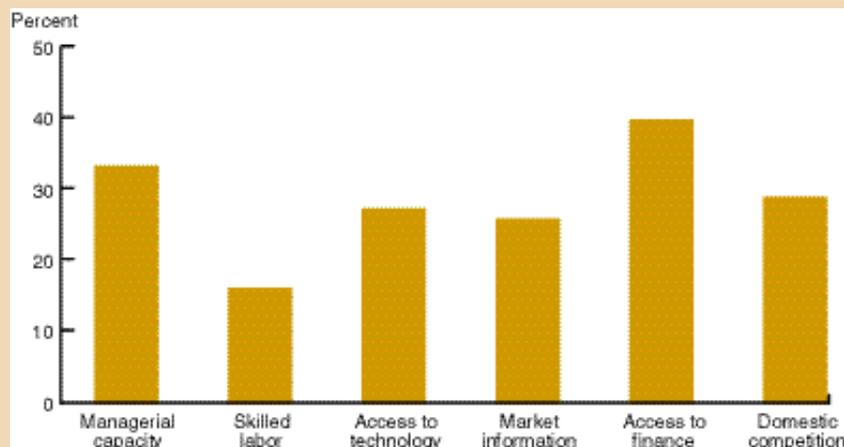
Townships in Shunde that in the past did not have an ACFIC office have organized their own chambers of commerce. Though officially affiliated with the city ACFIC office and granted substantial government support, most chambers are established and run by the private entrepreneurs themselves. Private entrepreneurs in the township told interviewers they see the chamber as a place to interact and are quite pleased with the facilities and services it provides. Its main drawback is the restrictions on entry, which exclude smaller firms from joining.

Another official organization for private entrepreneurs is the Association of Private Firms. It does not have a national headquarters and is organized by the local BICM. All private firms are eventually forced to join this association, according to the firms surveyed, because the BICM collects a 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 merely a way of collecting fees from them.

The Cost of Informality

In one sense, informality has been the private sector's great strength during a period of uncertainty and rapid change. It has allowed private enterprises to respond flexibly to changing policies and regulations and to new

Figure 3.5. Key Internal Constraints Cited by Surveyed Firms



Source: Survey.

market opportunities, while diversifying risk and avoiding excessive taxation, regulation, and competition. However, informality creates serious obstacles to the further growth and development of the sector, leaving large, mature companies stuck with structures more suited to small, young companies. It also makes companies opaque and unfocused, endows them with limited management capacity, and prevents them from attracting the finance and skills they need to grow. As figure 3.5 shows, the owners of the sample companies recognize these constraints, which together make it very hard for these companies to engage in beneficial partnerships with customers and suppliers or to work constructively with the government to improve the policy and regulatory environment.

Many larger private enterprises also recognize that they need to formalize their structures and allow them to adapt as the firms grow and mature. This process has already begun, with the transformation of many TVEs and collectives into private enterprises, the transfer of SOEs to private ownership, and the emergence of many stock-holding companies from *getihu*. At the policy level, the recognition of the private sector in the recent Constitutional Amendment provides greater

assurance of a stable policy environment for private enterprises, which should encourage formalization.

As the economic environment becomes more stable, private enterprise gains legitimacy, state support for SOEs and collectives declines, and capital and labor markets improve, the balance of advantage will shift away from informality. Increasingly, domestic Chinese firms will find themselves in open competition with foreign private enterprises. This will provide a strong incentive to adapt to international best practice in business organization.

Formalization has its costs, of course. Companies may find that they have to pay more tax and spend more resources on compliance with government regulations, audit and financial disclosure, and governance. They will become more exposed to policy changes and to developments in the markets they choose to focus on. International experience suggests that for all but the smallest firms, these costs are more than outweighed by the efficiency benefits of formalization. The policy and regulatory changes required to reduce the barriers and disincentives to formalization and to help firms make the transition are laid out in chapter 6.

TOWARD A RULES-BASED ENVIRONMENT

A key challenge for the development of the private sector today is to combine the continuing process of economic liberalization, which reduces the scope for government intervention in private sector activities, with institution building, which would gradually establish the rule of law as the basis for government-business relationships. As the experience of the transition economies during the past decade has shown, the transformation of an economic structure from state-dominated to private sector is a complex task. A great deal can be achieved in the short run through the use of consistent policies, combining liberalization of markets, trade, and new business entry, but in the long run, an efficient market response can be obtained only through such steps as the implementation of clearly defined property rights and the establishment of key supporting institutions.

The rule of law, it is generally agreed, includes (1) general, abstract rules that are prospective, never retrospective in their effect; (2) rules that are known and certain; (3) rules that are equal in the sense that they should not discriminate on the basis of irrelevant distinctions; and (4) a separation between regulators and the regulated. The rule of law therefore presupposes a protected private sphere whose economic aspects are defined mainly in terms of property and contract rights.

While this protection can never be absolute, it at least incorporates the principles of “no expropriation without just compensation” and of independent judicial review of government actions. The argument against interference does not mean that the government should not get involved in economic matters. On the contrary, there is a whole range of government activities that are not only compatible with the rule of law, but also necessary for its existence. The rule of law applied to the business environment guarantees transparency, predictability, uniformity, and the protection of private property rights, which are necessary conditions for the efficient functioning of markets.

China demonstrated its commitment to the rule of law by including the principle of “governing the country according to law” in the constitution. The Constitutional Amendment of 1999 upgrading the status of the private sector from a supplement to public ownership to an important component of the socialist market economy and guaranteeing legal protection of private property rights is an important step toward creating a protected private sphere in China. Significant progress has also been made in unifying certain areas of economic law and in separating regulators from the regulated. However, much more needs to be done. Many areas of the law still reflect the principle of “one country, two [and sometimes more] systems” with respect to forms of ownership. Private firms are often discriminated against on the basis of unclear and uncertain rules, and government interference in private economic activities is still widespread.

A frequently emerging theme from the survey is that local governments and administrative officials tend to overexpand their duties and focus on rent-seeking activities. This is reflected in part in the ill-defined roles of government departments, coupled with functions that are becoming increasingly obsolete and out of tune with a market system. The functions of many departments also overlap. In addition, rent-seeking behavior is evident in areas of administration, as well as institutions, not subject to market discipline. Reforms are needed to clarify and redefine the functions of government departments at different administrative levels according to the requirements of a market economy, and to prevent improper and unnecessary interference at different levels in enterprise operation.

The survey found that law enforcement and administrative performance were better in some locations than others. Shunde emerged as a role model in many respects, having undertaken reforms to bring about a radical downsizing and transformation of the role of the government in 1993, some six years ahead of other parts of China. At that time, the number of

government departments in Shunde was reduced from 49 to 29, and the number of employees from 1,400 to less than 900. Equally important, this was accompanied by a change in the role of government, which shifted from being a player in the economy to being an arbitrator and service provider. This has allowed it to pursue an agenda of openness and integrity in administration and to introduce a strong element of predictability and regularity into the business environment.

Without the rule of law, it is impossible to protect private property and contract rights. Ironically, the real need for such protection stems from the progress the government has already made in extricating itself from markets: that is to say, legal norms and procedures are needed to substitute for direct government control over economic decisions. As summed up by the World Bank (1997, p. 36), “Economic reforms have made legal rules matter.”

Establishing such a rule of law may take a while. It calls for a legal infrastructure that can implement the evolving legal framework, establish good governance, and foster a legislative system that works equitably and speedily. Even if laws were not the problem, adequate—meaning speedy and equitable—enforcement would be. Indeed, this may be the most significant challenge that China’s legal system will face in the foreseeable future.

Private property rights, including intellectual property rights, also need to be defined, legislated more clearly, and protected more effectively. Because legal redress against violators remains difficult to secure, businesses that are highly vulnerable to piracy (such as software companies) remain at a primitive stage of development in China. This chapter looks at issues related to the application of the rule of law in the areas of overall commitment to the private sector, the openness of markets, commercial legislation, the financial system, and taxation.

Commitment to the Private Sector

A government’s commitment to the private sector is usually reflected in its willingness to support privatization and in the consistency and long-term sustainability of its policies. Although a large SOE sector is not necessarily

inconsistent with the rule of law, it often creates conditions that may lead to deviations from this principle. For instance, large losses in the state sector may trigger government support in the form of subsidies or soft loans. In China, this has led to overcapacity in many industries and a huge stock of nonperforming loans in the financial system. As a result, private firms are often discriminated against in their access to markets and financing.

China is making progress on SOE reforms, but its commitment to the private sector may not be easy to assess. Progress in the reform of state-owned enterprises and creation of clear property rights has been clearly uneven. SOEs no longer dominate all sectors of the economy, but neither have they withered away. The government’s policy goals with regard to private sector development have often been less than transparent, but there has clearly been a growing emphasis on market orientation in the allocation of resources. This is reflected in China’s exceptionally high overall (total factor) productivity growth since the mid-1980s.

In one sense, the Chinese industrial economy seems to be operating in a vast grey area, somewhere between plan and market, while also in the grip of “extraordinarily rapid transformation and flux” (Steinfeld 2000, chap. 3). From this perspective, the organizational environment appears to have reshuffled opportunities and constraints, reshaping incentives and the ways in which autonomy is exercised. In this new dynamic, SOE reform in China may not manifest itself in conventional privatization measures, which involve a complete separation of state-owned firm from the government, but instead may take a middle path of market-oriented incentives imposed on managers through both a hardening of the firms’ budget constraints and a significant expansion of management’s autonomy. To this extent, government commitment to the market, and to private sector activity, may in fact be stronger than is apparent from progress in the transfer of property rights.

Although China has made progress in the divestiture of state assets, it will not reap the full benefits from SOE reform unless it limits the incentives and opportunities for interference in the operation of privatized companies. Of course the state has a legitimate interest in ensuring proper valuation and documentation before state assets move into private hands, as reflected in legislation on appraisal and verification of state assets and capital contribution. These regulations play a useful role in confirming to various investors or partners

the value of the capital contributions of other partners or investors and in reassuring potential investors that the state has no remaining interest in the assets. However, the vague language in the Company Law apparently giving the state the authority to maintain special rights over assets formerly under state control creates uncertainty as to whether property rights in privatized companies are fully protected.

Openness of Markets

While parts of the economy now function quite competitively, many markets remain restricted in certain respects. Though the government has allowed private firms to exist for more than 10 years, it still keeps them from entering many areas of business where the state sector continues to maintain monopolies. The government stipulates that private firms are to be excluded from 15 types of industries (see box 4.1). The group can be divided into three main categories: (1) industries using very scarce resources; (2) industries considered vital to the national economy; and (3) industries whose products entail certain public hazards. Since there are no general criteria with which to determine whether a business belongs to any of the three categories, officials have room to use their personal judgment in applying these guidelines.

Numerous other laws prohibit and restrict the entry of private enterprises into certain industries. According to press reports, certain lists exist that set out extensive industry-related restrictions for the establishment of private enterprises. Private capital is reportedly not permitted in some 30 industries plus 17 products belonging to other industries, including banking, railways, freeways, telecommunications, and wholesale networks for a large number of goods. Another list is said to “restrict” private capital in certain industries. This list contains more than 20 industries, including automobile manufacturing and chemical fibers. We are not aware that the lists have ever been made publicly available.

Private firms also face restrictions on direct access to foreign trade. Prior to 1998, private firms were not allowed to export directly, although this right had been granted to many SOEs for several years. Having an export license enables a firm to hold foreign currencies and bypass trading companies, which in turn not only acquire the value added of the exports but in many cases also hold the tax return belonging to the export companies. In 1998, the government began to grant direct

Box 4.1. Businesses with Restricted Entry for Private Firms

1. Production and sale of gold and silver products
2. Taxis ^a
3. Primary real estate market (in Beijing, private firms can engage in the primary real estate market by obtaining a license from the government)
4. Radio and audio products ^a
5. Safety products, rubber products
6. Pressure containers
7. Inflammable products ^a
8. Radio transmission equipment ^a
9. Anesthetic, psychiatric, and radiation medicines
10. Recycling
11. Air guns and hunting rifles
12. Antiques designated by the government
13. Important raw materials
14. Copper, steel, iron, and platinum
15. Polyethylene products

^a Imposed in Beijing.

Source: Beijing BICM.

export licenses to selected private firms. Privately owned production enterprises and research organizations may obtain limited foreign trade rights according to the Interim Provisions on Granting Self-Import/Export Rights to Privately Owned Enterprises and Science and Research Institutes effective January 1, 1999. By the end of 1999, about 150 private firms had been allotted these licenses.

To obtain such rights, a firm must meet certain conditions: most notably, it must have registered capital, as well as net assets of more than RMB8.5 million (US\$1 million). Moreover, its annual sales must exceed

RMB50 million (US\$6 million) and the export value must exceed RMB1 million (US\$120,000) continuously in the previous two years. It is obvious that newly established private companies cannot meet these requirements. Furthermore, there is still no statutory rule that explicitly permits pure trading companies to become established through private investment and to engage in the import and export of goods produced by others or to act as a foreign trade agent, as the existing state-owned import and export companies are at present permitted to do.

These forms of discrimination have aroused considerable attention in the past year because under the conditions China has negotiated to enter the World Trade Organization, some sectors (such as telecommunications and financial services) that are still closed to private Chinese investors will be open to foreign investors. According to the related agreement concluded between China and the United States on China's accession to the WTO, the government will grant free trade rights to all Chinese enterprises—within three years after the WTO accession.

Other types of entry barriers arise from tight market conditions in certain industries. The soft budget constraints of state-owned and collective enterprises and local protectionism are a particular concern because they create severe overcapacity problems for a large number of sectors. To address the problem, the government has undertaken industrial adjustment by prohibiting investment in certain industries, reducing the number of enterprises in certain industries, and ordering the elimination of certain types of enterprises, production facilities, and technological processes for the

production of certain products.¹ These restrictions greatly reduce new entries in these industries, however, and therefore limit the opportunities for private enterprises to play a role in the restructuring process.

To complicate matters, localities are able to impose additional restrictions and licensing requirements on specific industries at their discretion, which cause further fragmentation of the domestic market and a proliferation of entry restrictions. Increasing restrictions have serious negative consequences for the development of private enterprises. Those already established face even greater uncertainty about their future opportunities for growth and expansion, particularly to other provinces. State-owned and collective enterprises face disincentives for changing or clarifying ownership rights. A company that distributes medicines in Shunde, for example, will not be able to do business in Guangzhou, a place with much higher demand. A collective firm in Shunde that produced containers before it was privatized will be unable to continue this operation because private firms are not licensed to produce this kind of product.

Of the firms surveyed, 28 percent stated that various forms of market barriers hamper their business operations. Regional differences in these barriers appear to be fairly small. The main barriers cited by the majority of respondents consisted of licenses, general policy restrictions, and local protection.

The effects of entry barriers may differ for firms of different sizes, as seen from table 4.1. Whereas firms of all sizes had complaints about government licensing and policy restrictions, concerns about local protection increased in relation to the size of firms, perhaps

Table 4.1. Types of Entry Barriers by Firm Size (percentage of firms with yes answer)

Number of Employees	Licenses	Policy Restrictions	Local Protection	Industry Monopoly	Market Size
< 51	22.6	29.0	6.5	29.0	12.9
51–100	50.0	12.5	12.5	25.0	0.0
101–500	37.5	37.5	18.8	0.0	6.3
>500	80.0	0.0	20.0	0.0	0.0

*Percentage of firms providing an answer in the total number of firms in a size category.
Source: Survey.

because larger firms were more likely than smaller firms to sell their products outside their own provinces. Conversely, since larger firms enjoyed larger markets, they were less concerned about industrial monopoly and market size than were smaller firms. In addition, many firms complained about the lack of access to relevant business information. CEOs of firms surveyed found it particularly difficult to gain access to information on financial sources, investment opportunities, markets, and technologies. This dissatisfaction was greatest among those located in Beijing and lowest in Shunde.

Commercial Legislation

The regulation governing commercial enterprises has a direct impact on general market access. For example, registered capital requirements for a private limited company in China are among the highest in the world: minimum amounts for a limited liability joint stock company, for instance, amount to RMB300,000 (US\$36,000) in retail trade, and RMB500,000 (US\$60,000) in wholesale trade or manufacturing, and must be confirmed as paid up before a business license is issued.

One way for an entrepreneur to avoid these barriers would be to register himself under the Law for Wholly Individual Owned Enterprises (WIOE Law), whereby he would face no minimum capital requirement. However, this could entail a high degree of risk. Under the WIOE law, the entrepreneur is not allowed to raise capital from other individuals, and he bears unlimited liability for his business debts. This liability could even continue for a number of years after his company was liquidated and thus could seriously affect his ability to raise funds to start a new venture. Almost the same situation applies when two or more entrepreneurs form a partnership and register themselves under the Partnership Law of 1997.

Registration requirements are not only expensive but also time-consuming, with many ad hoc requirements and additional costs. According to a recent study (Djankov et al. 2000), the time frame for some of these steps could be between three and six months, because they could involve registering with the administrative bureau of industry/commerce in the relevant locality, obtaining registration certification from the State Administration of Industry and Commerce (SAIC),

registering with the local labor bureau, and so on, at the cost of another RMB5,000 (US\$600). In addition, it would be necessary to obtain permits for hiring labor, for environmental protection, and for factory set-up, which would add a further discretionary element to the process. Not surprisingly, out of a sample of 75 countries (including developed nations), China ranked 51 in terms of start-up delay, and 43 in terms of start-up cost as a ratio of GDP (Djankov et al. 2000).

In principle, local registration must occur within 15 days for a WIOE and 30 days for a partnership if the basic conditions are met. In practice, however, there is no fixed time limit for official review of an application for the establishment of a limited liability company. This greatly undermines the effectiveness of the routine treatment of such applications and exposes entrepreneurs to the possibility of official coercion.

An additional constraint arises from the requirement that entrepreneurs must define precisely their “scope of business” in the registration document. The business scope of the enterprise must be clearly (and, by implication, narrowly) defined, and such business scope is subject to the substantive review and approval of government authorities. SAIC officials must approve any subsequent changes to business scope, which makes it difficult for entrepreneurs to adapt flexibly to market. This obviously forces them to inform government officials of their business plans, which could have negative implications for confidentiality and competition. By contrast, developed countries do not unduly constrain an entrepreneur’s scope of business. (Perhaps the most liberal government in this regard may be that of the State of Delaware, in the United States, whose Article 102 of company registration procedures says it is sufficient for the enterprise to state that it is “engaged in any lawful activity.”)

Furthermore, the application for registration must specify a fixed site and “necessary conditions” for production. This requires an entrepreneur to organize key elements of his business before registering it. It also exposes an entrepreneur to the possibility of government interference in the selection of a site and perhaps of business partners.

The predictability of government policies and the degree of consistency in enforcing laws and regulations have a major impact on the environment for private sector

Box 4.2. Firm P's Loss of Its Land

Firm P, located in the western suburbs of Beijing, was a repair shop specializing in Volkswagen products. It was a new firm established in 1998 with RMB450,000 (US\$54,000) registered capital and 15 employees. It signed a contract with the township government for the use of the latter's land for 10 years because the latter assured it that there would be no land acquisition for at least 4 years. The contract was to be renewed on a yearly basis. After the contract was signed, the owner of the firm built the shop on the designated land and began operation. After only six months, however, the municipal government notified the firm that its land was to be used for a new road and it had 10 days to find a new place for the shop. With this short notice, the shop was forced to close down because there was no way for it to find a new place in just 10 days, and its hard-won customers would be lost in the time it would take to find a new place. In addition, no compensation was promised by the government, although the owner checked the Land Law and Law of Land Requisition and found that it should be compensated. The owner tried to contact several government agencies, but none of them would take on the case. Moreover, the 10-year contract with the township government had to be brought to an end. Again, there was no compensation for anything. A promising firm died in its infancy.

development. The enforcement of laws governing commercial enterprise and their administrative performance varies greatly across cities and regions. The firms surveyed reported that major laws, regulations, or policies changed only 0.36 times in Shunde during the past three years, but as many as 6.2 times in Beijing. This variation may also reflect different levels of familiarity with new laws and regulations. The seemingly higher stability in Shunde was accompanied by a greater degree of trust in the court system in the resolution of disputes. In Beijing, on the other hand,

private firms complained heavily about the government's frequent policy changes. The government's ability to suddenly and compulsorily acquire land was particularly destabilizing for many private firms, and in extreme cases could destroy a promising business (see box 4.2). Recently, the Bureau of Public Health issued a directive calling on all restaurants with a floor area of less than 30 square meters to close down because it felt that small restaurants did not meet hygiene standards. If strictly enforced, this directive would put more than 3,000 small restaurants in the city out of business. A similar directive from the Bureau of Publications aimed at all bookstores with a floor area of less than 50 square meters would, if strictly implemented, force the small bookstores in Beijing to close.

In an important recent development, China adopted the Administrative Review Law in October 1999. The new law gives citizens and private entrepreneurs the right to appeal an administrative decision if they believe that officials have acted outside their authority or refused to act when a proper application has been made. It also sets clear procedures and time limits for review. In contrast to court proceedings, which require a substantial fee before litigation can begin, the administrative review imposes no fee on the applicant. In an environment where numerous permits and licenses are still essential, this is a very important potential right. It would be helpful to monitor this law in practice.

Commercial legislation has yet another area of weakness: it lacks an effective competition policy. Private firms are still reluctant to enter sectors dominated by state enterprises because they do not believe that conditions for fair competition exist in such markets. Legislation protecting intellectual property rights remains vague or ineffective. Large firms fear unfair competition from smaller firms that may be able to pirate new technologies from them. Competition of this nature, unregulated by an effective legal infrastructure is, many say, a cause of inefficiency and market disorder (box 4.3).

Entrepreneurs in a rapidly changing economic environment need clear guidelines not only on establishment, growth, and enforceable commercial arrangements, but also on reorganizing or closing down a business. This process of "creative destruction" is an essential part of the optimal use of a nation's entrepreneurial talent. In this respect, the bankruptcy laws have not worked very

well in China. One problem is that different types of enterprises are subject to different legal treatment. For example, the bankruptcy of SOEs falls under a special Bankruptcy Law, while other types of enterprises (including SOEs) are covered by Chapter 19 of China's Code of Civil Procedures. As a result, it is often difficult to interpret and apply existing bankruptcy regulations. Another complication is that enterprises in the form of "natural persons," which include all firms with eight or fewer employees, do not come under any bankruptcy regime. The notion of personal bankruptcy still runs counter to ideology and raises widespread concerns about sociopolitical stability.

Bankruptcy also raises problems regarding the priority of claims. According to the Bankruptcy Law, the liquidation proceeds are to go to secured creditors ahead of workers. However, SETC Circular No. 492 of 1996 had made even land mortgage rights subordinate to worker claims under the so-called Capital Structure Optimization Program. A new bankruptcy law under final review may allow more bankruptcies to be declared in the future. This highlights a key challenge of enterprise reform in China, which is to create market-oriented corporate governance systems that are independent of government influence. This can be done only if entrepreneurs are empowered to undertake the market-driven consolidations, shakeouts, and capacity reductions that may be necessary to meet the tests of competitive efficiency.

Over the course of their growth cycle, enterprises may need to adopt different legal forms. However, Chinese regulations do not adequately allow for such a transformation. It seems that a WIOE or a partnership can transform into another legal category of business only by liquidating its current business and establishing a new entity. Limited liability companies face similar problems. Under Chinese law, they can only transform into companies limited by shares. The present system, which calls for liquidation of one legal entity and the establishment of another, wastes both time and money. It can also have an adverse impact on the continuation of normal business operations during the course of transformation.

The Financial System

China's financial system today is markedly different from the mono-banking system that prevailed about 15 years ago under central planning. It is dominated by

Box 4.3. Intellectual Property Rights and Their Protection

YZX, a building material producer in Wenzhou, established his operation in 1993 with the help of 17 private investors (only two remain). Because of sharp competition, the company's profit margin is low. But the general manager believes that YZX is doing well. In his view, a major problem for small firms, particularly private ones, is the risk that accompanies research and development.

The current legal system does not provide much protection to firms' patents and brands. A firm trying to develop a new product has only an 8–10 percent chance of success. Even if it becomes successful, its products will be soon be copied by other companies. In fact, two new products developed by YZX were copied by others, with minor changes. The company spent one and a half years and RMB200,000 (US\$24,000) on a legal suit against one of the violators. But the final judgment allowed both companies, the inventor and the company that copied, to produce the same product. A technician of the company was also "hunted up" by another company, which was interested in gaining access to the know-how of his company. The manager concluded: "You were waiting to die if you didn't develop new products, and you were hoping to die if you did: the money you spent was simply for others."

the big four state-owned banks—Agricultural Bank of China, Bank of China, Industrial and Commercial Bank of China, and China Construction Bank—each with an extensive network of branches nationwide and together accounting for more than 60 percent of the country's financial sector's assets.² There are a large number of nonbanking financial institutions. However, they hold less than 4 percent of the total assets in the financial system. Although steady progress has been achieved in transforming China's financial sector, financial reform and deregulation have generally lagged behind developments in the real sector.

The institutional structure of the financial sector in China has remained quite weak, especially in terms of risk management and credit analysis functions, as can be seen in the quality of the banks' portfolios. Despite efforts aimed at establishing commercial criteria in lending, China's banks continue to act as an extension of the treasury, one of their main tasks being to channel savings to designated state-owned enterprises rather than to the most creditworthy customers. At the same time, banks are expected to turn in more profits to offset shortfalls in the central budget.

Subject to conflicting constraints of this sort, Chinese banks are still administered in the manner of state agencies, and as such have little incentive to improve efficiency. This is becoming an urgent problem in view of the fact that WTO concessions portend increased competition. They envisage that foreign banks would be able to conduct local currency business with Chinese enterprises two years following accession, and local currency business with Chinese individuals five years after accession.

Outside of the banking sector, China's capital markets have been subject to many of the same kinds of constraints and controls, with quotas on how much equity and securitized debt can be issued in a year. The relatively small role of capital markets, it seems, "was not a product of market forces but of administrative decree" (World Bank 1997, chap. 3). In addition, government oversight of the capital market is weak. The capital market is still at a very early stage of development, however, and has been little used as part of China's macroeconomic program. Even if this market were to grow at more than twice the rate of projected (real) GDP growth, by 2020 the value of stocks and bonds in relation to China's economy would only approach that in India's capital market in 1997 (World Bank 1997, p. 34). Since 1993, the Chinese financial system has undergone considerable regulatory reform, reflected in more than 25 new laws and regulations, including the Central Banking Law and the Commercial Banking Law (both passed in 1995). The following are some of the more important reform initiatives:

Credit quota system. In 1998 the authorities replaced the credit quota system (for both working capital and fixed asset loans) applicable to the four state-owned banks with the indicative quota and a system of asset/liability management (as applied to

other banks). The quota system tended to create an uneven playing field in access to bank loans. Its elimination is a significant step toward the establishment of the rule of law in the financial sector.

Bad assets. A major source of vulnerability of the Chinese domestic banking system is the high level of nonperforming loans that occur mainly in SOE lending: according to official estimates, 25 percent of China's state-owned bank loans are nonperforming, and 5–6 percent are considered unrecoverable. The government has implemented several major measures to strengthen the balance sheets of state-owned banks, including (1) injecting additional capital to strengthen their capital adequacy (US\$32 billion was injected in 1998), (2) increasing loan loss provisioning and shortening the period for nonaccrual of interest on delinquent loans, (3) setting up asset management companies to take over their bad loans, and (4) increasing the write-off of their unrecoverable debts. A risk-based loan classification system was announced in early 1998, dividing loans into five categories, as recommended by the Bank for International Settlements. This represents a significant step in unifying Chinese banking practices with international standards.

Interest rates. Controls on interest rates tend to discriminate against small enterprises in their access to financing. China has partially liberalized interest rates by allowing banks to set deposit and lending rates within a wider band. Recently, it announced plans to liberalize its domestic interest rate regime within three years.

Provincial network of the central bank. The central bank has been restructured to improve its independence, authority, and professionalism. In order to break the links between local government and central bank branches, regional offices have been formed by combining provincial branches. This measure is expected to significantly reduce the scope of government interference in bank lending.

Foreign banks. In recent years, China has eased its control on foreign banks slightly, but not enough to make a substantial difference to the industry. Initially allowed to operate in Shanghai and Shenzhen, foreign banks can now expand in Guangdong, Guangxi, Hunan, Zhejiang, and Jiangsu. The ceiling on their domestic lending was raised from 35 to 50 percent of foreign exchange liabilities, and foreign banks have been allowed greater access to the interbank market.

Capital markets. The government closed the 20-odd city-level “informal” stock exchanges whose emergence had been tolerated earlier. In December 1998, the Securities Law, China’s first comprehensive national law on securities matters, was promulgated. However, it failed to unify China’s rigidly segmented securities markets. New rules open the door for both domestic and foreign insurance companies to purchase A shares, allowing for a greater presence of institutional investors on the Chinese stock market. In March 2000, the government announced that the quota system on listings would be abolished in favor of a system in which underwriters would determine the timing and pricing of new issues.

Tax System

Prior to 1994, the relationship between central and local governments in China was embodied in a revenue contracting system whereby provinces handed over a fixed amount of taxes to the central government and retained the rest. In 1994 China introduced a new system requiring the central government and each local government to collect their own specific taxes. Under this system, provincial governments may collect 25 percent of the value-added tax, sales tax, personal income tax, corporate income tax (of non-SOEs), agricultural tax, property tax, and other smaller taxes. As a consequence, tension now exists between China’s unitary state and decentralized financial system. By law, only the central government can set taxation policies. Local governments do not have the right to determine their own taxes as a means of increasing their revenues, but they are allowed to collect new fees. The end result is a proliferation of fees that can be introduced as government directives without obtaining legislative approval.

Most important, the incidence of these taxes and fees in the private sector has been fairly uneven. Because of the opaqueness of firms’ financial positions (see chapter 3), taxes are negotiated rather than levied. For the 217 firms in the survey that reported data for 1998, large differences were observed between corporate income taxes due and actually paid, especially among firms of different size. Smaller firms paid higher taxes than larger firms, which enjoyed many more tax breaks. The size of a firm had an even more unequal impact when it came to the schedule of fees: smaller firms faced average rates of 4.8 percent, in comparison with the 1.9 percent faced by the largest. This was reflected in the degree of the firms’ reported unhappiness with their

tax burdens: as many as 89 percent of firms with 51–100 employees were dissatisfied with the burden of fees, in comparison with 67–78 percent for all other sizes.

The tension between decentralized income rights and centralized tax legislation has created an uneven playing field for private firms, especially smaller firms. To complicate matters, taxes and fees are sometimes collected in an arbitrary fashion. Firms surveyed complained, for instance, that technical standards inspectors (in Chengdu) exaggerated technical defects so as to boost fees levied, or (in Wenzhou) that the environmental protection office levied arbitrary fines for equipment noise. There appears to be an urgent need to improve the consistency and effectiveness of tax laws, to avoid generating negative incentives that could further constrain the competitive efficiency of the private sector.

Conclusion

Building a rules-based framework for private sector development is a long and complex task, as many developing countries have found. Yet it is an essential step toward ensuring that barriers to entry, an uneven playing field, and all the other obstacles private sectors face are removed as efficiently as possible. Through competition, well-functioning markets provide the best opportunity for the optimal allocation of scarce resources. Furthermore, markets need rules to provide equal access and advantage to all participants, to protect the rights of third-party investors, and to provide adequate recourse for the resolution of disputes. As most governments have found, they themselves play a definite role in this structure—one that has changed from that of a player to that of a facilitator, ensuring that structures are in place that allow markets to work.

China’s economy has performed so well in recent years in large part because of a high degree of competitive pressure. This pressure has come from different actors, including provinces and local governments trying to foster prosperity. At the same time, as this report shows, the transition from plan to market has been uneven. State enterprises continue to dominate many key sectors, and a number of barriers to entry into various markets still exist, despite economic reforms. A serious weakness has been the slow pace at which a rules-based structure has developed to fortify the business environment. This has given rise to various distortions, which make it all the more difficult for the private sector to acquire formal status. Instead,

enterprises are forced to adopt time-consuming strategies to cope with the problems and pressures arising from an opaque regulatory and legal structure.

As China continues with economic reform to reduce the state's direct intervention in markets, the government must be prepared to adopt a new role: it will need to provide the institutional and policy frameworks markets require to function efficiently. Legal norms and procedures will therefore have to substitute for direct control over economic decisions, not only to encourage competitive behavior and allocate scarce resources efficiently but also to generate investible surpluses.

China has in fact made a great deal of progress in the development of legal norms corresponding to the

needs of a market economy. Yet much more needs to be done. As the responses from the enterprise survey have shown, many distortions exist: in the implementation of existing laws, in the uneven playing field between state and private enterprises, in the poor enforcement of contracts or the arbitration of disputes, and in the lack of the key oversight institutions needed to protect the interests of investors and to guarantee good governance.

China needs to continue with its market-oriented reforms—especially those aimed at improving commercial legal processes, the supervision of the banking system, and the functioning of official regulations—if it is to realize the true potential of its private sector.

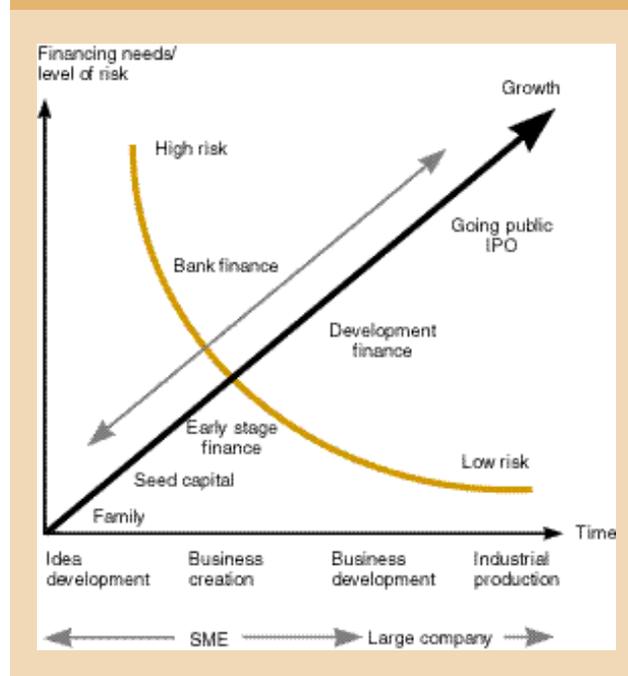
FINANCING DOMESTIC PRIVATE ENTERPRISES

A firm goes through a financial growth cycle in which its financial needs and options change as the business grows, establishes a track record, and becomes less informationally opaque. Start-ups and younger firms tend to rely on insider finance, trade credit, and family and friends. As the firm grows, it gains access to intermediated finance on the equity side (venture capital) and on the debt side (banks, finance companies). Eventually, if the firm continues to exist and grow, it may gain access to public equity and debt markets (figure 5.1).¹ The financial growth cycle model implies that a private sector populated by firms at different stages of development needs a diversified financial system to support its continued growth. This chapter considers the main sources of financing for private firms and some of the key factors affecting a private firm's access to financing, particularly bank lending.

Access to Bank Lending

Data on total lending by ownership are hard to come by in China, but the People's Bank of China (PBoC) does publish figures on working capital lending by ownership. According to this time series, fully three-quarters of all loans from Chinese financial institutions are classified as working capital loans.² Although the share of working capital loans from banks and other financial institutions outstanding to the private sector (including individual firms) has grown substantially over the past decade (figure 5.2), at the end of 1998 it was still less than 1 percent of total lending. Although this time series certainly underreports the private sector's share in bank lending (owing to classification and consistency problems), it nevertheless suggests that the share of lending to the private sector is low, particularly when compared with the sector's contribution to employment and GDP (see chapter 2).

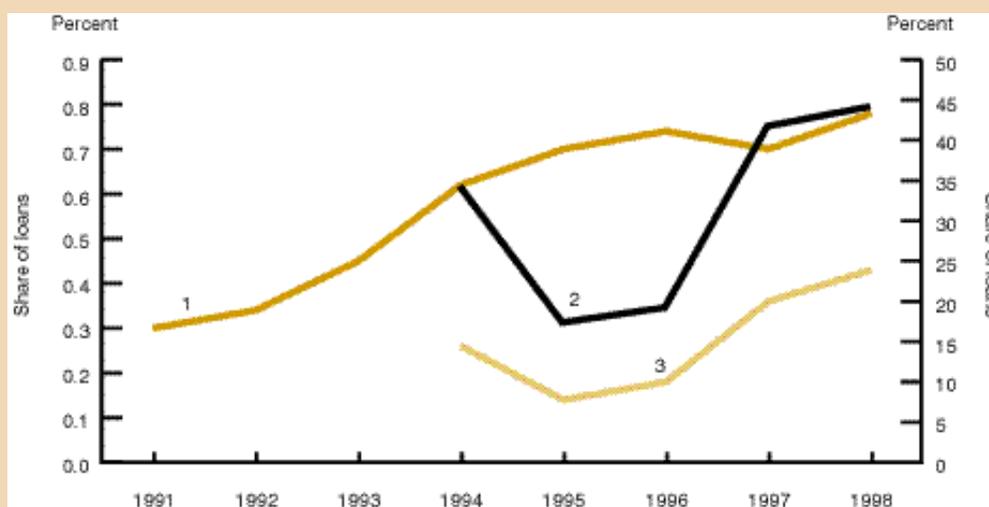
Figure 5.1. Financial Growth Cycle of Firms



Access to Private Equity

China lacks a developed organized private equity market to provide long-term capital to private SMEs. At present, there are no regulatory guidelines defining the legal/organizational structures available for the establishment of private equity funds. As a result, would-be fund promoters, generally local governments interested in developing their high-technology sectors, often set up limited liability corporations as investment vehicles. China has approximately 92 such venture capital investment corporations, with RMB10 billion (US\$1.2 billion) in funds, of which about RMB25 billion (US\$300 million) has been invested at home and abroad. Insurance companies and pension funds are not permitted to invest in nonlisted securities. Increasingly, large SOEs are among the most active domestic legal

Figure 5.2. Short-term Loans to Private Enterprises, 1991–98



1. Private enterprise loans as a share of all loans from all banks (left axis).
2. Private enterprise loans from state banks as a share of private enterprise loans from all banks (right axis).
3. Private enterprise loans as a share of all loans from state banks (left axis).

Source: Almanac of China's Finance and Banking, 1999.

investors in non-state firms. Some of these, especially listed companies, have stepped in to provide venture capital, primarily for hi-tech growth companies.³ Securities firms, asset exchanges, and trust and investment companies currently play a limited role in facilitating private equity financing to private enterprises.

Access to Public Equity Markets

To date, China's stock market has served primarily to finance SOEs and to enable them to take the first halting steps at diversifying their ownership. As a result, private firms have had limited access to the stock market. Although no explicit rules in the Securities Law or in administrative regulations prevent non-state firms from seeking public listing, the quota system and size requirements limit the number of private firms that make it to the stock market, either through initial public offering (IPO) or by buying into listed companies. Of the 976 companies listed on the Shanghai and Shenzhen stock exchanges, only 11 are non-state firms (table 5.1). In 1998 and 1999, a total of only four non-state-firm IPOs took place.

Until recently, China also had several regional stock markets for small and medium-size firms. These markets were recognized and managed by local governments, and many of them ran quite well and helped local firms finance their growth. During its reform of financial markets, however, the central government closed these regional markets. Non-state firms unable to list their own shares are now trying to gain access to the market through the purchase of a controlling (often relative rather than absolute) interest in an SOE (table 5.2).

In March 2000, the Chinese Securities Regulatory Commission announced that the quota system on listings would be abolished and underwriters would now determine the timing and pricing of new issues. This welcome news suggests private firms will have greater opportunity to acquire long-term funding through the equity market. During the current transitional period, however, many SOEs previously approved for listing under the quota system have yet to come to market. This is creating a bottleneck in offerings and preventing non-state firms from coming to market.

Table 5.1. Non-State Firms Listed via IPO

Firm	Capital (thousands of shares)	Date of Listing	Main Business
Shenzhen Exchange			
Wanxiang Qianchao	21,758	1994	Auto parts
Shisi Xinfu	6,798	1996	Conglomerate
Hena Sida	8,875	1996	Electronics, Instruments
Lasha Pijiu	6,600	1997	Alcohol
New Hope	14,002	1998	Agriculture
Shanghai Exchange			
Dongfang Group	35,479	1994	Conglomerate
Xinfu Industry	31,280	1996	Clothing
Xinchao Industry	14,336	1996	Textile
Jiahe Gufeng	12,750	1997	Agriculture
Fuxin Industry	15,070	1998	Biomedicine
Haixin Keji	19,800	1999	Computer

Source: Gao and Xu 2000.

Table 5.2. Non-State Firms Buying Listed Companies

Seller	Buyer	Shares Acquired	Holding (%)	Year	Original Business	Buyer's Business
Huali Gaoke	Stone Group	2,300	13.4	1995	Machinery	Hi-tech
Xiang Huoju	Xinjiang Delong	3,000	13.5	1997	Industry	Real estate
Yinghe Dongli	Yinghe Gaoke	2,058	29.0	1998	Auto parts	Computer
Tiange Group	Fubei Zhengchang	3,000	20.9	1998	Clothing	Hi-tech, agribusiness
Jinlu Group	Sichuan Santong	3,568	12.2	1998	Chemical	Building materials
Liao Wuzi	Shengyang Yingji	4,663	35.9	1998	Trade	Tourism, Real estate
Shen Jingxin	Guangdong Yi'an	1,923	26.1	1999	Real estate	Information technology

Source: Gao and Xu 2000.

Table 5.3. Sources of Financing for Sample Firms, by City and by Years of Operation (percent)

	Self-financed	Bank Loans	Institution	Other
All	90.5	4	2.6	2.9
By city				
Beijing	96.1	0.3	2	1.6
Shunde	87.1	6.5	6.4	0
Chengdu	91.5	2.8	2.1	3.6
Wenzhou	97.3	1.1	0.1	1.5
By years of operation				
< 3 years	92.4	2.7	2.2	2.7
3–5 years	92.1	3.5	0	4.4
5–10 years	89	6.3	1.5	3.2
> 10 years	83.1	5.7	9.9	1.3

Source: Survey.

Access to Financing among Sample Firms

About 80 percent of the firms we surveyed consider access to financing a moderate or major constraint. About 40 percent consider it a major constraint, the second highest after weak market demand. To the extent that the state of market demand reflects investment opportunities, this result implies that practically any sample firm with some investment opportunities perceives access to financing as a major constraint to its development.

Access to financing correlates with firm size and legal form of organization (figures 5.3 and 5.4). About 30 percent of larger private firms (having more than 500 employees) consider access to financing a major constraint to their development, whereas about 40 percent of the smaller firms (having less than 51 employees) think so.

In the case of organizational structure, about 49 percent of sole proprietorships and 28 percent of corporations in the sample mention access to financing as a major constraint to their development. Form of ownership, while clearly related to size, may also reflect

sectoral characteristics and different degrees of informational opaqueness, all of which affect access to financing as well.

Sources of Financing for Sample Firms

The firms in our survey started their businesses relying almost exclusively on self-financing (table 5.3). More than 90 percent of the initial capital came from the principal owners, the start-up teams, and their families. The reliance on personal savings is especially pronounced for the cities of Beijing and Wenzhou, where the share of self-financing in start-up capital exceeds 95 percent. This finding is consistent with the financial growth cycle pattern.

Comparisons with other similar surveys (table 5.4), however, indicate that Chinese entrepreneurs have to rely to a greater extent on personal savings and insider financing for start-up capital than do their counterparts in transition economies. The Chinese pattern of financing start-ups, revealed by the survey, is also markedly different from recent findings on sources of financing for U.S. small firms (86 percent of U.S. sample firms have fewer than 10 employees). Even

Table 5.4. Financing for Private Businesses: Results from Surveys in Transition Economies

	Czech and Slovak Republics	Hungary	Poland	Russia (St. Petersburg)	Vietnam
Year study conducted	1992	1991	1991	1992	1999
Sample size (number of firms)	121	106	93	99	95
Average firm size (number of employees)	42	44	32	74	200
Reliance on personal savings in start-up (%)	54	85	n.a.	66	79
Bank loans at start-up (%)	66	9	n.a.	22	5
Received at least one bank loan (%)	75	43	68	47	67

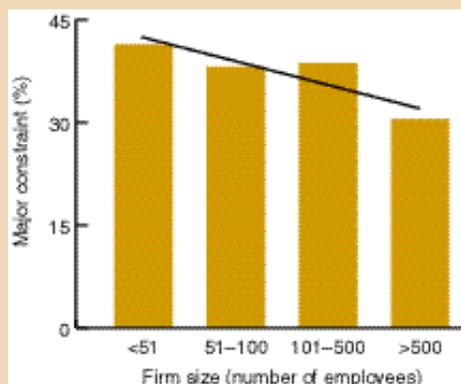
Source: Webster 1993a, b; Webster and Swanson 1993; Webster and Taussig 1999.

among the youngest U.S. firms, insider finance does not take the lion's share: for infant SMEs (from birth to two years of age), the upper bound of the share of insider financing has been about 54 percent (see Berger and Udell 1998).

The firms in our sample indicated that initial capital was available from various other sources as well, including bank loans and other financial or nonfinancial

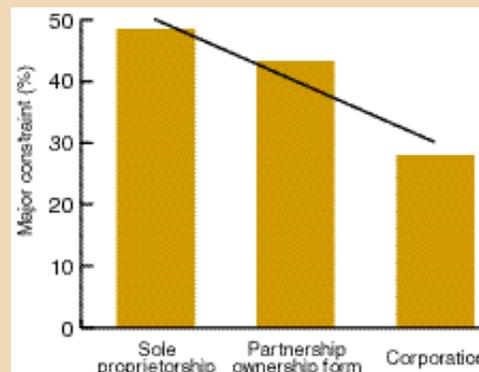
institutions. But these sources played only a minor role, except in Shunde, where bank loans were more evident. By contrast, SME start-ups in the United States receive on average about 30 percent of their initial funding from financial institutions, 16 percent of which comes from commercial banks. Start-up firms in transition economies, too, appear to have better access to bank loans (table 5.4). About two-thirds of start-ups in the Czech Republic appear to receive

Figure 5.3. Access to Financing as a Constraint in Surveyed Firms, by Size



Source: Survey.

Figure 5.4. Access to Financing as a Constraint in Surveyed Firms, by Type



Source: Survey.

Table 5.5. Sources of Finance in Surveyed Firms, 1995 and 1998 (percent)

	Outside Equity	Corporate Bonds	Loans from Banks	Loans from Credit Unions	Informal Channels	Retained Earnings	Principal Owner	Other
Total, by year								
1995	1	1	12.2	10.4	12.6	30.2	21.9	10.7
1998	1.3	0.3	9.7	8.3	9	26.2	35.8	9.4
City (1998)								
Beijing	0.6	0	3	5.3	11.1	23.1	45.6	11.3
Shunde	0	0	15.9	14.1	7.8	19.6	28.8	13.8
Chengdu	5	2.1	17.2	8.3	6.2	30.4	28.6	2.2
Wenzhou	2.3	0	17.6	1.7	6.5	43	28	0.9
Firm size (1998)								
< 51	1.1	0.6	3.4	6.3	10.4	22.4	45	10.8
51–100	0.3	0	7.8	11.3	6.1	32.9	31.7	9.9
101–500	2.8	0	16	10.5	7.7	35.2	21.8	6
> 500	2.3	0.4	25	9.7	4.2	30.2	23.6	4.6

Source: Authors' calculations based on answers to survey questions.

bank loans, and even in Vietnam, 5 percent use commercial loans within the first six months after registration (Webster and Taussig 1999).

In our sample, the percentage of self-financing in initial capital tends to decrease with the age of the firm (table 5.3). This may reflect the fact that *gaizhi* firms, being already established, need less initial capital, or rapid development and a longer history of private sector activities have produced more personal wealth. It may also be that entry conditions for private firms are changing. In the early years of China's reforms, an association with various state institutions yielded valuable "intangibles" in the form of market access, representation, and protection.

In the case of additional (post-start-up) investments for expansions, the sample firms continued to depend overwhelmingly on internal sources (table 5.5). Retained earnings and principal owner financing accounted for at least 52 percent of financing in 1995 and 62 percent in 1998. Among external sources, informal channels, credit unions, and domestic commercial banks were about equally represented. Outside equity,

including public equity, and public debt markets played an insignificant role.

Comparisons with transition and developed economies suggest a relatively high reliance on internal sources of financing. For example, a recent World Bank survey on the business environment finds that internal funds or retained earnings account on average for 60 percent of investment funding in transition economies. However, the share of internal funding is significantly lower in advanced reform nations such as Estonia (33 percent), Poland (34 percent), and Lithuania (37 percent). In the United States, even start-ups and very small firms have about 50 percent of their financing in the form of outside debt (Berger and Udell, 1998).

At the same time, the relative importance of sources of financing in our sample vary significantly across localities (table 5.5). Bank loans appear to be important for private firms in Shunde, Chengdu, and Wenzhou in 1998, but insignificant for those in Beijing. Among the sample firms, those in Beijing had the highest dependence on internal sources of financing. Credit unions were quite important sources in

Shunde. Informal channels for financing played an important role in all the cities surveyed, especially in Beijing. These differences are statistically significant after controlling for firm characteristics such as size, legal form, and age and hence suggest that local conditions play an important role in determining a private firm's access to various sources of financing.

The relative importance of these different sources of financing appears to depend directly on firm size (figure 5.5). Internal sources tend to become less important as firms grow larger. External sources for the smallest firms are mainly informal channels, but their share also tends to decrease as firms grow bigger. The share of commercial bank loans, on the other hand, increases with firm size and becomes the dominant source of external financing for larger firms. Hence, loans from commercial banks tend to substitute for informal financing as private firms grow bigger. Commercial banks become the second most important source of funds for the largest firms, after retained earnings. This seems to indicate that banks provide more support for larger and relatively successful private firms. These findings are in line with the financial growth cycle theory outlined earlier (see figure 5.1).

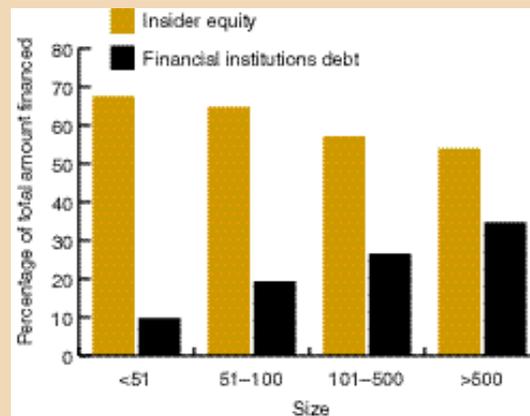
Although the survey did not collect specific information on working capital finance and the related issue of enterprise arrears, interviews with CEOs revealed that arrears were common among the sample firms. In certain cases, particularly among younger firms, arrears problems had a serious impact on firm performance. Large firms were more prone to defer their payments and were in a stronger position to request cash payments from small firms in their trading relationships.

Abetted by poor law enforcement, which makes the practice possible, interenterprise arrears are used primarily to alleviate liquidity problems. Many private firms use such arrears as a substitute for bank loans. Some have also learned to handle the risk created by weak law enforcement and to price the business risk associated with arrears in negotiations with their customers.

Demand for Bank Loans

On average, Chinese banks tend to play a smaller role in the financing of private firms, not only for start-up capital but also for subsequent investments. This is especially the case among smaller firms. According to

Figure 5.5. Sources of Finance in Surveyed Firms, by Firm Size



Source: Survey.

statistics on loan applications by the sample firms, one-third of these firms applied at least once for loans in the past five years, and the success rate was 84 percent. However, a low percentage of firms ever made an application, which indicates self-selection in deciding whether to apply for a loan. As table 5.4 reveals, corresponding numbers from other transition economies are significantly higher. There are major differences across the sample cities in China, however. Firms in Beijing had the lowest application rate and those in Wenzhou the highest. Firms in Wenzhou also had the highest success rate.

Effective demand for bank loans, as reflected in loan applications, tends to increase with firm size. Only 17 percent of firms with no more than 50 employees ever made a loan application, as opposed to 83 percent of firms with more than 500 employees (table 5.6). Larger firms also had a higher success rate in their loan applications. This size-related pattern of distribution shows that larger firms have significant advantages over smaller firms in getting a bank loan.

Information Problems

Information problems, which are generic to financial markets, are especially severe for private firms in China. Most of these firms are smaller and younger than their state-owned counterparts and are a higher risk in the eyes of banks. Furthermore, firm size bears a clear relationship to profitability. In 1998 about three-quarters of firms with fewer than 51 employees

Table 5.6. Applications for Bank Loans by Surveyed Firms

	Percent Applied	Success Rate (%)
City		
Beijing	14	88
Shunde	52	90
Chengdu	51	71
Wenzhou	70	96
Firm size		
< 51	0.17	76
51 - 100	0.46	78
101 - 500	0.63	87
> 500	0.83	88

Source: Survey.

reported they were profitable, but the figure rose to 93 percent for firms with more than 500 workers. Having developed in an unfriendly political and economic environment, private firms have in some cases deliberately made themselves more opaque and are especially cautious about revealing information to outsiders. The resulting lack of clear ownership and management structures imposes obvious constraints on borrowing (see chapter 3). To add to the problem, banks are unable and lack the incentive to collect and process relevant information (for their perspective on these problems, see box 5.1).

At present, the interactions between financial institutions and private firms do not encourage the use of transparent financial and accounting systems. Taxes and other potential liabilities, as mentioned earlier, are an additional concern. By avoiding formal accounting systems or keeping several sets of books, firms can make auditing difficult or impossible (see chapter 3).

Banks are naturally reluctant to accept financial statements that cannot be trusted. This is a multidimensional problem that involves the government, market forces, and cultural factors. The revised Accounting Law stipulates that every business unit is obliged to have account books and to keep true and complete records in the books. Every unit must have only one account book (or one set) that reflects its business operations and property situation. Under this law, the

unit's leader is legally responsible for the truthfulness and completeness of accounting materials. In addition, audited units must provide real material and documents for certified public accountants and should never ask accounts offices to produce unreal auditing reports. These documents are supposed to support the processes described in chapter 3, which are creating incentives for private enterprises to formalize. As one of the main users of financial information, banks have an important role to play in ensuring compliance with these provisions.

Recently, the PBoC announced mandatory registration requirements with the central bank's national credit database for corporate borrowers. In effect, corporate borrowers will be "licensed" to borrow through the issuance of a "borrower's card." The requirements will make the central database more comprehensive and prevent companies with poor records from getting loans or using the same collateral for multiple loans. The licenses will be renewed on an annual basis, except for borrowers having payment problems or failing to meet certain requirements; they will be barred from borrowing. China is also constructing a credit database for personal borrowers that should help with credit card, leasing, and housing finance. While potential borrowers and financial institutions welcome the initiative, its success will ultimately depend on the central bank's capacity to discourage free-riding behavior on behalf of participating lenders.

Transaction Costs and Risk Factors

Small and opaque private firms have difficulty obtaining external financing not only because they represent high risk and high unit transaction costs, but also because state policy is somewhat biased against lending to private enterprises. When a public borrower fails to amortize a loan, the state will almost certainly step in so that the bank will not have to absorb the entire loss on its own balance sheet (Lardy 1998).⁴ But when a private borrower fails, banks appear to have no recourse but to absorb the loss from their own provisions and profits. Until the asymmetry in risks associated with different types of ownership is eliminated, banks feel they must be careful about lending to private sector firms.

Banks therefore need added incentives to lend to private enterprises. One such incentive could be the expectation of higher returns, except that most banks

in China are owned by the state and face limited competition, with the result that the profit incentive is weak. Furthermore, the financial sector reforms focused on reducing the pace of accumulation of non-performing loans in the system are making banks more averse to risk. Their policies concentrate on avoiding loss and show little interest in sharing the rewards of riskier but higher net present value projects. Indeed, the central bank requires all banks to implement a policy called “responsibility to individuals,” which makes each credit officer personally responsible for loans. Such a “zero-risk policy” leaves bank employees with limited incentive to initiate lending. Adding to their reluctance are the controls on interest rates and restrictions on the use of transaction and monitoring fees, although the government has been gradually relaxing some of these restrictions. Interest rates on loans to SMEs are allowed to fluctuate within 30 percent of the prescribed interest rates, and rural credit cooperatives are allowed to charge interest rates up to 50 percent higher than the basic interest rate. Banks are taking advantage of this more flexible interest rate

regime but indicate interest rates need to be liberalized further to encourage more lending to private SMEs. Further relaxation is expected in preparation for WTO entry. For the time being, banks and credit unions are using “creative” ways to circumvent interest rate controls. According to the firms surveyed, state banks charge an average interest rate of 7.9 percent and credit unions 11.5 percent. These rates, with transaction costs factored in, are comparable to the informal market rate (the difference is not statistically significant). At the same time, most of the mechanisms used to circumvent restrictions on interest rates entail additional transaction costs, tend to discriminate against smaller firms, and are too blunt to reflect differences in the risk profile of projects.

Collateral and Guarantees

One standard mechanism used to alleviate generic information problems associated with debt markets is collateral and guarantees. This is especially the case for informationally opaque firms, where it is generally

Box 5.1. Lending to Private Firms: Wenzhou Branches of Agricultural Bank of China

Wenzhou was an experimental zone for interest rate reform. In the late 1980s interest rates on loans to private firms were allowed to float. After 1998, the practice was abandoned in favor of a uniform approach to state-owned and private enterprises. Today, about 70 percent of outstanding loans made by the Wenzhou branches of the Agricultural Bank of China are to private firms. The bank has deemed the performance of the portfolio to be satisfactory, with only about 10 percent consisting of problem loans to private firms, which is significantly lower than the national average.

According to bank officials, small and medium enterprises in the private sector have difficulties in obtaining external finance mainly because of the following problems:

- Uncertainty about the protection of private property rights. Despite important constitutional changes in recent years, there is a long way to go from official proclamations to real results on the ground.
- The quality and accounting practices of management in private firms continue to be unsatisfactory. Some firms were found to have three different account books for different purposes, and lowered credit grades at the bank.
- Accounting and auditing services are usually rubber stamps. The integrity of the profession is often under question.

These problems increase the perception of risk and persuade lenders to remain conservative in their dealings with the private sector.

easier to assess the value of particular assets than future cash flows. In the United States, 92 percent of all small business debt from financial institutions is secured (Berger and Udell 1998). This implies that the vast majority of virtually all types of financial institution loans and leases to small businesses—including loans drawn under lines of credit—are backed by collateral. In addition, almost 52 percent of financial institution debt is guaranteed, usually by the owners of the firm. On bank lines of credit to small business, accounts receivable or inventory (or both) appear to be pledged twice as often as all other types of collateral combined. In addition, small firms that pledge accounts receivable or inventory tend to be younger and have shorter relationships with their lenders, which suggests that this type of collateral is especially important for more opaque firms (Federal Reserve Board 1998).

According to the sample firms, the inability to meet collateral or third-party guarantee requirements is the most frequent reason for not being able to obtain a bank loan. Until recently, guarantees were commonly provided by local governments and by other firms. However, such guarantees contributed in large part to the soft-budget constraints in both public and private firms, especially in semi-urban and rural areas. Because the central bank discourages both government and firm-to-firm guarantees, providing collateral has become the only way for most firms to obtain a bank loan. Yet many firms do not have the capacity to provide adequate collateral. About two-thirds of the sample firms regarded collateral as a moderate or major obstacle to their ability to get bank loans. The problem is particularly severe for private firms in the services and hi-tech sectors, where working capital and intangible assets constitute a large portion of a firm's capital.

Banks accept various forms of collateral: land, buildings, houses, apartments, cashable saving instruments (savings certificates, government bonds), equipment, and sales contracts provided by credible buyers (buyer-guaranteed bank loans). In practice, however, real estate assets appear to be the most common collateral, and in some cases the only kind accepted. Equipment is frequently rejected as collateral because of its specificity. In contrast to U.S. and other developed financial markets, China's system makes only limited use of accounts receivable or inventory as collateral. The firms surveyed reported only a few cases of buyer-

guaranteed bank loans, one of which involved a foreign trade company as the guarantor. The preferred forms of collateral obviously depend on the existence of functioning markets in the underlying assets and on differences in the enforceability of creditor rights.

Although land use rights are commonly used as collateral, many private firms do not have their own land or buildings to use in this way. In the absence of a developed housing market, the houses and apartments are typically low in value, compared with the amount of loan needed. In rural areas, most owners have property rights to the house but not to the land, the latter being owned by the village. In such cases, banks are reluctant to accept the house as collateral. An increasing number of private firms, however, are acquiring land use rights for terms ranging from 50 to 70 years. The ability to buy land use rights and afford collateral is one of the significant factors behind the size-related distribution of loan applications presented in table 5.6.

The use of collateral also entails significant costs, which arise in acquiring the credentials needed to establish the value of a firm's assets. An appropriate government branch of land or real estate management usually delegates asset appraisal to a commercial real estate appraisal firm. After appraisal, firms have to register the assets with the government branches in charge. Table 5.7 shows the kinds of fees a firm could incur in the process. These fees usually amount to a percentage of the total value of the assets. In addition, firms must renew their asset registration on a yearly basis and pay an annual registration fee in full or in part. In many cases, however, the fee is based on the value of the property. This gives the appraisal firm an incentive to inflate the value of the property and creates a potential risk to the bank. Repeated and arbitrary fees have greatly reduced the incentive of firms to apply for a loan.

Bank Procedures and Relationship Lending

Chinese banks often complain about the poor quality of projects seeking financing. What they perceive as a "bankable" project, however, depends in part on the procedures they use to screen projects. These procedures, both formal and informal, rely on collateral (and personal) relationships in evaluating a project and make little effort to determine project intrinsics. Furthermore,

the procedures are inflexible and tailored, partly for historical reasons, to the “typical” state-owned enterprise.⁵ According to the firms surveyed, applying for a loan is a very bureaucratic and costly process. About 70 percent said that paperwork was a moderate or major obstacle to their application for a formal loan. To be able to use their assets as collateral, firms have to do paperwork not only with the bank but also with the office of notary public, the asset evaluation agency, and other related government agencies. Collateral requirements, the cost of the application process, and relationship banking tend to make it especially hard for smaller firms to gain access to financing (see figure 5.6).

To alleviate information problems, many potential borrowers establish a relationship with a bank. About 70 percent of the sample firms indicated that not having a good relationship with a bank was a moderate or serious constraint to their ability to get a bank loan. Establishing and maintaining such a relationship can be costly, especially for smaller and newer firms (box 5.2 and 5.3).

The nature of the relationship between banks and private entrepreneurs is likely to change, however, in the wake of recent financial sector reforms. First, some initiatives, such as the elimination of the credit quota system and the reorganization of the provincial network of the Central Bank, may break, or at least weaken, the links between local government and state-owned banks. Even so, tensions remain between the government’s effort to reform the banks and its desire to stimulate the economy

through greater bank lending to enterprises. Local bureaucrats, for instance, are finding it more difficult to intervene on behalf of private entrepreneurs in the credit decisions of banks, although anecdotal evidence suggests that local governments are finding new ways to preserve some role in the allocation of financial resources through the banking system.⁶ Second, the consolidation of urban and rural credit cooperatives and of investment and trust companies is allowing decisionmaking in those financial institutions to become more centralized and is endangering the “relationship capital” of some private firms, especially the smaller ones.

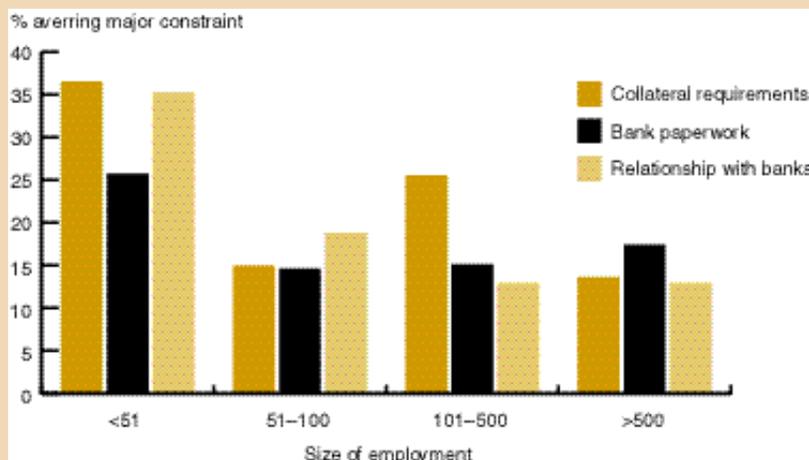
Other Forms of Financing

The current environment in China still draws private firms to seek financing from providers other than banks. Of the firms surveyed, most used the informal market. The stock market and the overseas market played an insignificant role.

The Informal Market

About half of the sample firms have at some point in their history resorted to the informal market to finance their activities. Lending in the informal market has several distinct characteristics. First, it usually takes place among friends or family members. Friends and family members form a closely knit network, and reputation is very important. These factors greatly reduce information asymmetry. Indeed, reputation and relationship often substitute for the use of collateral.

Figure 5.6. Constraints on Accessing Bank Loans among Surveyed Firms, by Firm Size



Source: Survey.

Box 5.2. Firm Y's Journey to Obtain a Bank Loan

Firm Y, located in Beijing, specializes in the export of Beijing duck to developed countries. Its owner explains the process of obtaining a bank loan:

First, you have to find a bank that believes in your repayment capacity. Besides satisfying formal bank requirements, you have to rely on an extensive social and information network.

Second, after locating a bank, you have to meet with the bank's manager, vice manager in charge of the respective industry, vice manager in charge of corporations, and vice manager in charge of lending. Of course, you have to spend time and money in the process.

Third, after you have met the managers, you have to convince the lending committee that you have the right credentials to get a loan. The committee does not send people to visit the firm, but makes its decision based on the credentials sent it.

Fourth, you have to meet with the lowest-ranking manager in charge of the loan decision in one of the bank's branches. This manager also has the power to kill your loan.

In the above four steps, you have already invested a considerable amount of money and time. Some officials may even ask to borrow a car or an apartment. However, the long march to get a loan does not stop here.

Fifth, you have to find a firm that is willing to deposit money in the bank. This is required by the bank. However, no firm will do this for free. You have to pay extra interest to the firm which is comparable to the interest it would get from the bank. Of course, to find a firm that is willing to provide the service, you have to spend additional resources.

Sixth, you have now entered the final stage, where you have to find a firm that is willing to provide a guarantee because you don't have enough collateral. You have to lend part of the loan to the guarantor. The chances that this money will ever be returned, however, are low.

You finally get the loan, but you have already spent part of it. In addition, the term of the loan is one year, and you have to worry about repayment by the end of the first half.

Second, informal lending is usually of a short-term nature. The primary reason is that individuals face tight liquidity constraints, but high interest rates are an important factor, too. The short maturities also reduce the risk of default. Thus it is not uncommon for firms to buy materials for an order through an informal loan and then pay it back after the order is settled.

Third, informal lending has more flexible terms than formal lending. Private firms often need money to complete a production cycle, which can be as short as several days for firms in specific industries. Whereas formal loans are usually issued for at least six months or a year and do not allow a grace period, the term of an informal loan can vary from several days to a year

and typically do permit grace periods. In fact, the rigidity of formal bank lending is an important deterrent to private firms.

Finally, applying for an informal loan does not require much time. A private owner can get a loan from friends or family members in one day. Survey respondents stressed not only the conveniences of informal lending but also the fact that the interest rates charged by formal and informal lenders are much the same, which means there is no disadvantage to using the informal market in this aspect.

However, the informal financial market encounters serious problems when its scope extends beyond friends and family members. The most prominent are default and cheating, which are difficult to control because the parties cannot turn to the law for protection, especially in the absence of written contracts, which is typically the case. Only 14 percent of the firms surveyed wanted to use informal borrowing in the future, yet 49 percent had used it in the past.

Not long ago, some semiformal financial institutions such as credit associations organized by county and township governments emerged in rural areas. They attracted savings by offering high interest rates and making loans to local firms. Many of them ran into serious problems, however, often because of the involvement of local governments. A large portion of the lending went to local TVEs and contributed to the soft-budget problem of these entities.

To avert a crisis, the central government decided to shut down all credit associations. Almost all are now closed, with their debts in the hands of local governments. Wenzhou is one place where they still seem to be operating. Wenzhou has a long history of informal financial markets and had private banks in the 1980s. Its credit associations were under less government influence, and they issued loans to private firms with hard budget constraints. Their good record of management explains in large part why they still exist and shows that semiformal financial institutions are viable in such conditions.

The Stock Market

The stock market has played a very small role in financing the development of the 628 sample firms. Of this group, only three are listed. However, 15 percent of the firms planned to finance their business through the stock market. A strong motivation for listing, they

Box 5.3. Fees for Collateral Appraisal and Registration

In early 1999, a major state bank organized a nationwide survey on fees collected on its clients in the process of collateral appraisal and registration. Table 5.7 presents 17 kinds of fees a firm may incur in one of China's autonomous regions in the process of having its assets appraised and registered. A firm may need to pay up to six or seven of these fees. For example, a firm that has to use its land as collateral needs to pay items 4, 5, 6, 7, 8, and 16. These fees add up to between 0.9 percent and 1.4 percent of asset value. Furthermore, different and conflicting standards may be issued by different government branches at different levels for the same item. In the case of the land appraisal fee, the standard rate issued in 1999 by the region's Bureau of Prices was set at 0.12–0.16 percent, even though the region's Bureau of Land Management, the government branch that collects the fee, had set the rate at 0.32 percent in 1998. Meanwhile, city L used an outdated standard of 0.16–0.32 percent issued by the region's Bureau of Prices in 1998.

said, is to improve the incentives for managers and employees, primarily through stock options. This is particularly the case in hi-tech firms, where human capital plays a critical role in operations.

Overseas Financing

Though overseas financing remains limited, its role appears to be increasing. Of the sample firms, 23 percent wanted to form joint ventures with foreign firms in order to get capital in the future, and 11 percent said they were willing to borrow from foreign banks. Currently, Hong Kong plays a significant role in providing capital to mainland firms. One such firm, MD in Shunde, was first listed in the Hong Kong stock market as H-type (Hong Kong) shares and then in Shenzhen as A-type (Shenzhen) shares. It also borrowed foreign money through its subsidiary in Hong Kong when the anti-inflationary measures were at their peak in 1995. Some fast-growing firms in Shunde also said they were considering listing in Hong Kong as H-type shares.

Table 5.7. Fees for Collateral Appraisal and Registration in G Autonomous Region

Fee name	Collector	Authorizing Agency	Fee (%)	Remark
1. Building appraisal	(1) Real estate appraiser	State Planning Commission and Ministry of Construction: (1995)	0.03–0.4	
	(2) Bureau of Building Management	Regional Bureau of Prices: (1999)	0.2	
	(3) Municipal Building Company	Y city Bureau of Prices: (1999)	0.01–0.4	In Y city
	(4) Municipal Real Estate Appraisal Center	Regional Bureau of Prices: (1996)	0.06–0.2	In L city
	(5) Municipal Building Appraisal Center		0.1–2	In Q city
2. Building collateral registration	Bureau of Building Management	Regional Bureau of Prices: (1997)	0.3–0.8	
3. Building collateral certification	Building company	Regional Bureau of Prices: (1997)	0.3–0.8	
4. Land appraisal	(1) Bureau of Land Management	Regional Bureau of Prices: (1999)	0.12–0.16	
	(2) Bureau of Land Management	Regional Bureau of Land Management: (1998)	0.32	
	(3) L city Real Estate Appraisal Center	Regional Bureau of Prices: (1995)	0.16–.32	
5. Land collateral registration	(1) Bureau of Land Management	Regional Bureau of Prices: (1998)	0.16	At least RMB 300
	(2) Bureau of Land Management	Regional Bureau of Land Management: (1998)	0.03–0.3	
6. Land collateral insurance	Bureau of Land Management	F county Bureau of Land Management: (1998)	2	Returned after loan repaid
7. Land transaction registration	Bureau of Land Management	Regional Bureau of Prices: (1998)	0.25–5	
8. Land collateral certification	L city Bureau of Land Management	Regional Bureau of Prices: (1995)	0.15	In L city
9. Equipment appraisal	L city Asset Appraisal Institute	State Bureau of State Asset Management and State Bureau of Prices document	0.4	In L city
10. Equipment collateral registration	Local BICM	National BICM and Ministry of Finance: (1999)	0.1	
	Local BICM	L county Bureau of Prices: (1998)	0.05–0.2	In L county
11. Equipment collateral certification	Local BICM	L county Bureau of Prices: (1998)	0.1	In L county
12. Property appraisal	Bureau of Building Management	Regional Bureau of Prices: (1997)	0.4	
13. Property registration	Bureau of Building Management	Regional Bureau of Prices: (1997)	0.1	
14. Building transaction registration	Local BICM (1997)	Regional Bureau of Prices:	0.2	
15. Building transaction certification	P County Real Estate Transaction Center		0.32–0.8	In P county
16. Contract certification	Local BICM	Regional Bureau of Prices and Bureau of Finance: (1994)	0.1	Maximum RMB 3,000
17. Collateral property insurance	Y City Insurance Company		0.43	In Y city

Overseas financing is not used that much, largely because of China's restrictions on foreign banks in its territory. Only recently have foreign banks been allowed to issue renminbi-denominated loans. In addition, to getting a loan denominated in a foreign currency, a domestic private company has to obtain government approval and be included in the country's foreign reserve management plan. It is very difficult for even an SOE to obtain such approval, let alone a private firm.

Conclusion

Many factors have contributed to the financial position of the firms surveyed, a primary one being difficult

access to financing, which is especially problematic for smaller firms. Private firms in the sample tend to rely predominantly on internal sources of financing, both for start-up capital and for subsequent investments. Compared with their counterparts in other transition economies, Chinese private firms appear to depend to a larger extent on internal sources of finance and have more limited access to bank loans. This poor access to bank loans is in part the result of policy-induced biases against lending to private firms; inherent information and risk problems related to the size, age, and informality of private companies; and inadequate capacity, procedures, and incentives on the part of banks.

AN AGENDA FOR THE FUTURE



The preceding chapters have described the emergence of China's domestic private sector, the evolution of the policy and regulatory framework, the availability of financing, and the resultant structure of private enterprises. Though partial and preliminary, this analysis points to a number of changes that could help improve government policy, enterprise management, and the operations of financial institutions and markets.

Together, they could help unleash the full potential of the domestic private sector to contribute to China's economic development. This concluding chapter draws out these implications from the preceding chapters and presents an agenda for the future for entrepreneurs, the government, and the financial sector.

As indicated earlier, China has already taken a number of important steps to support the growth of the domestic private sector. These range from the Constitutional Amendment recognizing the role of the private sector to the World Trade Organization agreements opening up more sectors to private enterprises. Membership in the WTO will open domestic private enterprises to greater competition in the Chinese market as well as to new opportunities to compete internationally. A principal feature of WTO membership is compliance with a rules-based framework for industrial policy. A rules-based framework will also help domestic private enterprises.

At the same time, the sector's striking achievements are due in part to the efforts of the sector itself, for until recently private enterprise has functioned under policies and regulations of a constraining nature (see chapter 3). But the environment is now changing, and enterprises will have an opportunity to build more appropriate structures as they grow and mature. They will need more than that, however, in order to be able to compete for financing, skilled employees, and markets on an open market: they will need to move toward global best practice.

An Agenda for Entrepreneurs

Now that the government has begun to rationalize the forms of registration available to private enterprises, businesses need to take on more appropriate forms. These forms will depend on the size of the enterprise and the stage in its life cycle.

The smallest enterprises will require less change—the prevalent model of owner-managed, closely held family enterprises will continue to suit them. For larger companies, the greatest scope for building the business, expanding the management team, and obtaining external financing lies in establishing a limited-liability shareholding company. International experience shows that sole proprietorships, collectives, and partnerships generally do not function efficiently beyond a fairly small size. Even in activities that accommodate large partnerships, such as law and accounting, the international trend is toward limited liability (for example, along the lines of the U.S. model of a limited liability partnership). In high-growth economies, a large proportion of small enterprises in high-growth industries are incorporated and therefore benefit from limited liability, transparent financial reporting, and corporate governance from an early stage in their life.

Cities such as Wenzhou and Shunde have made rapid progress in the transition to shareholding companies. The benefits of this can be seen in the rapid growth and adaptation of these enterprises (for an example of one such firm, see box 6.1). For many private enterprises, this transition will prove a challenge. Growing out of *getihu*, TVEs, or collectives, they may not have clearly defined assets or ownership structures. Their first task should be to establish the assets and liabilities of the enterprise and the identity of the beneficial owners. The equity needs to be allocated to individual shareholders. Meeting the legal requirements of the new form of enterprise may be another challenge, particularly if formalization

Box 6.1. Changing Ownership and Internal Governance In Private Firms

In Wenzhou city, private enterprises have developed quickly and dominate the local economy. Most private firms are owned by an individual or a family and also managed by the owners. However, many firms that have grown large are changing ownership and internal governance.

TZ, a private firm established in 1990, became fairly large after just nine years of growth, with more than RMB200 million (US\$24 million) of total capital and more than 3,000 employees. It had three episodes of internal restructuring. In 1994 it converted from a solely owned small private firm to a company.

Several senior managers became owners. In 1997 it changed into a shareholding company, issuing 50 percent of its shares to 50 middle-level managers. In 1999 it bought the largest parts of the shares of 10 member firms and made itself the shareholding company of these firms. Thus it was able to integrate these small factories into a large one.

These changes enabled the company to recruit experienced managers from outside to improve its management, to reduce the management cost, and also to expand its size. In these two years its total capital expanded six times, and its sales expanded four times. Its share of the domestic market and its exports increased. Technical innovation in the company also accelerated. The company now allocates 1–2 percent of its total revenue to research and development of new products.

imposes new tax and regulatory requirements. Firms undergoing these changes will require careful management and professional advice.

Corporate Governance

New corporate forms imply new formal structures of corporate governance. In particular, incorporation as a joint-stock company creates responsibilities toward

shareholders, one of which is to manage the company transparently and in their best interests. Where outside equity is sought, it is especially important to adhere to the required governance standards.

Beyond what is required by law, improvements to corporate governance will help the enterprise grow and adapt to a changing environment. Under a well-defined management structure with a framework of clear accountability and incentives, authority for business decisions can be delegated more readily. Such delegation is important for the successful management of a large business. It will also ease the problem of transfer of ownership from one generation to another.

Financial Disclosure

China's law of incorporation imposes limited financial disclosure requirements. These may be a step forward for many enterprises but are still much more limited than international best practice. Improved financial disclosure allows investors, suppliers, customers, and other business partners to make a fair assessment of the financial condition of the enterprise. This reduces the risk premium that such parties would otherwise charge for doing business with the enterprise and hence lowers business costs while improving profitability.

Enterprises that hope to attract foreign investment or to trade in international markets should aim to follow international financial disclosure standards. As the domestic market opens to international competition under the WTO agreement, domestic enterprises will compete more and more with firms that have adopted such standards and so should aim for those standards, too.

Before firms can adopt such standards, they need appropriate internal financial systems and controls to ensure more accurate, timely financial reports. They will also have to observe higher standards of external auditing to vouch for the accuracy of those reports. Again, the disclosure standard will depend on the size of the firm, the dispersion of its ownership, and its maturity. Investors expect large, mature companies to provide more information than young, closely held, small companies.

Subsidiaries and Conglomerates

To make corporate governance simpler and more transparent, many enterprises will need to reorganize the complex structures of holding companies and affiliated companies they have built up. The opaqueness inherent in such structures may have been beneficial for an

informal enterprise but is a handicap for a formal one. Firms of this nature find it more difficult to define their assets and liabilities, to report financial performance lucidly, and to assign clear management responsibilities and performance measures. Thus, improving corporate governance will in part involve restructuring related enterprises into a single corporate structure, or separating companies into wholly separate enterprises.

Such transformations should be driven by business efficiency rather than by the incentives created by a distorted regulatory and policy environment. As the government pursues its reform agenda, these incentives will change, especially as China integrates into the global economy. The general direction of change will be to reduce the distortionary impact of government policies and regulations. This will leave enterprises freer to structure their businesses according to commercial imperatives.

As the government becomes less involved in determining market access, reduces the distortionary impact of policies and regulations, and reduces the role of SOEs in many markets, the risk of focus will decline. As capital and labor markets improve, there will be fewer advantages to obtaining capital and labor from within a conglomerate, and the inefficiencies of managing across multiple industries will be revealed by competition from firms that obtain their capital and managers from the market.

Competition will also come from foreign companies. To stand up to this competition, China's enterprises will have to show the same focus and efficiency as foreign companies. The trend among conglomerates worldwide has been to unbundle them into separate firms operating in different markets, and to recombine them through mergers of firms operating in similar markets. Global best practice is to seek synergy between businesses, building on a company's core competences, resources, and capabilities. Chinese enterprises will compete more and more against foreign companies at home and abroad. Most of these are focused in one or a few related markets, or in markets that draw on the same core competences and resources. To compete effectively, Chinese companies will need to show the same focus and efficiency.

Furthermore, the WTO-related opening of domestic markets to foreign investors and competitors reduces the incentive to enter into joint ventures with foreign

partners. Foreign partners will increasingly view such alliances on strictly commercial terms, rather than as a required step in complying with investment and competition regulations. Chinese enterprises should do likewise and take stock of the business value of joint ventures.

Similarly, private firms should rethink their alliances with SOEs as the influence of SOEs on government regulation and markets declines. Again, the driving force should be the business case for partnership, rather than the advantages in dealing with government regulations or gaining market access.

Supplier and Customer Relationships

As the legal enforcement of contracts improves, businesses will have greater opportunity to trade at arm's length with customers and suppliers. Although this will increase market efficiency, individual companies will benefit only to the degree to which they are prepared to go out and seek new suppliers and customers.

Market Entry and Competition

As government control over market entry declines, private enterprises will have greater access to most markets. Their choice of markets should be based on an assessment of their own competencies and resources rather than on external regulations. This implies that companies should devote more attention and resources to building up resources and competences that provide competitive advantage, because they cannot easily be replicated by others. For example, they could do this by relying on proprietary technology or designs, either self-developed or licensed, rather than by using widely available (whether legally or through piracy) technologies or designs.

An important new opportunity for export enterprises arises from the deregulation of export marketing, which is allowing more private companies to obtain licenses to export directly. This gives companies greater flexibility and control over the marketing channel. To benefit from this, they will need to build up their skills and capacity in export marketing. In some cases, this may best be done by entering into partnership with foreign enterprises that know the export markets better.

Management Capacity

In order to thrive in more open, competitive markets, many private enterprises will need to upgrade the capacity and skills of their managers. Improved establishment and corporate structures will help, as they allow firms

to reward their most important managers with shares or share options. They also provide a framework for holding managers accountable for performance, through more transparent financial reporting.

There should also be greater emphasis on the hiring of managers with business skills and on staff development. The informal approach of hiring managers with limited skills at low pay and allowing them to develop on the job is not the way to attract or retain much-needed talent. A better tactic, as most international firms have demonstrated, is to follow a structured approach to management development to attract and retain the management skills they need.

The first step is to identify what kinds of training are in most demand. Our survey reveals that the top three areas of concern are technical training, accounting and marketing, and quality control. Among the firms interviewed, 59 percent needed technical training, 57 percent needed accounting and marketing training, and 46 percent needed quality control training.

Labor Relations

As firms come to rely more on specific skills acquired on the job or skills that are scarce in the market, labor relations will become one means of retaining necessary skills. Thus it will be important to establish adequate mechanisms (whether unions or other means) for voicing employee concerns, resolving grievances, and addressing other labor issues.

Financing

As companies formalize, they will have more access to external sources of finance. Ownership structures with transparent financial reporting will provide a stronger basis for borrowing from the banking system, whether the loans are based on assets or on cash flow. Transparency is also essential for selling equity through private placement or initial public offerings.

Transparency will allow private enterprises greater choice in their debt-equity ratios. Some fast-growing enterprises rely heavily on equity. This is appropriate in high-risk activities, but as markets mature and business growth levels off, companies should consider leveraging their equity with greater amounts of debt finance.

Many other private enterprises depend excessively on short-term bank debt, often backed by personal or government guarantees. They stand to benefit from

formalization and expanded financial markets in three ways. First, they will be able to lengthen the maturity of their debt to better match the maturity of their assets. Thus a company with long-lived assets (for example, a toll road) would be better off financing them with longer-term debt than would a company with short-lived assets (for example, an easily copied technology). Second, firms will be able to reduce their debt:equity ratio by issuing more equity, either privately or through an IPO. And third, they will not have to rely as much on personal, government, and other third-party guarantees but instead can use the assets of the business, clearly defined and transparently reported.

Most firms in China rely to some degree on arrears as a source of working capital. This imposes costs on their suppliers that are inevitably reflected in higher prices and less willingness to expand supply. By reducing arrears on payables, companies can enhance their reputation as an attractive customer, and thereby negotiate better terms and have a wider choice of suppliers. To do this, companies need to budget for adequate working capital in raising debt and equity finance for the growth of their business.

Government Relations

As the government moves toward a rules-based environment, businesses can reduce the amount of time and resources they devote to lobbying for special treatment. They will need to comply fully with regulations and with tax rules. They can then reduce the time they spend on disguising their activity from government. But government relations will remain important as the policy and regulatory environment continues to evolve.

The nature of the dialogue will change, though: instead of emphasizing the treatment of their individual firm, enterprises should focus on lobbying for regulations and policies that benefit the private sector as a whole. The best way to handle government relations will be to lobby as a group rather than as individual firms.

An Agenda for the Government

The government's reform agenda should concentrate on the protection of private property rights, openness of markets, improved commercial legislation, and the tax system.

Commitment to the Protection of Private Property Rights

Although the 1999 Constitutional Amendment guaranteed protection to private property, such property was not placed on exactly the same footing as state property (which was considered “sacred and inviolable”). Private property did not receive the same protection under criminal procedure law, for instance, so that if someone were to embezzle money in a private business, that would only be considered a crime of encroachment on the property of others and not, as it would in the case of state property, a crime of corruption (which carries a more severe punishment). Thus a great deal more remains to be done.

The government’s commitment to the protection of private property rights is often tested in cases of conflict between public and private interests. In such circumstances, the principle of “no expropriation without just compensation” is compatible with the rule of law. However, since typically it is difficult to estimate the intangible benefits of public action, and since bureaucrats tend to overestimate these benefits, the adequate protection of private property rights may require a bias in favor of the private owner, without opening the door to abuse.

Openness of Markets

China’s accession to the WTO will call for further opening up of private investment and trade. The survey findings provide support for several recommendations.

In most sectors, existing restrictions on private sector entry run against the spirit of the rule of law, since they are typically based on irrelevant distinctions. It is rarely the case that the form of ownership should be part of the ascertainable qualifications to perform specific economic activities. Therefore, all sectors in which form of ownership in the above sense is an irrelevant distinction should be open to private investors. Furthermore, it is urgent to unify the treatment of market access across localities, especially since this would be required under a WTO membership. Adjustment programs in various sectors (see chapter 4) should also be examined for their impact on private sector entry. More active involvement of private enterprises should be encouraged, for example, through mergers and acquisitions.

The Law on Protection against Unfair Competition, enacted in December 1993 to create a fair and

competitive business and investment environment, must be more strictly implemented.

Under WTO agreements, China would give “national treatment” to foreign institutions in a number of sectors. Establishing national treatment in such sectors should therefore be a priority. In this context, preferential policies toward SOEs and foreign investments should be gradually phased out and a policy of national treatments adopted to enable domestic private enterprises to compete with SOEs and foreign firms on an equal footing.

Foreign trading rights should be extended to all qualified private enterprises to allow them to participate directly and more widely in China’s foreign trade.

Commercial Legislation

The legal infrastructure for commercial enterprises has room for several improvements.

Minimum registered capital requirements for forming a limited liability company should be significantly reduced (or eliminated, as in many Western countries). To the extent that high minimum capital requirements were felt necessary on account of the high perceived risk of making loans to businesses, this might be addressed by improving disclosure requirements.

The line drawn between a *getihu* and a private firm should be erased. It merely creates an incentive for a private owner to remain a *getihu* for the purpose of minimizing taxes. Furthermore, by continued reliance on the TSRIPE to govern *getihu* registration, the system perpetuates an anomaly in China’s laws for business operation.

The scope for official interference and substantive review in the registration of private enterprises must be significantly reduced. The new laws (Company, Partnership, and the WIOEs) contain some provisions—such as the need for excessively specific definition of business scope and for approval of changes in business scope, site, “necessary conditions for production” and a “lawful enterprise name”—that open the possibility for bureaucratic interference in the registration and establishment of private enterprises. These provisions need to be significantly relaxed, in line with international practice, so as to reduce the scope of bureaucratic discretion, or altogether eliminated.

Box 6.2. An Anecdote about the Registration Process

We were told the story of an entrepreneur who wanted to open a restaurant under the name of “Paradise in the Real World.” In Chinese, the name has four characters, but the Bureau of Industry and Commerce asked the name to be changed to two or three characters. The entrepreneur asked whether “The Paradise” was acceptable. The bureau said, “You are on the earth so you cannot be registered as ‘The Paradise.’” The entrepreneur responded, “‘The Real World’ must then be a good name.” “No,” the bureau said, “since we are all in the real world, that name is not appropriate, either.” After several dinners and bribes, the entrepreneur was able to convince the bureau that “Paradise in the Real World” was an acceptable name after all.

Removing unnecessary entry restrictions for private enterprises, as discussed above, would probably eliminate the *raison d’être* for the requirement to define a narrow business scope. Box 6.2 provides anecdotal evidence of how such vague provisions can be used by local bureaucrats to obstruct the normal registration process.

The five-year period of unlimited liabilities for wholly individual-owned enterprises following a liquidation should be eliminated. This period seems excessive, and such unresolved potential liabilities may act to discourage entrepreneurial activity. To force entrepreneurs to accept personal liability until their business can reach the minimum size required to form a limited liability company would appear to discourage start-up activity or place entrepreneurs at unreasonable high risk of losing their personal property and that of their families to creditors.

Furthermore, it would be difficult to enforce this provision in practice. Up until now, China has not had a fully developed industry that investigates another person’s personal property. Anonymous banking, among other things, made such investigations impractical in the past. In recent years there have been a number of cases in which creditors sought to enforce court judgments

against individually owned enterprises. These individual investors that looked liquid previously suddenly seemed unable to pay off debts.

There is also an urgent need to unify Bankruptcy Law in China and to restore the normal priority of creditors claims. Bankruptcy regulations are one example of “one country, two systems” in the area of law. Bankruptcy Law applies to state-owned enterprises, and the PRC Civil Procedure Law contains bankruptcy provisions that apply to “an enterprise with legal status” (see chapter 4). The line between the scope of the two laws is not clear, since many SOEs are also persons. The definition of an SOE is not a trivial question, since stakes in many former SOEs have been sold to non-state enterprises and the public at large. Furthermore, the two laws differ substantially in areas that affect creditors’ rights. Under the Bankruptcy Law, for example, bankruptcy is not available if an enterprise is “public” or has “important bearing on the national economy and the people’s livelihood.” In those cases, relevant government departments “will provide economic assistance or take other measures to assist in the discharge of liabilities.” The law also gives the bankrupt’s department in charge two years to fashion a reorganization and thereby delay bankruptcy proceedings. The definition of a state-owned enterprise also determines the applicability of additional regulations (Supplementary Notice on Issues Concerning the Trial Implementation in Several Cities of State-Owned Enterprise Bankruptcy and Merger and Reemployment of Workers, of March 1997) giving workers first priority in the distribution of recovery proceeds. This dual-track approach to bankruptcy could undermine creditors’ rights.

Tax System

As survey results indicate, small and private firms experience a number of problems arising from the current tax system and the government’s collection of fees. The following policy changes and reform measures are recommended to deal with these problems:

- The government should begin a systematic effort to simplify the system of fees and taxes levied on the private sector. The fact that local governments are not allowed to adjust the rate of local taxes or create new taxes to meet their needs has in many cases encouraged them to impose arbitrary and nontransparent fees. As a result, the burden on firms is uneven, both

in terms of size and location. To rationalize and simplify this system, it will be necessary to decentralize some taxation powers and rights to revenue, where appropriate, and to make policies more consistent across locations.

- The tax system needs to be made more transparent and equitable in its application across firms, and arbitrary interpretations of tax laws and regulations should be avoided. Rent-seeking behavior in all forms by government officials and departments must be strictly prohibited. The key ingredients of reform here are clear rules, capable of simple enforcement, and specialized education and training. One important step would be to clarify or eliminate vague provisions in various laws (see chapter 4) which provide opportunities for government interference in private economic activities.
- The quality of accounting and auditing services should be encouraged to improve to meet the increasing needs of private firms, especially small firms. The role of the government would be to insist upon transparent reporting of financial data according to clearly defined standards, to support education and training in related fields, and to facilitate the development and operation of professional firms providing these services.

An Agenda for the Financial Sector

According to the survey results, one of the most serious problems for private firms is access to financing. Existing constraints arise from a complex set of factors. Some originate in lingering policy biases against lending to private enterprises; others relate to internal characteristics of the private sector, such as the smaller size of its enterprises, its informational opaqueness, and the weaknesses of management and governance. A third set of factors has to do with the underdeveloped nature of the financial sector. Although all of these factors are taken into account in this section, the emphasis is on issues pertaining to the development of the financial sector.

The existing universe of private firms in China has reached a point at which different types of financing are needed to coincide with the various stages of development in which the firms find themselves. This calls for

a diversified financial system with the institutions, instruments, and technologies required to solve different types of information and risk allocation problems.

Improving Private Firms' Access to Bank Lending

The recommendations here can be summed up as follows: establish a level playing field in providing access to bank loans, strengthen banks' incentives to lend to private enterprises, monitor the impact of consolidation of enterprises on incentives for SME lending, further liberalize interest rates, allow banks to charge transaction and monitoring fees, and improve incentives in credit guarantee schemes and the management of risks.

Establish a level playing field. Recent financial and SOE reforms have made significant progress in hardening budget constraints on SOEs and reducing government interference in bank lending. However, strong forces are still keeping the playing field uneven when it comes to access to bank loans. There is ample evidence that local governments continue to extend explicit or implicit guarantees for bank loans to enterprises with state ownership and find other ways to influence bank lending in favor of state-owned enterprises.

Disincentives regarding lending to private companies can also reflect implicit biases against non-state firms in older and new legislation. Chinese legislators have been trying to keep pace with the rapid developments in the real sector and the changing forms of ownership. Important parts of existing legislation, some of which have a direct impact on access to financing, are explicitly or implicitly aimed at SOEs in transformation rather than at newly formed companies. Bankruptcy regulations (see chapter 4) are an example.

Furthermore, bank culture still fails to consider a bad loan to a state-owned enterprise to be as serious as a bad loan to a private enterprise. Expectations, reinforced by recent experience with the asset management companies, are such that when a public borrower fails to amortize a loan, the state almost certainly will step in so that the bank will not have to absorb the entire loss on its own balance sheet. Private borrowers obviously do not benefit from the same kind of expectations. Until this asymmetry in the risks banks face in making loans to firms of different types of ownership is eliminated, banks will consider it rational to discriminate against lending to private sector firms.

Strengthen banks' incentives. An important step here would be to strengthen profit incentives through private ownership and competition. At present, the ownership structures of the real sectors do not balance with those of the financial sectors. Private ownership in the financial sector is practically nonexistent. The government should allow the entry of new domestic private financial institutions, especially in view of prospective WTO membership, which will open up entry opportunities to foreign financial institutions. To alleviate regulatory concerns, particularly in the light of recent financial crises, stricter entry and prudential requirements could be applied to new private financial institutions in the initial period.

Private financial institutions are likely to be more independent of political considerations and more profit oriented. They are not likely to compete directly with existing state-owned banks, although increased competition through new entry will have an invigorating effect on the state-owned financial sector. New banks tend naturally to focus on underserved market niches, especially younger and smaller firms, which constitute the bulk of the private sector today. They do not tend to discriminate among customers on the basis of existing relationships, and in their struggle to establish themselves in the market, they are more prone to trying innovative ways of doing business.

The big state-owned banks are likely to dominate the domestic financial landscape for the foreseeable future. Strengthening the profit incentives of these banks would therefore have a major impact on improving private firms' access to bank loans. Corporatization, listing, and strategic partnering with foreign financial institutions are some of the ways to reach this objective.

Monitor the impact of financial sector consolidation on incentives for SME lending. With consolidation taking place in urban and rural credit cooperatives, rural credit funds, and investment and trust company sectors, financial institutions are likely to become larger and credit decisions more centralized. Given the important role these financial institutions play in SME financing, any gains made in terms of financial stability should not have an adverse effect on information and relationship capital, which would tend to reduce SMEs' access to financing.

Further liberalize interest rates. Evidence suggests that further liberalization of interest rates is needed to improve private firms' access to bank loans. Such a

measure is not likely to have a significant impact on the borrowing costs of these firms. Most private enterprises that are able to borrow already pay effective interest rates that are significantly higher than the ones prescribed by the Central Bank. Entrepreneurs also indicate that access to financing is more important than the costs of funds.

Allow banks to charge transaction (and monitoring) fees. Although this recommendation is related to interest rate liberalization, it has other important dimensions. Banks find that lending to private companies, the bulk of which are smaller and informationally more opaque, carries higher unit transaction costs. Therefore, if they use uniform procedures that do not differentiate between different types of borrowers, they are likely to discriminate against small firms. Transaction fees would, to some extent, unbundle the decision to look at a project proposal from a credit standpoint. They would also encourage banks to consider the proposals of a larger number of smaller and informationally more opaque firms. Banks would then be encouraged to develop a more service-oriented culture and to play an active role in promoting higher transparency and better accounting standards. Banks would then need to adopt new procedures and develop skills in areas such as cash flow analysis, project finance, and risk management. The introduction of such fees would also be an important aspect of the realignment to international practices in banking, which seems inevitable in the light of prospective WTO membership.

Improve incentives in credit guarantee schemes and improve the management of risks. In the first half of 1999, the State Economic and Trade Commission issued Establishing Credit Guarantee System Pilot Projects for Small and Medium-Size Enterprises Guidance Opinion to stimulate bank lending to SMEs. By November 1999, 70 cities had established credit guarantee agencies with a total capitalization of RMB4 billion (US\$483 million). These agencies are treated as nonfinancial institutions and are outside the regulatory scope of the Central Bank.

International experience suggests that under certain conditions (see box 6.3) such schemes can be successful and play a useful transitional role in improving SMEs' access to bank loans. If properly managed and supervised, such schemes could help reduce transaction costs for banks, improve current practices of risk pricing through more flexible guarantee fees (if those are allowed to be negotiated between guarantee funds and

borrowers), and alleviate collateral problem faced by smaller, mostly private firms. However, credit guarantee schemes also entail risks, which are potentially high in China's context. Credit guarantee schemes could be used by local governments as a mechanism for continuing interference in credit allocation and as a substitute for policy lending. Also, at present there is no risk sharing between guarantee agencies and banks, which creates perverse incentives in lending decisions. Furthermore, the introduction of such guarantee schemes should not divert attention from the long-term issues surrounding the role of collateral in bank lending, namely, the need for a system for registering assets used as collateral, especially movable assets; a better system of auctioning machinery and equipment, and of creating secondary markets in such assets in general; and a better system of enforcing collateral and promoting the development of project finance and leasing.

Alternatives to Bank Lending

Some alternatives to bank lending are leasing and factoring. Leasing and factoring are underdeveloped in China and play an insignificant role in the financing of private enterprises. Yet they are useful ways to deal with insufficient collateral and, in the case of leasing, with the enforcement of collateral.

Leasing. However, the concept of leasing may prove difficult to apply in China: rent arrears have long been a problem, China has no leasing law, accounting standards are unclear, appropriate tax incentives are not in place, and funding is a perpetual concern. A welcome recent development is the inclusion in the new Contract Law of a chapter on finance lease contracts. This is the first time either national or regional legislation has covered the fundamental principles of finance leases. However, the legislation should not be viewed as a substitute for a special leasing law, which would address the issues identified above.

Factoring. Liquidity and arrears problems are common among private enterprises in China. Factoring, under which the factor manages the trade debts of a client company, is a method of improving a company's liquidity by substituting a cash balance for book debt. Factoring is not fully developed in China. However, provisions in the new Contract Law (effective October 1, 1999) may stimulate the growth of factoring and other such international practices in the future. The new Contract Law makes it possible to

assign contractual rights independently of the assumption of the corresponding obligations and without the consent of the debtor.

Developing Private Equity Markets

Private equity markets in China, venture capital in particular, are in an embryonic stage of development. Indeed, offshore venture capital appears to be a far more important source of capital for start-up companies in China than domestic venture capital. Recognizing the importance of private equity markets for the development of the hi-tech sector, the government has stepped up efforts to stimulate the development of these markets. Recently, the Bank of China established a RMB1 billion (US\$121 million) venture fund, and the government has reportedly started work on venture capital and investment fund legislation.

Establish a legal framework for private equity funds. Private equity funds should be developed within a comprehensive legal framework; transitional arrangements can speed up the process. At present, no regulatory guidelines are available to define the legal/organizational structures that can be used to establish private equity funds, known in China as "industrial investment funds." As a result, would-be fund promoters, generally local governments interested in developing their high-technology sector, often set up limited liability corporations as investment vehicles. These corporations issue shares in exchange for investment; funds are then pooled and managed by a fund manager. The corporation must abide by the limitations of the company law, which does not permit more than 50 percent of capitalization to be invested in subsidiaries or other legal entities. While the 50-percent rule was instituted to prevent siphoning of company assets (and is often diluted by a generous appraisal of assets, which effectively raises the 50-percent ceiling), it prevents the corporations from investing more than half of their assets in anything other than cash-equivalent securities.

Certain legal and taxation instruments must also be in place before private equity funds can be developed. The most important ones relate to the legal organization of such funds (whether a joint stock company or contractual), the need for trustees to protect investors from the adverse actions of the fund manager, and the use of a fund manager and tax treatment to avoid double taxation. At present, the rights and obligations of fund investor, fund manager, and custodian are not

Box 6.3. Best International Practices in Credit Guarantee Schemes for SMEs

The following best practices have been identified from a review of SME experiences:

- Guarantee schemes are introduced to entice the financial sector to provide more credit to SMEs. Given the high cost of lending to SMEs, credit schemes need to reduce the transaction costs for banks. Thus a well-functioning guarantee scheme will forge a cooperative relationship with the lending banks that is based on a high degree of mutual confidence. This will ensure that both sides adhere to the arrangements and carry out their respective obligations without delay and without protracted dispute or recrimination.
- The size of the fund and the leverage should signal confidence (leverage in this context means the outstanding guarantee-to-capital ratio, but not borrowings). Leverage that is too low (two to three times the fund size) is considered too conservative; leverage that is too high will not provide confidence. The best practice to date seems to suggest a leverage rate of 5--10, to be reached after five years.
- Most serious guarantee schemes would consider a 5 percent loan default rate high. They would also see it as a signal indicating that all features of the schemes' design need to be reviewed and that remedial action may be required, particularly in the procedure for approving guarantees, risk-sharing arrangements, and the level of the guarantee fund.
- The fund should never guarantee the full size of the loan. On the other hand, it should still be an attractive mechanism to provide lending. Coverage in most successful schemes is 70--75 percent.
- Credit guarantee schemes need staff to carry out their own independent review. Schemes that just accept the review of banks have consistently high subrogation rates.
- Successful credit guarantee schemes take whatever collateral they can get: cars, future revenues, and promissory notes. The client needs to get the right signal that money is valuable.

Source: *Financier, Llorens (1997)*.

clearly defined by current Chinese law. As a result, the relationships between them are somewhat uncertain, and the role of a trustee who can represent the fund in legal proceedings is ill-defined. The draft trust fund law currently before the National People's Congress should provide a significantly clearer definition of the obligations and rights of the parties.

Transform the role of the state in venture capital.

The state still plays a ubiquitous role as sponsor, investor, and fund manager. The investment industry in general would benefit considerably if the state acted

less as a patron of the companies in which it invests and more as a protector of efficient competitive markets. As a transitional step, the state could use indirect mechanisms to ensure that venture capital flows are strong, stable, and accessible to a wide range of companies, including private ones. The experience of the Small Business Investment Corporation (SBIC) program in the United States exemplifies one transitional mechanism to ensure that small companies with attractive futures but not the high returns demanded of private venture capital also have access to pre-listing equity capital (see box 6.4).

Box 6.4. Increasing Access to Venture Capital through SBICs: A Novel Approach

Forty years ago, small businesses in the United States faced considerable difficulty obtaining capital, particularly equity capital. In 1960 the U.S. government, through the Small Business Administration (SBA), introduced a program offering financing through accredited financial intermediaries known as small business investment companies, which were to provide equity capital, long-term loans, and management assistance to small businesses, particularly during their growth stages. Since then, SBICs have invested more than US\$22 billion in nearly 90,000 small business, many of which receive multiple SBIC financings.

The SBA's role consists of licensing the SBICs, typically venture capitalists interested in supplementing their own private investment capital with funds borrowed at favorable rates through the federal government. However, funding does not come from government budgets. To obtain funding, SBICs issue debentures, which are guaranteed by the SBA. These debentures are then formed into pools, and SBA-guaranteed participation certificates, each representing an interest in the pools, are sold to investors through a public offering. Under current procedures, the debentures have a term of 5 or 10 years and provide for semiannual interest payments and a lump-sum principal payment at maturity.

An SBIC may receive funding equal to 300 percent of its private capital. In addition, an SBIC that has invested or committed in "venture capital" at least 50 percent of its "total funds available for investment" may receive an additional tier of leverage per dollar of private capital, for a total leverage of 400 percent of private capital (although in no event may any SBIC or SSBIC draw down leverage in excess of US\$90 million).

By law, the SBIC must provide equity capital to small businesses and may do so by purchasing their equity securities. SBICs can make long-term loans to such concerns in order to provide them with funds needed for their sound financing, growth, modernization, and expansion. An SBIC may also lend money to a small business in the form of debt convertible into equity, or with an option to purchase equity in the small business concern.

Source: Lerner (1996).

While venture capital plays an important role in financing the growth of small, technology-oriented companies, it also has its limitations. Venture funds typically back only a tiny fraction of the technology-oriented businesses begun each year. Furthermore, the structure of venture investments is inappropriate for many young firms: venture capital groups are unwilling to invest in very young firms that require only small infusions. Public programs to provide early-stage financing to firms, particularly to high-technology companies, have become commonplace in many countries. As the Small Business Innovation Research (SBIR) program in the United States has

shown, successful initiatives tend to complement venture capital rather than substitute for it (see box 6.5). If carefully implemented, such programs could play a useful role in promoting the development and commercialization of intellectual products and the associated protection of intellectual property rights, an important issue in China today.

Broaden the range of issuable equity-related securities. Investors in venture capital and pre-IPO companies need latitude to structure transactions most beneficial to issuing companies and to themselves. Risk/return preferences vary, and different securities

Box 6.5. The Government as Venture Capitalist: The U.S. SBIR Program

Established in July 1982, the Small Business Innovation Research program is designed to address imperfections in the market for the financing of young technology-based firms. Under the program, all federal agencies spending more than US\$100 million annually on external research must set aside a fixed percentage (1.25 percent) of these funds for awards to small businesses. When the program was reauthorized in 1992, Congress increased the size of the set-aside. While the 11 federal agencies participating in the program are responsible for selecting recipients, they must conform to the guidelines stipulated by the act and the U.S. Small Business Administration. Recipients must be independently owned, for-profit firms with fewer than 500 employees and must be at least 51 percent owned by U.S. citizens. Promising proposals are awarded Phase I support (originally no more than \$50,000 or less), which is intended to allow firms to conduct research to determine the feasibility of their ideas. Approximately one-half of the Phase I recipients are then selected for the more substantial Phase II grants. Phase II awards of at most US\$750,000 (originally US\$500,000) are designed to support two years of development work. The funds are transferred to the small firms as a contract or grant. In return for the funding, the company must submit a report on the technology under development. The government receives no equity in the firm and does not have any ownership claim on the intellectual property that the firms develop with the funds.

The program has reportedly had a positive and substantial long-run impact: over a 10-year study period, SBIR recipients grew significantly faster than a matched set of firms. The positive effects of SBIR awards were confined to firms based in areas with substantial venture capital activity. This finding suggests that public funding did not crowd out private sector investment and was actually complementary to venture capital investment.

Source: Lerner (1996).

might better fit the needs of the issuing company as well. This requires the ability to structure investments using a range of securities, which can be issued by the company receiving investment.

Permit the issuance of preferred stock. A security essential to many private equity transactions but not permitted in China is the preferred stock. The cumulative preferred share satisfies the balance of risk and return acceptable to some investors at a level between that of ordinary common shareholders and that of bank lenders. The lack of provision for such different classes of shares seems to deny needed flexibility to the financial arrangements of private enterprises. In limiting ownership to a single class of shares, policymakers originally intended to create a simple and transparent

shareholding environment and to prevent a controlling class from abusing the rights of others. However, the failure to acknowledge different classes of shares, and different rights attaching to such classes, will both stymie efforts to provide sophisticated financing strategies for investors in Chinese issuers and make it difficult to establish a basis upon which minority holders or investors giving different value can be recognized and protected.

Permit such equity-related securities as options and warrants. Issuers also need to be able to offer investors quasi-debt securities, which provide current income as well as the potential for equity appreciation in the future. Securities of this kind include bonds that are convertible into shares (currently permitted only for

listed companies), or bonds that carry “warrants,” meaning the right to purchase a fixed amount of shares at a predetermined price in the future, and stock options. The PRC Company Law does not provide any basis for the issuance of share options and warrants. In particular, it lacks specific regulations regarding authorized but unissued shares or authorized capital increases. To the contrary, any single capital increase is subject to government approval at the time it is effected. Consequently, it is not possible for a company to reserve unissued shares and grant the vested right to acquire such shares in the future. There is likewise no obvious way to provide debt obligations to lenders that can be converted by their terms into equity claims against a company.

Improving Access to Public Equity

A few ways to improve access to public equity would be to broaden and strengthen the range of exit mechanisms available to investors, relax listing requirements, simplify share buybacks, strengthen the incentive to list on the domestic exchanges, and reduce restrictions on the sale of founders’ shares.

Broaden and strengthen the range of exit mechanisms available to investors. Measures that would strengthen the securities markets and provide increased access to small firms—such as the expected establishment of the Second Trading Board by early 2001—would have a profound effect on pre-listing investors by signaling that they would be able to sell their investments when the time comes.¹ With the advent of the secondary board and official pronouncements of transparency in the listing approval process, non-state companies are sure to enjoy more equal access to listing. This should water down the favoritism historically shown to SOEs on the main boards in Shanghai and Shenzhen. Until then, investors are still likely to see the possible lack of viable exit as their greatest risk, and to eye the possibility of listing firms in Hong Kong or offshore.

Relax listing requirements. Listing requirements could be relaxed, even for new Second Trading Board listing. Although intended to protect investors, listing requirements that are too restrictive may actually constrain private equity investment by raising questions about the viability of listing as an exit mechanism if they exclude small but attractive companies. The fact that many private firms are too small or have limited operating histories would disqualify them from listing

in the two Chinese exchanges.² Also, they may not qualify because of poor profitability—though many high-technology companies are attractive investments despite low profitability in their initial years.

Proposed listing rules for the Second Trading Board would make considerable progress in this area, as companies would not have to demonstrate a history of profitability to be listed. Furthermore, their proportion of intangible assets could be as high as 70 percent, but they would be required to disclose their corporate information every three months. The capital required to obtain a listing is expected to drop from the main boards’ RMB30 million (US\$3.6 million) to RMB20 million (US\$2.4 million). This is progress, although the need for such a high minimum level of capital can still be questioned.

The establishment in late 1999 of a secondary board in Hong Kong, known as the “GEM,” has provided small non-state firms with a trading venue with less stringent listing requirements. These include lower income requirements, shorter operating histories, and a lower minimum portion of total shares offered at IPO. Several mainland high-tech non-state firms have already been listed there, and several more are pending.

Simplify share buybacks. An investor must be able to sell his shares in the event an IPO is not possible. One alternative as part of the investment arrangements would be to require that a company or its major shareholder buy back the investor’s shares at some point in the future. A company buyback would result in the cancellation of the shares, and under existing legislation a company may not repurchase its own shares except when canceling shares in order to reduce the company’s capital or when merging with another company or companies that hold its shares. Otherwise, cancellation of shares must be subordinated to the consent of the investor, the other shareholders, and the company’s creditors, either by stipulating the possibility of cancellation in the company’s articles of association or through subsequent amendment, which would be approved by the stakeholders.³

These rules were instituted to protect the rights of the investor, creditors, and shareholders. In the case of a company buyback negotiated by the investor, there is no question of any infringement of the investor’s rights. Creditors have other means at their disposal—such as covenants that are intended to

prevent management activity detrimental to their position—that are far more meaningful than any detriment arising from the erosion of capital through share cancellation. The means cited above seem sufficient to protect existing shareholders. A simple solution would be to amend company law to permit share buybacks from investors unless expressly forbidden by a company’s articles of incorporation (which themselves could be amended by shareholders).

Strengthen the incentive to list on the domestic exchanges. It is hoped that the practice of conducting a “rights” offering to existing shareholders, at discounts of as much as 40 percent, will be curtailed in favor of a broader subscription to new and existing investors alike. This should make offerings more attractive to potential issuers while strengthening investor perceptions regarding the viability of the securities markets as an exit mechanism.

Reduce restrictions on sale of founders’ shares. Another reason founders and other pre-IPO investors favor offshore listings is the restriction on the sale of founders’ shares for a period of three years from the date of founding of a firm (which is deemed to include the conversion of a company to a “company limited by shares”).⁴ The reduction of this “lock-up” period for founders’ shares would make raising capital on the exchanges a considerably more attractive option for non-state firm owners and managers, whose companies, unlike SOEs, are frequently less than three years old at the time of offering.

The purpose of the lock-up period is to prevent speculation and possible manipulation by owners of small, often unproven companies without the kind of track record that would promote a more stable market among more seasoned companies. Nevertheless, the lock-up period acts as a regulatory disincentive to listing in the domestic

markets. Similarly, this restriction can be expected to make listing on the new Second Trading Board less attractive than it otherwise could be.⁵

There is a perception in China today that increased share supply, whether from the sale of founders’ shares or from the many non-state companies that would list on the exchanges if given the chance, would cause an oversupply of shares and bring share prices down. This is unlikely to be the case, given the considerable pent-up savings that are earning a paltry income in commercial banks; as markets increased in breadth (from new issues) and depth (from more shares available), they would probably become more robust markets and more stable. Furthermore, there would be fewer opportunities to manipulate share prices on thinly traded markets.

Ultimately, the Chinese securities markets will reach a state of development where securities firms conducting IPOs on behalf of issuers will determine, on the basis of their reading of investor sentiment toward share sales by insiders, the appropriate lock-up period for founders and other pre-listing investors.⁶ Later on, once the company is listed, the size of share sales by insiders will be regulated by the brokers handling the sale, for they will have to ensure that the downward pressure a large sale would exert on the shares is mitigated.

At present, the general speculative nature of the securities markets suggests it may be too early to eliminate the regulatory requirement and leave the determination of the lock-up period to the discretion of the brokers on a case-by-case basis. Instead, by allowing a gradual reduction over time in the lock-up period to a span of, say, six months, the regulatory intent of the restriction can still be realized, while the disincentive to listing from the standpoint of the owner of a non-state firm can be reduced.

NOTES

Notes to Chapter 1, “Introduction”

1. Throughout this study, we define “domestic private sector” as business enterprises under the effective private control of resident Chinese private persons, whatever the legal status of the enterprise or formal ownership rights. Because data are so limited at present, the survey results cover only a narrow segment of the private sector, as explained later in this chapter.
2. For obvious reasons, it was not possible to find a database of collectives or TVEs that identified those under private control.

Notes to Chapter 2, “Evolution and Current Status of the Domestic Private Sector”

1. *Tentative Stipulations on Private Enterprises*, Article 2.
2. According to Chinese sources, this seemingly arbitrary distinction was based on an example Marx used in *Das Kapital* with eight people to illustrate the capitalist production process. Marx gives one purely hypothetical example in which the employer has to employ eight people in order to extract enough surplus value to make twice the income of the employees, plus the same again to use as capital (Young 1995, p. 5; Marx, *Capital*, pp. 291–92).
3. Unless otherwise indicated, “private sector” refers to *getihu* and *siying qiye*.
4. See Table 2.3 for a definition of the true private sector.
5. Several factors, such as systematic differences in reporting and in the degrees of vertical integration, can have distorting effects on these results. The higher capital-to-output ratio in SOEs could be due to the concentration of state-owned enterprises in capital-intensive industries, but disaggregated data suggest otherwise. Food processing and textiles are generally less capital-intensive than machinery, chemical, automotive, and electronics industries. In all six of these, SOEs had much higher capital-to-output ratios than did non-state enterprises. A 1995 World Bank survey found that in 37 of 39 industrial sectors, non-state enterprises were more capital-efficient than SOEs.
6. *People’s Daily, Overseas Edition*, October 7, 1999, p. 2.

Notes to Chapter 3, “Informal Status of Domestic Private Enterprises”

1. Because “management” meant different things to different respondents, we restricted the meaning to the top managers or those managers plus medium-level managers.
2. However, the sample included a heavy concentration of high-tech industry, where technical education is particularly valuable, so it may overstate the average educational attainment of managers.
3. Cities like Beijing and Chengdu have also set up high-tech development areas or zones with special policy packages in place to attract Chinese students or scholars overseas to work there.
4. Even among those who did respond, there may be overreporting to show compliance with government policy, which requires enterprises with more than 25 employees to have trade unions. Another survey in 1997 found only 3 percent of private enterprises were unionized.
5. The Law of Corporation requires that a corporation have both a Communist Party organization and a union.
6. This is such a pervasive problem that the 1999 Accounting Law explicitly outlaws this practice (see box 3.3).
7. Issues of enterprise arrears are discussed in detail in chapter 5.
8. The “Star Plan” focuses on promoting small firms, and the “Torch Plan” on promoting high-tech industries.

Notes to Chapter 4, “Toward a Rules-based Environment”

1. *Catalogue (No.1) of Projects Prohibited for Repeated Industry Investment, effective September 1999, and Catalogue (No.1) of Outdated Production Facilities, Technological Process and Products to Be Eliminated, effective February 1, 1999.*
2. China has 14 national and regional commercial banks, which account for about 5 percent of financial sector assets; 3 policy banks, which account for another 5 percent; 8 relatively small Sino-foreign joint venture banks with 1 percent; and a large number of urban and rural credit cooperatives, for 11 percent.

Notes to Chapter 5, “Financing Domestic Private Enterprises”

1. From data and research on SMEs and larger firms, this stylized pattern appears to be largely consistent with empirical evidence. This paradigm differs in some important respects, however, from recent findings on SME financing in developed financial markets and in some transition economies. There, younger firms have access to bank financing, and external financing plays a significant role in a firm's life cycle. In the United States, for example, bank debt financing accounts for a surprisingly large share of total financing, even for start-up firms (see Berger and Udell 1998, pp. 9–10). That also appears to be the case in the Czech Republic (Bratkowski, Grosfeld, and Rostowski, 1999; Webster, 1993a, 1993b). Several studies have also found that the share of external financing tends to decrease as firms grow over time (See Berger and Udell 1998).
2. People's Bank of China, China Financial Outlook '99, p. 92.
3. For example, Shanghai First Department Store gave seed money to college students from Qinhua University who were starting a new business in large-screen projected TV. In another example, Legend, the biggest PC maker in China, invested in a small software company, Kingsoft Technology, whose software rivals Microsoft Word (see Gao and Xu 2000).
4. The experience of the Asset Management Companies created in 1999 provides supporting evidence.
5. For example, the relationship between state-owned enterprises and banks is typically intermediated by a government “sponsoring” agency. The same is usually expected from a private enterprise as well (see box 5.2).
6. One mechanism consists of “conditionalities” attached to government deposits in commercial banks. Another consists of interventions through the government-sponsored credit guarantee funds.

Notes to Chapter 6, “An Agenda for the Future”

1. Trial operations will be carried out on the Shenzhen Stock Exchange, and then trading will begin on the Shanghai Stock Exchange.
2. Size requirements are substantial and will eliminate most small and many medium-size companies: the value of the company before IPO must exceed RMB50 million (US\$6 million), of which the value of the “sponsor's” shares must exceed RMB30 million (US\$3.6 million). Companies must not only have been profitable in the most recent three-year period but must maintain a sufficient rate of profitability (as measured by the ratio of net income to total assets, which must be greater than the PBoC base lending rate). In addition, the IPO must result in at least 1,000 subscribers. (Other listing requirements, which do not unduly burden small companies in particular, dictate that offerings equal at least 25 percent of preexisting shares, that sponsors must own at least one-third of shares after IPO, and that a maximum debt-to-equity ratio must be met.)
3. The articles of association of a company limited by shares could either define the scenarios that would lead to an automatic cancellation of shares or delegate the final decision regarding the cancellation to the general meeting of the company's shareholders.
4. There is no explicit stipulation as to when such a three-year period starts in the case of the conversion of a limited liability company into a company limited by shares. If a limited liability company is to be changed into a company limited by shares, however, it must satisfy the conditions for companies limited by shares set forth in the company law. Promoters (that is, founders) exist as such only from the establishment of the company limited by shares. That seems to indicate that the three-year-period is meant to start from the conversion, that is, from the issuance of the new business license of the converted company limited by shares. The legal situation, however, is not totally clear.
5. Secondary board rules are also expected to have a two-year lock-up provision for management (though the definition of management is not clear) holding more than 5 percent of a company's shares, and six months for “strategic” investors with more than 5 percent.
6. In the United States, for instance, IPO underwriters determine whether to agree to the frequent request by existing shareholders to participate in the IPO by selling some of their own shares alongside the shares to be newly issued by the company. The underwriter must consider the reaction of investors to this sale, as it is crucial that such sale is not perceived as a lack of faith by insiders in the company's prospects.

Note: US\$1 = RMB8.2793.

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