The Revival of Private Enterprise in China

Edited by
Shuanglin Lin and Shunfeng Song
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The Revival of Private Enterprise in China

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Chapter 1

Introduction

Shuanglin Lin, Shunfeng Song

The reemergence of private enterprises is the most important event in China’s recent economic development. In 1957 China completed socialist reform on the ownership of production means, eliminating all private enterprises. In the following year, China established people’s communes in rural areas and collectivized all farm households. For 20 years, while its neighboring countries were making economic strides, China was still a low-income country. In 1978, a new reform started to bring market mechanics into the economy. The government implemented the household responsibility system in the rural areas, encouraged township-village collective enterprises to develop, and allowed foreign enterprises to establish joint ventures in China. At the end of 1980s, private enterprises were legalized. In his 1992 South China tour, Deng Xiaoping, the architect of China’s economic reforms, called for deepening economic reforms and establishing socialist market economy. Since then, private enterprises have grown rapidly and China has experienced the highest economic growth in the world.

There are officially seven different types of enterprises based on ownership: individual ownership, private ownership, foreign ownership, joint ownership, shareholding corporations, collective ownership, and state ownership. The first five ownerships consist of China’s private sector. Since 1985, the private sector has been the most dynamic source of industrial output growth. In the past 15 years, private enterprises outpaced the state-owned sector and the collectively owned town and village enterprises (TVEs). The persistent growth differentials have translated into a significant shift in the composition of industrial output by ownership types. Until 1990, state-owned and collectively owned firms produced more than 90% of gross industrial output. Since then, the share of output produced by private firms has risen rapidly. In 2000, industrial value-added of state-owned enterprises above designated size accounted for 47% of total industrial value-added, while other types of enterprises produced 53%. In 2004, industrial value-added of state-owned
enterprises above designated size declined to 35% of total industrial value-added, while other types of enterprises produced 65%.

The private sector plays a more important role in creating new jobs. In 1990, state-owned and collectively owned enterprises employed 70 and 24% of urban labor force, respectively, while individual enterprises employed only 4.6% of urban labor force. In 2000, state-owned and collectively owned enterprises employed 35 and 6% of urban labor force, respectively, while other enterprises employed 59% of urban labor force. In 2004, state-owned and collectively owned enterprises employed 25 and 3% of urban labor force, respectively, while other enterprises employed 72% of urban labor force.

Although private enterprises have taken a strong hold in the Chinese economy, they face many obstacles to further grow. Private enterprises are not treated equally, as they are discriminated against by state-monopolized banks in borrowing and are subject to numerous taxes, fees, and levies from local governments. In many aspects, private property ownership is not effectively protected by laws. Private enterprises in China also face many other challenges, such as lack of technical and information support, management experience, international trade and investment experience, and long-run planning. In addition, they must deal with the competition from the state enterprises and government officials’ corruption.

The faster development of the private sector is crucial to the successful handling of the internal and external challenges faced by the Chinese economy. First, unemployment rate remains high. Many state-owned enterprises (SOEs) and collectively owned enterprises (COEs) are losing money and have to lay off workers. Rural disguised and hidden unemployment problem could be much worse. As China further opens markets to foreign competition, there will be more unemployment in SOEs and in rural areas. Second, the income inequality is widening. Income gaps between the rich and the poor and between the rural and city residents are growing. Third, the banking sector is burdened with large non-performing loans and the non-banking financial sectors are underdeveloped. It is difficult to channel large amounts of savings to investment, and the threat of a potential financial crisis still exists. Fourth, China faces a challenge of maintaining a healthy economic growth. The official Chinese statistics show that the growth rate is still as high as 10%. The high growth rate was achieved with large investment in state enterprises and government deficit spending. The influence of government command-and-control on the economy is still strong, and economy has periodically experienced the cycle of decontrol-overheating-control-slump. Fifth, China has entered the WTO and must honor its commitments, including the opening of a number of crucial markets. State-owned enterprises in these markets lack competitiveness.

The economic achievements of the developed countries rely on the development of private enterprises. China is no exception. Private enterprises have contributed significantly to China’s recent economic growth and will play a key role in achieving China’s goal of building a comprehensively well-off society. What are the main obstacles to private enterprise development in China? What measures should be taken to promote private enterprise development? How can private enterprises help China mitigate its macroeconomic problems such as unemployment, income inequality, financial disintermediation, and unhealthy economic cycle? What lessons
can China learn from other countries in promoting private enterprise development and privatization?


Part I begins with a chapter contributed by Li Gan, Shunfeng Song, and Chiu Tan “Higher Efficiencies or Resource Reallocation?” In this chapter, Li Gan, Shunfeng Song, and Chiu Tan analyze the differences in quality of labor between public and private firms in China. Using panel data from different provinces, the chapter finds that more educated workers are better off in non-SOEs while more experienced ones in SOEs. In spite of this, more educated workers are more likely to be found in SOEs, as are more experienced ones. For people leaving school for the work force, the more educated people are more likely to choose to work for an SOE. This trend continues despite an increasing difference in non-SOE compensation. This result suggests that the decline in output for SOEs is not due to less able human capital inputs, but more to inefficiencies in the sector, implying that the slide in SOEs output is likely to continue. Simply matching non-SOEs compensation is unlikely to solve the problem because more able workers are already found in SOEs.

Chapter 3, “Size of the State-Owned Sector and Regional Growth in China,” is contributed by Kerk Phillips and Kunrong Shen. The chapter tests the contributions made by SOEs to China’s economic growth. The authors estimate regressions with various measures of real output growth as the dependent variable and a variety of other factors, including measures of the size of the state-run sector, as regressors. Controlling for a variety of other factors, they find the greater the size of SOEs, as measured by their share of total industrial production, the lower the provincial growth rate. The estimates indicate that a decrease in the SOE share of industrial production by 10 percentage points increases real GDP growth the following year by between 0.7 and 1.2%. The average impact of a reduction in the SOE share in employment by 10 percentage points is between 1.6 and 2.3%.

Chapter 4, “Resource Allocation and Economic Growth in China,” is written by Shuanglin Lin. This chapter shows that the allocation of resources among enterprises of different types of ownership is important to economic growth. The data on 30 Chinese provinces indicate that the investment share of SOEs is negatively related to
the growth rate of per capita GDP, while the investment share of private enterprises is positively related to the growth rate, i.e. the provinces which invested more in private enterprises grew faster than the provinces which invested more in state enterprises. Meanwhile the effect of total investment on the growth rate of per capita GDP appears to be insignificant. The share of trade in GDP was positively related to the growth rate of per capita GDP, indicating that openness is beneficial to economic growth. Also, illiteracy rate of employees seems negatively related to the growth rate of per capita GDP, implying human capital is important for economic growth.

The second part of the book starts with Chapter 5, “Government and Private Enterprises: Wenzhou Experiences” by Wenbo Wu. The chapter presents an analytical narrative on the relationship between government and private enterprises in Wenzhou. In particular, the chapter focuses on the role played by the central and local governments in the evolution of private property rights in Wenzhou’s private enterprises. Since their birth in the late 1970s, private enterprises in Wenzhou have been growing rapidly and developed different guises for their ownership and private identity. The author argues that intergovernmental fiscal relations and private enterprises’ expansion are two critical factors in shaping the development of private property rights. He observes two favorable conditions for the establishment of a secure system of private property rights. Firstly, radical fiscal reforms in 1994 have restricted local expropriation to some degree. Local governments found it less meaningful to directly control operations of private enterprises. Secondly, the private sector’s demand for a well-defined property rights system has been increasing. Under these two conditions, local governments find it in their own interests to collaborate with the central government to protect private property rights.

In Chapter 6, “Property Rights Developments and Productivity Gains in China: A Law and Economics Perspective,” Xiaowen Tian and Vai Io Lo examine the issue of property rights developments from a law and economics perspective to refute an established view in favor of collective rather than private property rights developments in China. The authors find that the Chinese experience cannot, as some have claimed, pose a challenge to the property rights theory. The unsatisfactory economic performance of the Chinese private sector in the 1980s was attributed to the discriminatory legal environment within which private property rights developed. Private property rights had to develop, to a large degree, under the disguise of collectives. Once the political and legal environments improved in the 1990s, the private sector achieved significantly greater productivity gains and contributed more to economic growth than all other sectors, which is shown in a growth model based on an aggregate production function, employing a large set of data that covers 30 Chinese provinces from 1980 to 2000.

Chapter 7, “Evolution of Economic Development: Entrepreneurs, Market, and the State,” contributed by Jack W. Hou, compares the experiences of China and Russia. Though the Russian economy has shown improvement, the current performance still lags behind China, and when one examines the time series of the past decade and a half, the disparity is even more profound. If 1989 is used as the starting point, China’s GDP has nearly doubled, while Russia’s GDP has shrunk more than 40%. Comparing and contrasting the experience of the two dominating former socialist economies in the transition is both inevitable and necessary. Both are waging a great battle for the survival and prosperity of its people. This chapter attempts to address
why China’s reform succeeded while Russia’s didn’t and indirectly tries to find out the reasons why Russia may not be able to replicate China’s reform lies in culture, history, and other “invisible” traits, rather than the erroneous shock therapy.

In Chapter 8, “Private Enterprise Development and Governmental Functions,” Jian He provides a theoretical and systematical definition or explanation of the western governments and gives a detailed discrimination of the central and local governments of the United States. The Chinese economy is experiencing a period of development of private enterprises. However, many obstacles hinder the further growth of the private sector. How can private enterprises overcome those problems? What governmental actions should be taken to promote the development of private enterprises? What lessons can China learn from other countries in promoting private enterprise development and privatization? The chapter attempts to answer the above questions by capturing the nature and flavor of the public manager’s job in western countries and by discussing how the US government promotes private enterprise development by using many different cases. The chapter gives some ideas and views that could be employed by the Chinese administrators in their effort to promote private enterprise.

Part III focuses on financial reforms, openness and private enterprise development. In Chapter 9, “Causes of the Non-Performing Loan Piling-Up in the Late 1990s: A Research Note,” Ding Lu, Sandre Thangavelu, and Qing Hu argue that banks were systematically more risk-taking in giving loans to SOE borrowers because they “gambled for resurrection” in hoping for ex post bailout. The piling up of non-performing loans in China’s banking sector in the late 1990s coincided with the government’s bolstered efforts to restructure SOEs and the banking sector. It is not apparent whether the rise of non-performing loans was mainly caused by the government’s ex ante intervention in banking business or banks’ own rational choice upon the expectation for government’s ex post bailout.

Chapter 10, “Public Venture Capital: Understanding the US and Chinese Experiences,” is contributed by Changwen Zhao, Shuming Bao, and Chunfa Chen. The authors conduct a comparative study of the public venture programs in the United States and China by comparing those differences between public and private venture capitals in terms of their objectives, functions, performance and their policy implications. They try to answer questions such as: why and where should the public venture capital be invested and what is their relationship with private venture capital; how can the public venture capital be more efficient for funding hi-tech start-ups; and what are the strategies to integrate public venture capital and private venture capital? The authors conclude that the hi-tech development in China suffers from the lack of both public venture capital and private venture capital. The government should take a more active role in developing venture capital, fostering a good investment environment for the venture capital industry, and integrating public venture capital with private venture capital for better performance.

In Chapter 11, “The Challenges China’s Private Enterprises Face in the WTO,” Shaomin Huang, Dongxia Wu, and Grant Forsyth argue that China’s accession to the World Trade Organization (WTO) will bring new challenges for many private enterprises. The typical private enterprise is small, family owned and operated, and located in the light manufacturing, agricultural, retail, or service sectors, and it uses
a limited amount of physical capital. Within China, private enterprises have been relatively successful in competing with large SOEs. However, in China’s post-WTO economy, foreign corporations are increasingly encroaching on the private enterprises’ traditional markets. As the competitive pressure increases, it will be crucial for the survival of many private enterprises to update their managerial methods, increase their use of capital, and look for strategies that will grow their businesses. However, this will be difficult given the hurdles associated with obtaining sufficient levels of human and financial capital.

Part IV of the book has three chapters. Chapter 12, “The Privatization of Russian State Industry: Some Lessons for China,” by Marshall I. Goldman, discusses how the results of privatization have been affected by the differences in the way communism in Russia and China evolved. It also attempts to provide insights into what pitfalls China must avoid if it wants to implement a successful program of privatization. In this chapter, the author argues that if Russian reforms had been successful, then neither Soviet-era factory directors nor members of the Soviet nomenklatura would have automatically become owners of the state factories they had been administrating. All those who become owners of state property should have had to compete to obtain that ownership on an equal footing and should pay a fair value for it. The author believes that China should emulate Poland’s model, in which the factory directors do not automatically take over as the owners and the public at large derive some real material benefit from the privatization process, not just in the beginning but on a continuing basis.

Chapter 13, “Politician Control, Agency Problems and Ownership Reform: Evidence from China,” is a permitted reprint of an article in *Economics of Transition, Volume 13 (1) 2005, 1–24*. In this chapter, Lixin Colin Xu, Tian Zhu and Yi-min Lin study the effects of reducing politician control and agency problems on the financial performance of the reformed firms by using data from a recent national survey on the ownership reform of SOEs in China. Taking into account the endogenous nature of the reforms, the authors find that firm performance is positively affected by the lessening of politician control by increasing the firm’s flexibility in labor deployment and mitigating the agency costs through the introduction of more effective corporate governance mechanisms such as one-share one-vote and shareholding-based board structure composition. Ownership structure also affects performance. Relative to shareholding by the state, foreign ownership has a positive effect on firm performance; individual (mostly employee) shareholding has a negative effect; and the effect of collective and legal person shareholding is indistinguishable from that of state shareholding. Somewhat surprisingly, operating autonomy (excluding labor deployment flexibility) has a negative effect on firm performance, suggesting serious agency problems in the reformed enterprises.

In Chapter 14, Wei Yu addresses the issue, “Hospital Ownership: What can China Learn from the US Experience?” He shows that the influence of private for-profit hospitals on China’s hospital market depends largely on the market environment. At the moment, private for-profit hospitals cater to China’s rich patients who are willing to pay for improved quality of services and quality of care. The competition from these hospitals has limited effects on state hospitals. If the private for-profit hospitals begin to serve the general public, the effects on state hospital will be substantial.
He suggests that, due to the special features of medical-care services, such as moral hazards and asymmetric information, the government should be actively involved in quality assessment and regulation, information dissemination, and price management. Many guidelines for these interventions can be gleaned from the US experience.

Part V of the book concerns Corporate Governance and Efficiency. Chapter 15, “Corporate Governance and the Development of Private Enterprise in China,” by Aimin Chen and Ping Li, examines the basic aspects relevant to corporate governance of Chinese firms by evaluating four important relationships concerning ownership structure and corporate control: firm’s relationship with banks, the stock market, the government, and the relationship between managers and employees within the firm. The chapter also tries to answer what type of governance structure is more suitable to help private firms become future modern corporations and what must they consider in seeking a corporate governance model for their future development. The authors conclude that China’s corporate governance structure is neither the Japanese-German style, in which banks have significant control over corporations, nor the Anglo-American style, in which stock and managerial markets function to alleviate principal-agent problems in modern corporations. While Chinese banks remain the major financier of investments in corporative SOEs, they exert little supervising role over the corporations. Meanwhile, stock markets in China are still at its infancy in terms of its capitalization as percentages of total investment financed and of GDP, of the limited number of firms publicly listed, as well as of the irregular operations of corporative firms. There also lacks the managerial market as the government still has considerable control over who to become managers and chairpersons of the boards. China’s enterprise reform, however, is striving to build a modern enterprise system that resembles the Anglo-American mode of corporate governance.

In Chapter 16, “The Productivity Efficiency of State-Owned Enterprises in China,” Chun-Chien Kuo examines the efficiency of SOEs to see if they have improved after the 1997 full-scale share-holding conversion. A stochastic frontier model is adopted to estimate the productivity efficiency of SOEs during 1994–2001. Thirty-seven industry groups during 1994–2001 are included in this study. The primary finding is that the production efficiency of China’s SOEs does not seem to improve after the conversion to the 1997 state share-holding type. The production efficiency of the heavy-industry groups is less efficient compared to other industry group during 1994–2001. This finding indicates an unsatisfactory improvement in the SOEs, suggesting the promotion of the private sector is the most important task that should be given first priority in China’s economic development.

In Chapter 17, Xiaowen Tian discusses “The Prospect of Private Economy in China”. The author talks about how the Chinese government has gradually changed its policy toward the private economy from 1978 onwards, and the economic necessity for the change. He argues that the driving force behind the policy change had been the advantages of private-owned enterprises (POEs) in competitive markets. The author also describes how the private economy arose in China after 1978 and the specific compositions of the private sector. He divides the development of the private economy into three stages. The first stage covered the period of 1978–1988, which was characterized by the rise of individual-owned enterprises and the hidden development of POEs. The second stage covered the period of 1989–1992, in which