The private sector: the new centre of gravity of growth

Yang Yao

Peking University

The private sector has been playing an increasingly important role in China's national economy. Before 1985, the share of private sector industrial output in the national total was negligible, although its share of employment was already around 2 per cent of the national non-agricultural labor force in 1981. In 1985, its share of industrial output reached nearly 2 per cent of the national total. By 1993, that figure climbed to 8 per cent. In 1997, it reached 18 per cent. In value terms, private sector industrial output has experienced an exponential growth in the last 20 years to reach 2,171 billion yuan in 1995 at constant prices. Its share in industrial employment had already reached 18 per cent of the national total by 1995. The expansion of employment experienced a major downturn in the period of 1989 to 1991, but has since grown fast. By 1997, the total number of workers in the private sector reached 67.9 million.

The rapid development of the private sector in the 1990s has been a major catalyst for SOE reform. A major SOE reform in the 1990s was the privatization of small SOEs. Currently, about 80 per cent of firms owned by governments at the county or below administrative units have been privatized. By any standard, this is a major transformation because it has totally changed China's economic makeup by bringing private ownership to the vast majority of firms and workforce in the country (as in any other countries, small firms account for the vast majority of firms in China). There is no doubt that the records of the private sector's performance have been a major catalyst for this great transformation.

In 1995, the central government, after several rounds of investigation and discussion, formed a policy called "*zhuada fangxiao*", "keep the large ones and let go the smaller ones". The policy allowed the state to focus on 500 to 1000 large state firms and allowed smaller firms to be leased or sold out.[1] The government had a good reason to implement this policy. In 1997, the 500 largest state firms had 37 per cent of the assets held by state industrial firms, contributed to 46 per cent of the tax collected from all state firms, and to 63 per cent of the total profit in the state sector. "Control of the (500) largest firms means we have a control of the largest chunk of the state economy." On the other hand, smaller firms owned by local governments had a worse performance than those owned by the central government. In 1995, 24.3 per cent of the central firms were in red, but 72.5 per cent of the local firms were in red (Zhao, 1999).

[1] In 1994, as the ministry in charge of the government's economic affairs, the SETC sent a report *Suggestions on Revitalizing Small State-owned Enterprises* to Vice Premier Wu Bangguo who was in charge of enterprise reforms. In September, 1995, the policy was formally announced by the central committee of the CCP in one of its plenary sessions and was put into the suggestions to the ninth five-year plan.

From the "let go the smaller ones" part of the policy came a word "*gaizhi*", meaning "changing the ownership structure". Starting in 1994, *gaizhi* began to spread to the whole country. The content of *gaizhi* included contracting and leasing, the 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. Yet the government was determined to get rid of the red hat firms. In March 1998, it issued a directive requiring all the red hat firms to ‘take off the hat’ or show their private ownership by November 1998.

Not all the localities had been fully prepared for *gaizhi*. Many firms just changed their names, but nothing else substantial. This is particularly true for firms taking up the ownership category of employee shareholding. These firms are still regarded as collective firms, and local governments still interfere in their operations. This is a problem in the transformation of local governments' functions. Yao and Zhi (1999) have shown that privatization is not sufficient to improve economic efficiency if the role of the government is not changed.

In particular, if the government tolerates its employees' rent-seeking behavior on privatized firms, the efforts provided by private entrepreneurs will not reach the social optimum. In this regard, the municipal government of Shunde has performed well. In the course of its privatization program, the Shunde government undertook a radical reform by cutting one third of its employees and 40 per cent 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 micro-level interference. To a large extent, the smooth and successful transformation in the city should be attributed to government reform.

Before 1988, private firms with more than 5 people were not officially acknowledged. Private entrepreneurs who wanted to expand their operations to more than 5 people had to find a disguise although a few of them dared to ignore the government restriction and operated without any disguise. This created many red hat firms that were registered as collective, but actually run by private entrepreneurs. This was more common in the countryside.

The success of China's rural industrialization prompted an interest to explore whether the combination of private entrepreneurship and collective ownership played a significant role in attaining that success. Many authors argued that this combination was indeed a contributing factor to the success. Their main argument was that the combination was a second best response to China's imperfect market and policy environments (Che and Qian, 1998; D. Li, 1994; S. Li, 1997, to name a few).

While this argument was theoretically sound, that is, the combination of private entrepreneurship and public ownership could be one solution to market and policy failures, it missed the point that many private entrepreneurs put the red hat on just to evade the ideological bias and government regulations (the period of 1989-1991 was the best example). From the perspective of the local government, in many cases it suffered rather than benefited from the presence of a red hat firm.

Before 1988, the existence of red hat firms was more a result of the ideological restriction and government prohibition than a rational choice made jointly by private entrepreneurs and the local government. The influence of ideology was no more obvious then in the period of 1989-1991 when many private owners transferred their factories to collective ownership under pressure of the conservative ideology prevailing in that period. After Deng Xiaoping paid his visit to the south in the spring of 1999, however, private firms flourished again, showing yet another example of what an ideological change could accomplish in China.

Currently, three kinds of ownership are defined for private firms by the Chinese laws governing firm registration. They are sole ownership, partnership, and a limited liability company.[2] Owners of the first two kinds of firms take unlimited liability, and the owners of the last kind of firms only take limited liability in their firms.

As a result, the shares of the three kinds of firms changed dramatically. Limited liability companies had the smallest share in 1991, but became the predominant form of ownership in 1997. A limited liability company offers a firm several advantages including protection of personal wealth, a better firm image, and better internal governance.

In terms of registered capital, limited liability companies are the largest, partnership firms are the second, and sole ownership firms are the smallest. The sizes of all three kinds of firms increased from 1991 to 1994, but from 1994 to 1997, the sizes of partnership and sole ownership firms declined significantly while that of limited liability firms almost remained unchanged. These trends matched clearly China's macroeconomic fluctuations in general and government anti-inflationary measures in particular.

The size and growth rates of private enterprises vary in different sectors of the economy. For example, by the first half of 1999, there are altogether 30,000 private firms in primary industry (mainly agriculture) with a growth rate of 20 per cent compared with the number at the end of 1998. There are 530,000 firms in secondary industry (manufacturing) with a growth rate of about 5 per cent from half a year earlier. The majority of private firms are in tertiary industry (services). The number of firms in this sector reached 722,000 by June 1999, accounting for about 56 per cent of the total number of private firms in China. According to the latest statistics released by BICM, private enterprises hired a total of 8.0 million workers, accounting for about 45 per cent of the total employment in the tertiary industry; their registered capital reached 504.8 billion yuan, accounting for about 62 per cent of the total registered capital in the same industry.

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[2] In the *Law of Incorporation*, two kinds of limited liability companies are defined. One is ordinary limited liability companies, the other is limited liability shareholding companies. The distinction is purely for registration purpose and ignored in most statistic publications. For a discussion of the registration of different types of ownership, see Chapter 10.

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