Modeling the Private Sector in the PRC

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Accompanying CD-ROM contains full-length text in both Chinese and English versions of the original ADBI research paper Modeling Private Sector Development in the People’s Republic of China (Code 62-2005)
The development of private enterprises in the PRC has its own specific background. During the 1950s, the old Chinese capitalist economy essentially died out with the establishment of the PRC and the reconstruction of industry and commerce within the framework of a Soviet Union-style socialist economy.

The socialist economy achieved miracles in some specific areas and historical periods, thanks to the guidance of socialist ideology, which advocated a spirit of dedication to others and society as a whole. However, in the long run this spirit ran against the intrinsic human nature of pursuing self-interest, and the traditional socialist planned economy was unable to attain economic growth on the level achieved by the capitalist economies.

**Why weren't the traditional socialist countries able to compete with the capitalist economies?** Traditional socialist theory assumed that people in socialist countries had common interests and would work hard to attain them. The relationship between people was considered to be cooperative rather than competitive. Communist party members were supposed to have no interests other than the people’s interest as a whole. The motivation to work was to be promoted by a cooperative spirit.

These assumptions were clearly different from those of neoclassical economics originating from Adam Smith, which regarded human beings as selfish entities pursuing self-interest. This behavioral pattern is seen as part of human nature, and not something that is influenced by what and how much education people receive.

Under the policies and practices derived from classic socialist economic theory, people’s activities aimed at attaining wealth, consumption goods, freedom and democracy were greatly suppressed. However, in spite of the ideology and theory people were not motivated to work hard for the common interest and may in fact have tried to work less. It can be concluded that traditional socialist practice was not
successful, and that the promise of the Communist Party to improve the people’s standard of living was never fully realized.

However, at least one basic principle of the “materialism” advocated by traditional socialist economic theory seems to be relevant, i.e. “the economic base determines the social superstructure.” It seems that the Communist Party clearly understood that it would not be able to maintain its advantage and strengthen its political power without having a strong economic base, and satisfying people’s demand for food, clothes, housing, transportation, etc.

People also have non-physical needs, such as democracy and freedom. In fact, ordinary Chinese people never abandoned the objective of improving their living standards. Even in the era of the planned economy, when the demand for goods was distorted and suppressed and private business was regarded as unlawful, the desire for a better life never seems to have disappeared. In most cases, private business existed underground.

The failure of traditional socialist economic practice led some members of the Communist Party of China to reconsider the road of socialism they had pursued. Deng Xiaoping recognized that only a reform and opening up policy could satisfy the people’s needs and maintain social and political stability. Under his leadership, economic reform and a policy of opening to the outside world were launched in 1978. However, with respect to the proper approach for developing the economy, it was not without controversy.

Actually, there are many modes of reform in the world. Academically they can be classified into two main categories, gradualism and the “Big Bang.” What the PRC adopted was a reform characterized by gradualism and a problem-solving approach, in contrast to the “Big Bang” adopted in Russia. It began with the easiest part and then gradually expanded to others, making compromises with vested
interest groups in the planned economy, and when difficulties were encountered, sought new approaches.

In carrying out privatization, there are two general approaches. The first is to privatize existing government agencies, and the second is to maintain existing agencies intact and allow private enterprises to enter into new areas (this is called the “dual system”). The PRC government adopted the second, which is more gradual and smoother than the first. At the early stage of reform, the government was very sensitive on this issue. Though the terms “opening up,” “reform” and “competitive forces” frequently appeared in official documents, the word “privatization” was seldom used.

However, in recent years the PRC has begun to accelerate the privatization of SOEs and to sell SOE assets through the Asset Management Commission, established in 2002. In the past, the provincial governments were simply agents entrusted with tasks by the central government. Now, however, as owners of SOEs, they are able to dispose of SOEs and put the sales earnings into their own budgetary resources.

With the encouragement of the central government, revenue-hungry local governments have rushed to privatize small- and medium-sized SOEs under their jurisdiction. (The South China Morning Post reported that 90% of provincial SOEs in the capital of Hunan province have been sold.) The State Asset Commission indicated that 80% of small SOEs at the county level and 60% of municipal SOEs have been privatized.

As a result of the reform and opening, the PRC achieved a nearly 9% average annual economic growth rate over the past 26 years. The number of private enterprises grew from 90,000 in 1989 to 3 million in 2003, an increase of nearly 33 times, and the number of individual business increased from 12.47 million to 23.53 million, a near doubling during the same period. The number of foreign-funded enterprises increased from 15,919 in 1989 to 226,373 in 2003, up almost 14 times. In contrast to the rapid growth of the private sector, the number of SOEs fell
from 1.55 million to 1.05 million from 1992 to 2003, and the number of collective enterprises from 4.16 million to 1.63 million.

The development of the private sector can be also characterized by the relatively small size and decreasing trend in the average number of employees. In 2003, the average number of employees was 14 for private enterprises and two for individual enterprises, compared to 54 for SOEs in 2001. In 1989 on average, about 18 workers were employed in each private enterprise, but by 2004 this number had fallen to 14. In contrast, the average number of employees in SOEs was relatively stable during the same period, fluctuating within a narrow range between 49 and 56, except for 1992 when it registered a high figure of 76. It should also be noted that most small- to medium-sized SOEs have been privatized.

Although the private sector has attained rapid development, private enterprises, SOEs and foreign funded enterprises are competing on an uneven “playing field.” They still face many barriers. For example, private enterprises face high transaction costs including administration approval costs, barriers to entry, immaturity of the capital market, low management skills and a lack of credibility in the government sector.

There are also many macroeconomic phenomena that can be explained by looking into the private sector development and SOE reform. For example, the 'township-village' enterprises (TVEs), which were once considered to be new and efficient creatures by the PRC, have been disappearing since reaching a temporary heyday in the 1980s. SOEs under the contract responsibility system are facing the same fate. The economy of the PRC has gone through a long period of inflation, and most SOEs and state-owned banks are now burdened by losses and huge non-performing loans.

In the full paper, we begin by analyzing the objectives of enterprises based on the survey carried out by the Chinese Academy of Social Sciences (CASS) and lay out some assumptions. We attempt to create a simple model that can be helpful in simplifying the issues. Based
on this model, we draw some propositions on the determination of output, investment and employment in the course of privatization. Moreover, also based on the model, we discuss the determination of a firm’s residual profit and its implications for the banking sector. Then, we discuss how the number and size of private enterprises in the PRC is determined.

In summary, the findings and implications of the models by us are that:

As far as the CASS survey is concerned, it seems that all firms pursue, roughly speaking, three objectives:

- maximization of profit,
- sales revenue, and
- market share.

Though the difference in behavior between firms may be large, we do not see a significant difference in behavioral patterns among sectors. From the model analysis, we find that enterprises with multiple objectives have larger demand for investment and labor, and tend to produce more output than do those with the single objective of profit maximization. This accords with the objectives of the government sector to pursue higher economic growth and increased employment opportunities.

However, enterprises with multiple objectives may be less competitive than those with the single objective of profit maximization, since they earn smaller profits. Worse, since the marginal productivity of capital is lower than its cost, profits tend to become negative, and enterprises may be unable to repay their loans to the banks. This results in a weakening of the foundation for the existence of the enterprise, or in non-performing loans in the banking sector. In other words, SOEs actually redistribute state-owned assets through negative profits and relatively high salaries that cannot be justified from the real contribution of labor to output.
This model also helps to explain why the number of private enterprises has increased so rapidly along with the scaling down of size. The factors behind the increase in the number of enterprises are privatization and marketization, labor and capital costs, entrance costs and the tax rate.

The deepening of privatization and marketization, relatively lower labor and capital costs, and falling entrance costs, all contributed to increases in the number of private enterprises, while the fall in marginal manager’s ability and deepening of privatization and marketization, fall of entrance costs and other costs all contributed to a decrease in firm size.

The model at least partly helps to explain why the “big bang” reform in Russia led to the sudden and widespread collapses of privatized SOEs, and to some extent helps to explain why gradual reform has been somewhat successful in the PRC. According to this model, the development of private enterprises depends not only on privatization and marketization, but also on a variety of other factors, such as capital cost, labor cost, entrance cost, tax and especially manager’s ability. Holding other conditions constant, bigger enterprises require higher managerial ability and skill, and thus only firms with appropriate marginal ability can survive in a market economy. If a big firm is run by a manager with low ability, it will lose profits and eventually go bankrupt.

The collapse of privatized SOEs in Russia may be attributed to this matching problem. As is well known, in the early period of reform, most private enterprises in Russia were created from the privatization of very large SOEs, and therefore required high managerial ability. However, most of the managers only had experience running enterprises under a planned economy, and had little knowledge about running them under market conditions. Eventually, they ended up being unable to manage big private enterprises. In contrast, when the PRC started to privatize its SOEs, it not only trained a mass of high-level managers in private enterprises to match the size of enterprise, but also accumulated a great
deal of wealth to prepare the physical conditions for the privatization of SOEs.

Due to the rather high political profile of SOEs in the early period of reform, the PRC did not privatize them immediately, but left their nominal ownership unchanged and instituted a so-called contract responsibility system. As a result, many SOEs inevitably faced losses. However, unlike the big bang reform, where individuals took the losses, under the gradual reform in the PRC, the government typically absorbed them.

This process quickly eroded the state’s financial resources, including fiscal and banking, and the state’s liabilities came increasingly close to assets. Once the government (including stated-owned banks) became unable to absorb the losses incurred by SOEs, the acceleration of privatization became inevitable. This is the background of the so-called “Zhuan Da Fang Xiao” reforms.

In summary, we believe this model, described more fully in the paper, has very strong policy implications. SOEs, TVEs and the banking sector should all actively and continuously carry out market-oriented reforms. Private enterprises need to promote market awareness, and thereby transform themselves into pure profit-maximization entities.