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## **The Growth of the Private Sector in China and Implications For China's Accession to the World Trade Organization**

**Updated March 28, 2001**

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# The Growth of the Private Sector in China and Implications for China's Accession to the World Trade Organization

## Summary

Over the past 21 years, economic reforms have transformed China from a relatively inefficient, centrally planned, economy to one that is significantly more market-oriented. The gains in efficiency resulting from free market policies have helped make China one of the world's fastest growing economies in recent years. A key policy in China's economic success has been the decentralization of economic production, which has helped produce a thriving private sector in China.

Prior to 1979, Chinese government policies eliminated most private enterprises. However, over time, the central government's policy towards the private sector has evolved from prohibition, to toleration, to active encouragement. Chinese government data show that the number of private sector employees (i.e., those working for a privately-owned Chinese company or self-employed) rose from 4.5 million in 1985 to an estimated 81.3 million in 1999. The percentage contribution of the private sector to industrial output rose from 1.9% in 1985 to 17.9% in 1997. These data indicate that the private sector in China has become a major factor in China's economic growth and development.

The growth of the private sector in China has occurred to a large extent from the government's efforts to reform China's money-losing state-owned enterprises (SOEs). Workers who have been laid off from SOEs have been encouraged to find jobs in the private sector or to start their own businesses. Yet, private firms in China continue to face a variety of discriminatory policies that restrict their development, especially in sectors dominated by the SOEs. However, in preparation for its eventual accession to the World Trade Organization (WTO), the Chinese government has announced plans to end most restrictive policies against Chinese private firms.

Some analysts contend that WTO membership for China serves U.S. interests by expanding capitalism and diminishing the government's control of the economy, promoting the rule of law in China, subjecting China's trade regime to multilateral trade rules, and creating new markets for U.S. goods and services. Others question whether China's membership in the WTO is good for U.S. interests, especially if China's economic development threatened U.S. jobs at home, China failed to faithfully implement its WTO obligations once it became a member, China opposed U.S. trade liberalization objectives in the next round of WTO multilateral negotiations, or if economic liberalization failed to produce improvements in human rights conditions in China. Either way, this report indicates that the private sector is growing in China and will likely continue to expand in the near future, although it is unclear whether the Chinese government is prepared to truly give private firms an even playing field. A key question is whether China's private sector will be kept as a complimentary feature of China's "socialist market economy," or whether it will be allowed to develop into the dominant sector of that economy. This report examines the changing role of China's private sector, and the outlook for its future development.

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# The Growth of the Private Sector in China and Implications For China's Accession to the World Trade Organization

Over the past 21 years, the Chinese government has undertaken various economic reforms that have helped transform China from a centrally planned economy to one that is considerably more market-oriented. A key aspect of China's economic transformation has been the expansion of the non-state sector (economic activity not directly controlled by the central government) in China, including a growing private sector.

Prior to the implementation of reforms in 1979, the private sector in China was nearly non-existent, due to government policies that strongly discouraged capitalist activities. However, after economic reforms were implemented, the government began removing restrictions on the private sector. In recent years, the central government has encouraged Chinese citizens to start their own businesses, especially workers who have been laid off as a result of government efforts to reform and restructure unprofitable state-owned enterprises (SOEs).

The changing nature of China's economy, and the potential effects on Chinese economic and trade policies resulting from its possible accession to the WTO, could be a factor in congressional debate during the year 2000 over whether to extend permanent normal trade relations (PNTR) status to China. (While PNTR status is not tied to China's WTO accession, it will determine whether U.S.-China trade relations are based on WTO rules once China becomes a member). Many analysts argue that WTO membership would force China to substantially reform its economy, including the privatization of many of its state-controlled sectors. Such a development, it is argued, would benefit U.S. firms doing business in China, namely through the reduction of government interference in the economy, and expanded opportunities for U.S. firms to develop business partnerships with Chinese entrepreneurs. Conversely, other analysts question whether China would fully implement its WTO trade obligations or allow the private sector to play a dominant role in China's economy, especially if such reforms undermined the financial viability of its SOEs.

## **Background on China's Economy Prior to Reforms**

Prior to 1979, China essentially maintained a centrally planned, or command, economy. A large share of the country's economic output was directed and controlled by the state, which set production goals, controlled prices, and allocated resources throughout most of the economy. During the 1950s, all of China's individual household farms were collectivized into large communes. To support rapid industrialization, the central government during the 1960s and 1970s undertook large-scale investments in physical and human capital. As a result, by 1978 nearly three-fourths of industrial production was produced by centrally controlled state owned

enterprises (SOEs) according to centrally planned output targets. Private enterprises and foreign-funded enterprises (FIEs) were nearly non-existent. A central goal of the Chinese government was to make China's economy relatively self-sufficient. Foreign trade was generally limited to obtaining only those goods that could not be made or obtained in China.

China's real GDP grew at an estimated average annual rate of about 5.3% from 1960-1978. However, government policies kept the Chinese economy relatively backward and inefficient, mainly because there were few profit incentives for firms and farmers, competition was virtually nonexistent, foreign trade and investment was severely restricted, consumer goods were scarce, and price and production controls caused widespread distortions in the economy. Chinese living standards were substantially lower than those of many other developing countries.

## **The Introduction of Economic Reforms**

Beginning in 1979, China launched several economic reforms. The central government initiated price and ownership incentives for farmers, which enabled them to sell a portion of their crops on the free market. In addition, the government established four special economic zones for the purpose of attracting foreign investment, boosting exports, and importing high technology products into China. Additional reforms followed in stages that sought to decentralize economic policymaking in several economic sectors, especially trade. Economic control of various enterprises was given to provincial and local governments, which were generally allowed to operate and compete on free market principles, rather than under the direction and guidance or assistance of state planning. Additional coastal regions and cities were designated as open cities and development zones, which allowed them to experiment with free market reforms and to offer tax, trade, and other incentives to attract foreign investment. In addition, state price controls on a wide range of products were gradually eliminated. The government also attempted to initiate reforms to improve the financial performance of SOEs, such as removing mandatory production plans and giving greater autonomy to managers and workers to run their operations. Over time, the government has given greater emphasis to the development of the private sector. In 1992, the Chinese government announced that the goal of economic reform was to create a "socialist market economy" in which market forces were to become increasingly important in determining production and prices, but where the state would continue to exercise overall control of the economy as well as over key economic sectors. Reforms were intended to be gradual and experimental: "crossing the river by touching the stones."<sup>1</sup>

## **China's Economic Growth Since Reforms: 1979-1999**

Since the introduction of economic reforms, China's economy has grown substantially faster than during the pre-reform period (see **Table 1**). Chinese statistics show real GDP from 1979 to 1999 growing at an average annual rate of 9.7%, making China one of the world's fastest growing economies. According to the World

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<sup>1</sup> These characterizations are attributed to remarks made by Deng Xiaoping, the Chinese leader chiefly responsible for launching the reforms.

Bank, China's rapid development has raised nearly 200 million people out of extreme poverty.<sup>2</sup> By 1998, China had become the world's tenth largest trading economy and the second largest recipient of foreign direct investment (FDI) after the United States..

**Table 1. China's Average Annual Real GDP Growth Rates:  
1960-1999**

Time Period	Average Annual % Growth
1960-1978 (pre-reform)	5.3
1979-1999	9.7
1990	3.8
1991	9.3
1992	14.2
1993	13.5
1994	12.7
1995	10.5
1996	9.7
1997	8.8
1998	7.8
1999	7.1

**Sources:** Official Chinese government data reported by the World Bank, *World Development Report* (various issues), and DRI/McGraw-Hill, *World Economic Outlook*, various issues. Note, many analysts suggest that China's GDP growth data may be overestimated.

## Causes of China's Economic Growth

Economists have concluded that productivity gains (i.e., increases in efficiency) were a major factor in China's rapid economic growth. The improvements to productivity were largely caused by a reallocation of resources to more productive uses, especially in sectors that were formerly heavily controlled by the central government, such as agriculture, trade, and services. For example, agricultural reforms boosted production, thus freeing workers to pursue employment in more productive activities in the manufacturing sector. China's decentralization of the economy led to the rise of non-state enterprises, which tended to pursue more productive activities than the centrally controlled SOEs. Additionally, a greater share of the economy (mainly the export sector) was exposed to competitive forces. Local and provincial governments were allowed to establish and operate various enterprises

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<sup>2</sup> The World Bank. *From Plan to Market*, World Development Report, 1996, p. 19.

on market principles, without interference from the central government. In addition, foreign direct investment (FDI) in China brought with it new technology and processes that boosted efficiency.

A study by F.C. Perkins found that export-oriented firms in China have experienced significantly higher productivity growth than non-exporting firms and that non-state-owned enterprises have experienced higher productivity growth than the SOEs. Perkins cites autonomy in decision making and exposure to free domestic markets as the key factors in productivity growth by the non-SOEs.<sup>3</sup> A World Bank study also attributed productivity gains to the expansion of market forces in China, including the rise of the private sector in China:

The reforms also gave greater room for private ownership of production, and these privately held businesses created jobs, developed much-wanted consumer products, earned important hard currency through foreign trade, paid state taxes, and gave the national economy a flexibility and resiliency that it did not have before.<sup>4</sup>

## The Changing Composition of China's Economy

A central factor in China's reform process has been the decentralization of economic policymaking in China in order to promote greater competition and efficiency in the economy. A key aspect of this policy has been to gradually expand the role of the non-state sector in various sectors of the economy (while attempting to improve the performance of the state-run sector). Prior to 1979, SOEs accounted for a significant share of the country's industrial production and employment. Private firms and foreign-funded enterprises (FFE) were nearly non-existent, while local enterprises were subject to state controls and supervision. Since the initiation of reforms, the role of the SOEs in China's economy has greatly diminished, while the role of the non-state sector has substantially increased.

Beginning in the early 1980s, the central government encouraged local and provincial governments to establish their own firms. Local officials in the cities and townships, as well as groups of individuals, were allowed to raise funds to establish and support a wide variety of enterprises (including joint ventures with foreign firms) relatively free of assistance or control from central authorities. Over the past several years, town and village enterprises (TVEs) and urban collectives, which are generally owned by local governments, have been one of the most dynamic sources of Chinese economic growth.<sup>5</sup> The relative success of these ventures has been attributed to the fact that, though government financed, they are essentially run like private businesses

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<sup>3</sup> Perkins, F.C. *Export Performance and Enterprise Reform in China's Coastal Provinces*. Economic Development and Cultural Change, Volume 45, April 1997, p. 502.

<sup>4</sup> Hu, Zuli and Khan, Moshin S. *Why is China Growing So Fast?* The International Monetary Fund, Economic Issues, No. 8, 1997, p.3 (available at [www.imf.org](http://www.imf.org)).

<sup>5</sup> Expanding the authority of local governments to establish their own enterprises has likely been an important factor in building political support for the central government's economic reforms. It enables local officials to become directly involved in such reforms and, in many cases, to directly benefit from such reforms financially.

and must compete in domestic and international markets.<sup>6</sup> Local governments have strong incentives to ensure the efficient operation of such enterprises, since money-making firms are an important source of tax revenues and job creation, while inefficient firms can drain away local financial resources.

Restrictions on private enterprise in China have eased substantially since 1988, and the role of these enterprises in the economy has increased markedly (see discussion below). The role of FFEs in China's economy have also expanded sharply due to a gradual removal of geographical and operational restrictions.<sup>7</sup> The non-state sector is most actively involved in the consumer goods and export sectors, while the state sector dominates heavy and extractive industries such as iron and steel, coal mining, petroleum extraction and refining, as well as utilities, banking, tobacco processing, and transportation.<sup>8</sup> While non-state enterprises exist throughout China, the most dramatic growth in the non-state sector has occurred in the coastal regions.<sup>9</sup>

SOEs accounted for 77.6% of gross industrial output in 1978, but that share fell to 64.9% in 1985, 54.6% in 1990, and to 25.5% in 1997. The non-state sector overtook the state sector in industrial output in 1995, accounting for 57.3% of total industrial output, and that share rose to 74.5% in 1997. Together, TVEs and urban collectives constituted the largest source of industrial output in 1997, accounting for 38.1% of total output. (see **Table 2**). The private sector's share of industrial output rose from 5.4% in 1990 to 17.9% in 1997. The share of other types of non-state enterprises, mainly FFEs, rose from 4.4% in 1990 to 18.4% in 1997.

While the share of SOE industrial output to total industrial output has fallen sharply, SOEs have remained a major source of jobs in China. Employment by SOEs rose from 74.5 million in 1978 to 112.6 million in 1995 (a 51% increase). Recent reform and restructuring of the SOEs, however, have reduced their employment levels to 112.4 million in 1996 and 110.4 million in 1997.<sup>10</sup> Employment in the non-state sector risen more dramatically; from 1978 to 1996 it rose by 385%. TVEs and collectives became China's largest employer in 1990 with 128.1 million employees, and that level increased to 165.2 million by 1996. The private sector in China in 1978 was nearly non-existent, but after reforms were initiated, the number of individuals

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<sup>6</sup> Such enterprises existed prior to 1979. However, they were not allowed to sell their products at market prices.

<sup>7</sup> Initially, foreign investment was permitted only in Special Economic Zones (SEZs), mainly located in China's coastal regions, and was limited to joint ventures. In 1986 the government began to allow foreign firms to establish wholly-owned enterprises in certain sectors. In recent years, the government has removed most geographical restrictions on foreign investment, although restrictions on the scope of foreign investment are maintained in many industry and service sectors.

<sup>8</sup> Australian Department of Foreign Affairs and Trade, *China Embraces the Market*, 1997, p. 360.

<sup>9</sup> *Ibid*, p. 362.

<sup>10</sup> SOEs continue to remain the most significant source of employment in urban areas, although their importance has gradually declined, from 78.3% in 1978 to 64.9% in 1995.

employed in the private sector (i.e., private firms or self-employed) rose from 4.5 million in 1985 to 68.0 million in 1997 (see Table 3).

**Table 2. Percent Share of Gross Industrial Output by Various Sectors: 1978, 1985, 1990, and 1995-1997**

Year	State Owned	Urban Collectives and TVEs	Private Enterprises and Self-employed	Other Types of Non-state Ownership (including FFEs)
1978	77.6	22.4	0.0	0.0
1985	64.9	32.1	1.9	1.2
1990	54.6	35.6	5.4	4.4
1995	32.6	25.5	14.5	17.3
1996	28.5	39.4	15.5	16.6
1997	25.5	38.1	17.9	18.4

Source: *China Statistical Yearbook*, 1998.

**Table 3. Chinese Employment by Type of Ownership: 1978, 1985, 1990, and 1995-1997**  
(millions)

	SOEs	Urban Collective and TVEs	Private Firm or Self-employed*			Other Types of Non-state Ownership (mostly FFEs)
			Total	of which, Private Enterprises	of which, Self-employed	
1978	74.5	48.8	–	–	–	–
1985	89.9	54.3	4.5	–	4.5	–
1990	103.5	128.1	22.8	1.7	21.1	–
1995	112.6	160.1	55.7	9.6	46.1	8.9
1996	112.4	165.2	61.9	11.7	50.2	9.6
1997	110.4	NA	68.0	12.0	56.0	11.1

Note: prior to 1988, official data on private enterprises not fully available.

Source: *China Statistical Yearbook*, 1998.

## China's Growing "Private Sector"

It is difficult to measure accurately the extent of the private sector in China due to the lack of reliable Chinese statistics on this sector and because of the complicated mixture of government and private involvement in the economy. For example, it is difficult to determine whether (or which) TVEs should be classified as private enterprises. On the one hand, these enterprises are generally run like private enterprises and must operate according to market principles (e.g., without government subsidies). On the other hand, such enterprises are owned and controlled by local governments, which often use their political influence to obtain capital for investment as well as to impose restrictions against potential competitors (domestic and foreign).<sup>11</sup> Some private companies in China register as TVEs (or even SOEs) in order to benefit from preferential government policies given to these entities and to evade discriminatory policies against private firms. FFEs might also fall under the private sector category, since the parent company usually is a private business. Yet, while many FFEs in China are wholly-owned ventures, a large number of them are joint ventures; the partners of these types of ventures are mostly SOEs or locally-owned collectives.<sup>12</sup> Thus, it is likely that the private sector accounts for a much larger share of China's economy than is reflected by official Chinese data (such as in tables 2 and 3).<sup>13</sup> Still, even China's official data on the private sector indicate that it is becoming an increasingly important component of China's economy. The rise of the private sector in China has been the result of a gradual change in attitude by the government towards the compatibility (and usefulness) of the private sector with Chinese socialism. The government's attitude toward the private sector appears to have evolved from one of prohibition, to reluctant toleration, and recently to active encouragement.

**Background on the Rebirth and Growth of the Private Sector in China.** Following the Communist takeover in 1949, most private firms were allowed to stay in business, although they were subject to state planning and regulations. In 1952, the government began a series of anti-capitalist campaigns that sought to undermine private entrepreneurs. Businesspeople were routinely condemned as "counter revolutionaries" and many were assessed heavy fines. It is likely that such efforts were intended to make it easier for the state to take control of privately-owned assets. By 1956, the government required private firms to be jointly owned and run by the state; in practice, the state controlled and ran the businesses. Additionally, the state sought to exert its control over China's 29 million full-time handicraft producers (in effect, self-employed entrepreneurs) by taking over the supply of raw materials and

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<sup>11</sup> The level of local government control of TVEs may vary considerably. Sometimes, local governments allow individuals within a community to establish a TVE with little or no direct interference from the government. The enterprise is run like a private firm, but it is technically collectively owned by the community. Some analysts describe TVEs as quasi-government enterprises while others describe them as quasi-private.

<sup>12</sup> Chinese investment data for 1998, indicate that about 48% of approved FDI was for wholly-owned ventures, while about 51% were joint ventures.

<sup>13</sup> The Chinese government in January 2000 announced it intended to conduct surveys on the private sector in China in order to develop more accurate data on its composition and size.

the marketing of handicrafts, and then by requiring handicraft producers to form cooperatives (collective ownership).<sup>14</sup> China's industrial policies were essentially aimed at stamping out capitalist elements in China and establishing state control over most sectors of the economy.<sup>15</sup> As result, entrepreneurship in China was held in low regard.<sup>16</sup>

One of the major objectives of China's paramount leader Deng Xiaoping during the initial stages of the economic reforms launched in 1979 was to revive individual businesses in urban areas in order to promote more rapid economic growth. While private enterprises began to reappear in China during the early 1980s, the highly negative stigma of capitalism generated in the past discouraged many individuals from starting their own businesses. As a result, a significant portion of those entering the private sector initially were ex-convicts, school drop-outs, retirees, and others who had limited options for employment. Eventually, mainstream members of society began to start their own businesses (such as bike repair, restaurants, and beauty parlors).<sup>17</sup>

Prior to 1988, the private economy did not have a defined legal position in China. As a result, many private firms were registered as TVEs or collective enterprises in order to avoid potential interference from the central government and local governments.<sup>18</sup> In April 1988, the National People's Congress adopted an amendment to the constitution stating:

The State permits privately owned economic entities to exist and develop within the limits prescribed by the law. The private economy is a complement to the socialist public economy. The State protects the legitimate rights and interest of the private economy while providing the private sector with guidance, supervision and administrative regulation.

This represented the first time since the Communist government takeover in 1949, that China's private sector was officially awarded legal status.<sup>19</sup> The growth of the private sector was further encouraged after Deng Xiaoping's famous Southern Tour of China in 1992 where he proclaimed the government's commitment toward expanding and deepening economic reforms and opening up to the outside world. In

<sup>14</sup> Dreyer, June Teufel. *China's Political System: Modernization and Tradition*, Third Edition, 2000, pp. 141-142.

<sup>15</sup> Similarly, Chinese agricultural policies during the 1950s led to the collectivization and abolishment of private plots.

<sup>16</sup> Dreyer, June Teufel. *China's Political System: Modernization and Tradition*, Third Edition, 2000, p. 144.

<sup>17</sup> Some individuals feared potential backlashes against entrepreneurship, while others preferred working for the SOEs, where pay, benefits, and pension for minimal work were generally guaranteed.

<sup>18</sup> In addition, such firms wanted to take advantage of tax advantages which were afforded to the TVEs and collective enterprises, but not to private firms.

<sup>19</sup> Wang, Zhonghui. *Private Enterprise In China: An Overview*. *Journal of Communist Studies*, Sept. 1990, p. 85.

1993, the Chinese constitution was amended again to indicate that the government's goal was to establish a "socialist market economy" and that the private sector was a "complement to the socialist market economy." This change represented official government recognition that the market system was not incompatible with socialism. The constitution was amended again in 1999 to state that the private sector was "an important component of China's socialist market economy."<sup>20</sup>

**China's New Entrepreneurs.** It is difficult to make general characterizations of China's new entrepreneurs. Business Week describes them as coming "from a broad sector of society, from peasants' sons to managers who cut their teeth in foreign ventures to academics who are abandoning government institutes and young engineers who studied and worked in California's Silicon Valley."<sup>21</sup> Most private enterprises are small firms involved in production and services that are closely related to daily livelihood, such as light industry, manual trades, transport, construction, and to a slightly lesser extent, commerce and food services and repair industries.<sup>22</sup>

In 1998, about 37.1 % of the country's retail sales and consumer goods and 19.1% of industrial output were generated by the private sector.<sup>23</sup> While some large private companies exist (there are 40 private firms in China having capital of over \$12 million), the average Chinese private enterprise had a registered capital of about \$60,000, employed 14 people, and was involved in simple services or making light industrial goods.<sup>24</sup>

The greatest concentration of private firms is along the eastern seaboard, particularly in the provinces of Guangdong, Shandong, Zhejiang, and Jiangsu, and in the city of Shanghai.<sup>25</sup> Together, these four provinces and one municipality account for almost half of all private businesses in China; Guangdong alone accounts for about 15% of private firms in China. According to one estimate, in parts of China's southern region, private firms produce over 90% of the region's contributions to GDP.<sup>26</sup> Increasingly, private firms are becoming involved in high technology ventures, due in part to the relative lack of competition from SOEs and the desire on the part of the central government to develop high tech industries in China. Examples of major high tech firms in China that are privately owned include Stone Computer in Beijing and Fuxing Hi-Tech Group in Shanghai.<sup>27</sup>

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<sup>20</sup> Muzi Dailynews, March 19, 1999 (available at [www.latelinenews.com](http://www.latelinenews.com)).

<sup>21</sup> Businessweek, *China's New Revolution*, September 27, 1999, P. 23.

<sup>22</sup> Wang, Zhonghui. *Private Enterprise In China: An Overview*. Journal of Communist Studies, Sept. 1990, p.85.

<sup>23</sup> Hong Kong Trade Development Council world wide web site ([www.tdc.org.hk](http://www.tdc.org.hk)).

<sup>24</sup> *Far East Economic Review*, June 11, 1998, p. 49.

<sup>25</sup> Private firms in Shanghai total 99,000 and employ over 900,000 people.

<sup>26</sup> Fang, Xinghai, *Problems with China's Development Strategy*. The World Bank Group, August 1998, available at China Online web page ([www.chinaonline.com](http://www.chinaonline.com)).

<sup>27</sup> Wall, David. *State Needs Help From Mom and Pop*, The World Today, February 1999, (continued...)

The number of individuals employed by the private sector (i.e., privately-owned enterprises or individually-run businesses) has grown rapidly in recent years, rising from 61.9 million in 1996 to 81.3 million in 1999 (an increase of 31.3%). Despite the growing number of private businesses in China, such enterprises face a wide variety of problems:

- ! While firms are allowed to lease property for up to 70 years, private property is not considered sacrosanct and not protected by the Chinese constitution. As a result, many private entrepreneurs do not feel safe about their wealth, which may dampen their business activities.<sup>28</sup> In some instances, corrupt Chinese officials have forced private firms to register as SOEs, then seized their assets. As a result, many private entrepreneurs invest their profits overseas.<sup>29</sup>
- ! Private firms often find it difficult to obtain bank loans. The Chinese government requires China's state banks to provide preferential treatment to SOEs, which, as a result, obtained 87% of China's bank loans in 1996. Private enterprises may only get bank loans outside the official plan, where they face higher interest rates (around 20%) than are given to SOEs and loan periods of just three to six months. When private enterprises need more funding, they must often turn to friends, relatives or neighbors. The interest rates in these circumstances often reach 25-30%. Until recently, most private firms have been barred from using the stock and bond markets to raise funds.<sup>30</sup> At the end of 1998, of the 745 firms listed in China's two stock exchanges, only one was a genuine private company.<sup>31</sup>
- ! Private firms are barred from a variety of industries and services, partly to avoid their competing directly with SOEs. For example, In June 1999 the government defined 18 investment and manufacturing industries that are "forbidden zones for private investment," such as production of non-ferrous metals, fertilizer, pesticides, and cigarettes and tobacco, as well as wholesale sales of goods exclusively sold and managed by state monopolies, state regulated commodities, essential consumer goods, "certain other"

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<sup>27</sup> (...continued)  
p. 26.

<sup>28</sup> Fang, Xingai, *Problems with China's Development Strategy*. Available at China Online web site ([www.chinaonline.com](http://www.chinaonline.com)).

<sup>29</sup> *Washington Post*, January 5, 2000, p. 17.

<sup>30</sup> Xu, Dianqing. *China: Contradictory Measures Frustrate Bank Reform*, Center For International Private Enterprise, 1995. Available at U.S. embassy in Sweden web site (<http://www.usemb.se/ERT/e15/CHINA.HTML>).

<sup>31</sup> Wall, David. *State Needs Help From Mom and Pop*, *The World Today*, February 1999, p. 26.

commodities, and books and periodicals.<sup>32</sup> Also off-limits to private firms are investments in a number of service industries, such as banking and telecommunications.

- ! Some government departments tend to give special treatment to locally-owned TVEs and urban collectives, and many state enterprises are unwilling to establish business relations with private entrepreneurs. While the central government has encouraged the growth of private firms, it continues to give preferences to SOEs in the hope of turning them into large conglomerates.
- ! Corruption has become an enormous problem for many businesses, due to the incomplete nature of China's reforms. Property rights, legitimate business practices, and other basic elements of a market economy remain poorly defined. The state and its bureaucrats (both nationally and locally) are powerful players in the economy. However, there are few legitimate channels of interaction and negotiation between bureaucrats and entrepreneurs.<sup>33</sup> Published laws and regulations are often not enforced. Firms generally must rely on *gaunxi* (connections) with high-ranking government officials, which routinely involves providing officials with entertainment, presents, or cash in order to register businesses, and to obtain licenses, bank loans, and raw materials.<sup>34</sup>
- ! Private firms often find it difficult to obtain accurate information on China's economy. According to one Chinese businessman: "Although the Chinese press has improved a great deal from its heyday of propaganda, it is still unsatisfactory to intellectuals who demand more information and less party talk."<sup>35</sup> Business executives often must rely on foreign sources of information on China through the Internet and other channels. Basic information on China's economy is often unreliable. For example, the State Statistical Bureau and the

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<sup>32</sup> *China Online*, June 22, 1999 ([www.chinaonline.com](http://www.chinaonline.com)).

<sup>33</sup> Johnson, Michael. *The Vices—and Virtues—of Corruption*, Current History, September 1997, p. 270-273.

<sup>34</sup> Some observers have concluded that, in the absence of the rule of law and clear property rights in China, corruption often proves the only effective means for firms to cut through government red tape to obtain needed resources. According to this view, "a corrupt market is preferable to no market." (See Kennedy, Scott. *Comrade's Dilemma: Corruption and Growth in Transition Economies*, Problems of Post-Communism, March/April 1997). At the same time, however, some observers believe that corruption has reached such a high level in China that it has provoked widespread cynicism and anger among China's citizens and has undermined political support for the government. Yet, corruption has helped make local officials rich, so they have little incentive to change the current system. (See U.S. Congress, Joint Economic Committee. *China's Economic Future: Challenges to U.S. Policy*; Study Papers. Politics and Economics in China, by Kenneth Lieberthal, 1996, p. 13.).

<sup>35</sup> Mautz, Hong. *China's Millionaires: A Product of Economic Reforms*, October 7, 1999, (available at [www.intellectualCapital.com](http://www.intellectualCapital.com)).

Ministry of Labor list the official unemployment rate at 3%, while the state media often quotes an unofficial rate of 8%; foreign observers argue that the actual rate is likely to be in the range of 10 to 15%.<sup>36</sup> In addition, many analysts argue that Chinese data on its real GDP growth is overly optimistic, due in part to fabricated data provided by local governments. The inability to obtain reliable economic and financial data affects the ability of firms to make efficient business decisions.

- ! China maintains extensive barriers on import trade and foreign investment. While such barriers insulate many Chinese firms from foreign competition, they also lessen pressure to perform more efficiently. Import barriers raise prices for private (as well as non-private) firms using imported inputs for production. This undermines their international competitiveness. In addition, the central government restricts foreign firms from investing in joint ventures with private firms.

**Recent Improvements to the Business Climate for the Private Sector.** Despite the wide variety of barriers faced by private entrepreneurs, it appears that the political environment for the private sector is rapidly improving. Private sector growth appears to be increasingly viewed by the central government as an important factor in maintaining healthy economic growth as well as for reforming unprofitable SOEs. China's SOEs put an increasingly heavy strain on China's economy. Over half are believed to lose money and must be indirectly subsidized through the banking system. While the government understands that support of unprofitable SOEs diverts resources away from potentially more efficient and profitable enterprises, it has been reluctant to reform SOEs too quickly due to concerns that such reform would lead to widespread layoffs and possible political instability.

In September 1997, Chinese President Jiang Zemin stated that China would take steps which, if implemented, would essentially privatize (although referred to by the Chinese as "public ownership") all but 1,000 out of an estimated 308,000 SOEs by cutting off most government aid and forcing them to compete on their own. The plan called for the closing down of some unprofitable SOEs, while merging others. The government anticipated that such reforms would lead to layoffs for a significant number of workers but expressed confidence that such individuals would be able to find employment in non-state enterprises, mainly in the private sector. In March 1998, Chinese Premier Zhu Rongji announced that SOE restructuring would be accomplished within three years. However, the negative effects on China's economy resulting from the Asian financial crisis forced the government to slow the pace of SOE reforms (especially for the large SOEs) during 1998. During 1999, SOE reform

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<sup>36</sup> U.S. Embassy, Beijing China. *The Reliability of Chinese Statistics*, November 25, 1997, p.5, available on Chinaonline.com). According to the embassy report, "some progress has been made in specific areas of statistical collection, but in most areas, coverage, methodology, and accuracy need to be improved."

was quickened; several small and medium-sized SOEs were allowed to go bankrupt or were sold off and several larger firms were restructured.<sup>37</sup>

Promoting the growth of the private sector has become a key element in the government's attempt to reform and restructure the SOEs. The government appears to be hoping that workers laid off from restructured or bankrupt plants will be able to quickly find employment in the non-state sector, including the private sector. Chinese media reports indicate that the private sector is becoming increasingly important in this respect. For example, it was reported that during the first 11 months of 1999, the private sector absorbed 1.36 million workers laid off by SOEs.<sup>38</sup>

A number of recent steps have been taken by the central and local governments to promote the development of the private sector:

- ! In January 1999, the central government announced that private firms for the first time would be given trading rights (the right to import and exports products); by June 1999 142 trading rights licences had been granted.<sup>39</sup>
- ! In June 1999, the State Economic and Trade Commission for the first time completed guidelines that establish loan guarantees to facilitate bank borrowing by private firms.<sup>40</sup>
- ! In June 1999, the Shanghai government announced that foreign firms will now be allowed to cooperate with or form joint ventures with any legally established private firm. (In the past, policy relating to Sino-foreign ventures was preferential to state-owned firms, while alliances between foreign firms and private enterprises were restricted).<sup>41</sup>
- ! In August 1999, the Chinese National People's Congress passed legislation (effective in January 2000) lowering the minimum capital needed to start a private business from 100,000 yuan (\$12,048) to 1 yuan (\$0.12).<sup>42</sup>
- ! In September 1999, the Guangdong government announced it would permit private firms to own a controlling share of provincial SOEs

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<sup>37</sup> The Chinese government estimated that 11 million workers were laid off from SOEs in 1999 (*China Online*, January 26, 2000). The *Washington Post* (April 6, 2000, p. A23) reported that the Chinese government planned to lay off more than 11 million SOE workers in 2000.

<sup>38</sup> *China Online* ([www.chinaonline.com](http://www.chinaonline.com)), January 6, 2000.

<sup>39</sup> *Muzi Dailynews*, June 30, 1999 (available at [www.china.muzi.net/news/](http://www.china.muzi.net/news/)).

<sup>40</sup> *South China Morning Post*, September 9, 1999, p. 1.

<sup>41</sup> *Muzi Dailynews*, June 30, 1999 (available at [www.china.muzi.net/news/](http://www.china.muzi.net/news/)).

<sup>42</sup> *China Daily*, January 7, 2000, p. 3.

and collectively-owned enterprises in certain industries.<sup>43</sup> In January 2000, the Guangdong announced that certain infrastructure projects would be open to private sector investment.<sup>44</sup>

- ! In January 2000, the Chinese government announced that it planned to scrap all obstacles to the development of the private sector, except in areas relating to national security and certain state monopolies.<sup>45</sup>

Such policy changes, if fully implemented, could make it significantly easier for Chinese entrepreneurs to start and operate their own businesses, borrow money from state banks, and raise capital through public stock offering on China's two stock exchanges.

## **China's Accession to the WTO: Implications For the Private Sector**

Over the past several years, China has been negotiating to accede to the World Trade Organization (WTO), the international agency that administers multilateral trade rules. Part of the WTO accession process involves negotiating bilateral trade agreements with major trading partners who are currently WTO members, including the United States. Until recently, U.S.-China WTO talks had progressed slowly, but on November 15, 1999, the two sides announced that a bilateral WTO agreement had been reached. China must reach agreements with a handful of other WTO members and complete negotiations with the WTO Working Party handling its accession before the full WTO can vote on its membership. Many observers believe China is close to wrapping up all of its negotiations and could join the WTO by the end of 2000. China's membership in the WTO would require it to adhere to multilateral trade rules such as the provision of most-favored-nation, or nondiscriminatory, trade treatment; reliance on tariffs, rather than non-tariff barriers, when it is deemed necessary to protect domestic producers; adherence to tariff rates at fixed maximum levels; national treatment of foreign firms and imported products; and protection of intellectual property rights. The U.S.-China bilateral trade agreement commits China, upon its accession, to make major cuts in tariffs on agricultural and industry products, provide full trading and distribution rights for U.S. firms in China, remove quotas and other quantitative restrictions, eliminate unscientifically based sanitary and phytosanitary restrictions, end export subsidies on agricultural products, open service sectors (many of which are currently closed to foreign firms, such as distribution, value-added telecommunications, insurance, banking, securities, and professional services), eliminate various import restrictions and requirements, and require SOEs to make purchases and sales on a commercial basis.

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<sup>43</sup> *China Online*, September 14, 1999 (available on [<http://www.chinaonline.com>]).

<sup>44</sup> *China Online*, February 1, 2000.

<sup>45</sup> *Washington Post*, January 5, 2000, p. 17.

China's accession to the WTO could result in significant changes to China's economic and trade regimes, many of which are likely to benefit the private sector in China :

- ! The removal of trade and investment barriers would expose a greater share of China's economy to international competition. While some Chinese firms could be negatively affected by such competition, many more stand to gain from the expansion of free market forces. For example, competition from foreign banks could force China to substantially reform its banking system and financial practices, compelling them to cut off loans to unprofitable SOEs and redirecting them towards more profitable ventures. Additionally, competition from foreign banks might force China to permit the growth of privately-owned financial institutions. These measures could substantially improve the ability of the private sector in China to obtain low-cost financing. Reducing tariff and non-tariff trade barriers would lower the cost of imports used as inputs for production, while lowering barriers on services would likely improve efficiency and lower costs of services in China. These measure could help boost the international competitiveness of many Chinese firms.
- ! WTO rules require its members to maintain transparent, consistent, and non-discriminatory trade rules. Should China be admitted to the WTO, it would be required to bring its trade regime in line with WTO rules. Many analysts contend that China's WTO membership would encourage it to enact new laws on business, intellectual property rights, and property ownership rights, as well as to develop an independent judicial system to enforce such laws. Advancing the rule of law in China would create a more stable environment for Chinese businesses to operate in and could weaken the ability of corrupt government officials to extort bribes from private businesses or use their influence to provide special treatment to businesses they own or control.<sup>46</sup>
- ! Upon its accession to the WTO, China would have to give Chinese private firms the same benefits and rights given to foreign firms (such as trade and distribution rights and the ability to invest in certain sectors). Failure to do so, would put Chinese firms at an extreme disadvantage in competing with foreign firms in China.
- ! Liberalization of Chinese trade and investment rules would expand the ability of foreign investors to choose their own Chinese partners for joint ventures. Foreign firms would no longer be forced to join up with a government owned company in order to do business in

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<sup>46</sup> USTR Charlene Barshefsky stated that the strengthening of the rule of law in China was the most important achievement of the U.S.-China WTO trade Agreement. See USTR Press Release, November 15, 1999.

China; instead they could establish partnerships with individuals and firms deemed to be the most dynamic and efficient.

- ! Under the U.S.-China WTO agreement, China agreed that its SOEs would make purchases and sales based on commercial considerations and give U.S. firms the opportunity to compete for sales on a non-discriminatory basis. In addition, SOEs would be subject to WTO rules on subsidies and countervailing measures. These measure would force the Chinese government to end many preferential policies it now gives to the SOEs, and hence could help create a more level playing field for Chinese private firms.

Some analysts believe that China's willingness to undertake reforms necessary for WTO membership represents a substantial change in Chinese economic policy. For example, Edward S. Steinfeld in a September 1999 *Current History* article wrote:

Since the late 1970s, Chinese policymakers had attempted to tweak the socialist system by gradually introducing market forces. The basic idea was to preserve the economy's socialist core—state firms and banks—by introducing change along the margins. These incremental measures over time saw markets established, state planning effectively eliminated, prices liberalized, and non-state-owned industry allowed to prosper, but the underlying logic remained constant. Reforms would be introduced, but always as part of an overriding effort to preserve the traditional core of the economy. The concessions of 1999 represented a thorough reversal of course. Instead of reform serving to sustain the core, the core itself would be destroyed to save reform, along with the growth, prosperity, and stability that reform has brought to China. In the new view, instead of using market forces to save state socialism, state socialism itself would have to be sacrificed to preserve the market economy.<sup>47</sup>

According to this view, China's membership in the WTO will require it to essentially privatize a substantial portion of its economy, not only to be in compliance with WTO rules, but to be able to compete internationally. Such a development, it is argued, would likely benefit U.S. firms doing business in China, namely through the development of the rule of law in China, the reduction of government control over various sectors of the Chinese economy, and enhanced opportunities to develop partnerships with Chinese private firms and entrepreneurs. It is further argued that a vibrant and growing Chinese private sector will enhance economic opportunities, living standards, and economic freedom for the average Chinese citizen, which could help promote greater openness and freedom in China.<sup>48</sup>

Other analysts are not as optimistic over China's entry into the WTO. They argue that, based on China's past record on implementing trade agreements with the United States (which they view as poor), China cannot be trusted to implement its

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<sup>47</sup> Steinfeld, Edward S. *Beyond the Transition: China's Economy at Century's End*, Current History, September 1999, p. 272.

<sup>48</sup> See Remarks by President Clinton to the Paul H. Nitze School of Advanced International Studies, Washington, D.C., March 8, 2000 (available at [www.chinapntr.gov](http://www.chinapntr.gov))

WTO commitments once it becomes a member, especially if trade reforms cause widespread bankruptcies and layoffs as some predict.<sup>49</sup> In addition, many analysts doubt whether China would allow private firms to operate freely in sectors dominated by SOEs, due to concerns that to do so would force many SOEs out of business.<sup>50</sup> Finally, some analysts argue that significant economic reforms in China cannot be made until political reforms are first implemented. Notes John Seel, vice president at Morgan Stanley Dean Witter in Hong Kong:

It is becoming clearer that it's hard to have real economic liberalization without at least some political liberalization—fixing the banks gets even harder without the ability to speak out about the mis-allocation of their resources, and fixing the state sector is harder unless you have a private sector big enough and secure enough to stand up and criticize the government for pumping so much money into state dinosaurs.<sup>51</sup>

## Conclusion

China has substantially expanded the role of the private sector over the past several years. To a large extent, the Chinese government appears to have gotten around the ideological problems of promoting capitalism, first by describing the private sector as a complimentary feature of a socialist market economy, then describing it as an important component. This represents a pragmatic approach to economic policymaking. The private sector has become an ever increasingly important source of economic growth and productivity and has proven to be a critical source of employment in recent years. Without a growing and dynamic private sector to absorb displaced workers, SOE reform would likely prove politically destabilizing.<sup>52</sup> It is not yet clear, however, whether the Chinese government is ready (ideologically or as a practical matter) to allow the private sector to operate on a level playing field with the state sector, let alone to become the dominant force in China's economy. For example, will the government tolerate the development of large privately-owned corporations? What will the government's response be when private firms begin to compete more and more with SOEs and possibly drive some of them

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<sup>49</sup> Mastel, Greg. *Enter China*, Washington Post, January 2, 2000, p. A15.

<sup>50</sup> Such analysts also justify this position on repeated statements by the Chinese government that, under a *socialist market economy*, the government permits various types of ownership, but maintains control over key economic sectors and sets overall economic policies. Based on this ideology, it is argued, China would never allow the private sector to become a dominant force in China's economy.

<sup>51</sup> *The Asian Wall Street Journal*, October 25, 1999. P. S14.

<sup>52</sup> SOE reform has become a critical centerpiece in the Chinese government's efforts to reform the economy in order to ensure long-term economic growth. Nearly half of China's 300,000 SOEs lose money and must be subsidized through China's banking system. Without such assistance, many SOEs would go bankrupt. However, a large portion of state bank loans to the SOEs are not repaid, which threatens the financial solvency of the banking system. Many analysts argue that China's banking system can only be reformed if the banks are allowed to cut ties to unprofitable SOEs, and this can only be accomplished if the SOEs are first reformed and restructured. In order to reform the SOEs, the government must ensure that laid-off workers can find jobs in other sectors of the economy.

into bankruptcy? Will China privatize its banking system? Will the government allow private firms to freely sell stock in China's stock markets? Will the government allow individuals to buy, own, and sell private property? Finally, will the government establish a transparent regulatory business environment (e.g., one that is relatively free of government graft and corruption) that will enable firms to compete fairly and freely?

Many analysts contend that the growth and development of the private sector is critical to China's continued economic growth and ability to compete in international markets. For example Dr. Xinghai Fang, formerly an economist with the World Bank, notes that despite 21 years of reform and rapid economic growth, China has produced few internationally competitive privately-owned firms. Fang states: "I believe that the biggest difficulty that will confront the Chinese economy in the near future is that internationally competitive private firms may not emerge in China for a long time to come. And that it will stunt China's economic growth."<sup>53</sup> Fang believes that China's leaders, while accepting the need for a vibrant private sector, still believe that state-owned companies should play the major role in China's development and have locked out private firms from participating in major sectors of the Chinese economy, thus preventing them from developing large-scale operations. Fang states that this strategy is severely flawed:

Some people may believe that China can become an industrialized economy by properly restructuring and growing its huge number of state-owned companies. This belief is certainly wrong. Countries may manage a few state-owned companies well and make them internationally competitive. Such examples include Singapore and France. But no country can run thousands, and in China's case tens of thousands, of state-owned companies well.<sup>54</sup>

It is difficult to determine what role the private sector will play in the development of China's economy in the near and distant future. Premier Zhu Rongji's March 5, 2000, economic report to the Third Session of the Ninth National People's Congress (NPC) barely mentioned the private sector other than to state: "While keeping the public sector of the economy in the dominant position, sound development of the non-public sector, including self-employed and private businesses, should be encouraged." Instead, the report's main focus was on the modernization of SOEs in preparation for China's WTO accession.<sup>55</sup> However, during the NPC session, 30 NPC representatives submitted a proposal that would give China's private sector access to China's telecommunication's market prior to China's entry into the WTO. While the measure was not adopted by the NPC, Premier Zhu, during a March 16, 2000 press conference, stated that "there is no problem and no difficulty concerning allowing private businesses to take part in the telecom industry. We have already promised to allow overseas private investment to take part in China's telecom

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<sup>53</sup> Fang, Xinghai, *Problems with China's Development Strategy*. The World Bank Group, August 1998, p.1, available at China Online web page ([www.chinaonline.com](http://www.chinaonline.com)).

<sup>54</sup> *Ibid*, p. 2.

<sup>55</sup> Zhu Rongji's *Report on The Work of the Government*, March 5, 2000, 15 pp.

industry. Why should we shut the door on our own private business people? This is not logical.”<sup>56</sup>

It appears that China’s accession to the WTO will likely create substantial new opportunities for Chinese firms, especially in sectors that are being liberalized as part of that accession, and that the Chinese government will continue to promote the development of the private sector to in order to provide jobs for workers laid off by SOE restructuring and reform. However, it appears that central government’s current main economic priority is to make SOEs profitable and internationally competitive, especially in preparation for China’s WTO membership. Thus, it is likely that the Chinese government, in the short run, will continue to maintain many policies that give preferential treatment to SOEs. However, should the SOEs prove unable to meet foreign competition and are forced into bankruptcy, the Chinese government will likely have two options: (1) violate its WTO commitments by re-imposing protective trade and investment barriers, or (2) privatize most or all of the SOEs. The first option would do little to make SOEs more competitive and would likely result in the imposition of trade sanctions against Chinese products by other WTO members. The second option, while likely boosting economic efficiency, might prove a difficult option to swallow, based on current government ideology on what constitutes a socialist market economy, unless Chinese leaders were willing to draw upon an old Chinese saying attributed to Deng Xiaoping: “It doesn’t matter if the cat is black or white, so long as it catches mice.”

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<sup>56</sup> Zhu Rongji press conference, March 16, 2000, p. 5.

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