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## Abstract

China's economic development since 1978 has been fuelled largely by a new private sector that has depended on entrepreneurship. In 1978 the private sector virtually did not exist. In 2005 it was estimated that about one-quarter of gross domestic product (GDP) was produced by the domestic private sector. However, the academic discourse on China's private sector is lagging behind the sector's actual development. Before the market reforms introduced by Deng Xiaoping in 1978, China relied on state entrepreneurship. When the model of state entrepreneurship began to run out of energy, the Chinese Communist Party (CCP) turned to private entrepreneurship as a way of sustaining and accelerating economic development. What were the driving forces behind this rapid growth? An important reason was raw entrepreneurship. This concept has been introduced in the paper as a way of distinguishing new, green-field private firms from privatised SOEs. The definition of raw entrepreneurship or green-field enterprises included two types of genuine private firms: *geti gongshanghu* and *siying qiye*. The *gaizhi*, or privatised firms, have been deliberately excluded in an attempt to generate a study that focussed on the relatively untold story of private business rather than the much better documented history of reformed SOEs. This paper documents the development, history and the present situation of Chinese private enterprises with emphasis on the private sector in Zhejiang province, because private businesses in that province have been best exemplified by raw entrepreneurship and developed more rapidly relative to many other provinces in China.

## Keywords

development, private, businesses, China

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# The Development of Private Businesses in China: 1978-2004

Guibin Zhang<sup>1</sup> and Zhong Qin

## ABSTRACT

China's economic development since 1978 has been fuelled largely by a new private sector that has depended on entrepreneurship. In 1978 the private sector virtually did not exist. In 2005 it was estimated that about one-quarter of gross domestic product (GDP) was produced by the domestic private sector. However, the academic discourse on China's private sector is lagging behind the sector's actual development. Before the market reforms introduced by Deng Xiaoping in 1978, China relied on state entrepreneurship. When the model of state entrepreneurship began to run out of energy, the Chinese Communist Party (CCP) turned to private entrepreneurship as a way of sustaining and accelerating economic development. What were the driving forces behind this rapid growth? An important reason was *raw entrepreneurship*. This concept has been introduced in the paper as a way of distinguishing new, green-field private firms from privatised SOEs. The definition of *raw entrepreneurship* or *green-field* enterprises included two types of genuine private firms: *geti gongshanghu* and *siying qiye*. The *gaizhi*, or privatised firms, have been deliberately excluded in an attempt to generate a study that focussed on the relatively untold story of private business rather than the much better documented history of reformed SOEs. This paper documents the development, history and the present situation of Chinese private enterprises with emphasis on the private sector in Zhejiang province, because private businesses in that province have been best exemplified by raw entrepreneurship and developed more rapidly relative to many other provinces in China.

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# The Development of Private Businesses in China: 1978-2004

As one of the fastest growing emerging markets in the world, China is experiencing a transition from a planned, socialist economy to a market or mixed economy. The emergence of a significant private sector is one of the most important developments of the market-oriented reforms in China over the last quarter of a century. Before 1978 the private sector virtually did not exist, and most of the enterprises were owned by the state or public sector. Since the late 1970s a new type of ownership form has appeared and mushroomed in China's market-socialist economy. An amendment to the Chinese Constitution, passed in 1999, explicitly specifies this emerging phenomenon as the "private economy," which indicates that private enterprises have been legally recognized.<sup>2</sup> This paper describes the development, history and the present situation of Chinese private enterprises with emphasis on private enterprises in Zhejiang province, because private enterprises in that province have developed more rapidly relative to many other provinces. More importantly, the paper emphasizes the ownership structure of private enterprises, focusing on the role of government and family. It then provides stylized facts on the characteristics of family businesses.

## 1 General Backgrounds of Private Enterprises in China

Private business was first revived in the period after the Cultural Revolution as a quick way in which the Chinese government could respond to the mounting pressures of unemployment and economic stagnation. Young (1991) noted that private business was first allowed on the fringes of the economy and was initially regarded as a "supplement" to the state and collective sectors. It was allowed to "fill up gaps" left in the economy, especially in areas such as retailing, handicrafts, food and consumer services. By the late 1970s, private business was operating in this way, but without

<sup>2</sup> This paper focuses on domestic private enterprises. However, due to the availability of official data, the data cited in this paper covers only those enterprises registered as private enterprises; that is, the data exclude "red-hat" firms.

having any real impact on China's central planning mechanism. Thus the early reform process was consistent with the long-term policy and philosophy of the Chinese Communist Party (hereafter CCP). Since the establishment of the People's Republic, the CCP had aimed to eradicate the private sector in the economy. Therefore, even the modest changes allowed in the 1980s were in sharp contrast with past ideology and state priorities (Young 1995: 15). These contradictions continue to characterise some of the most important policy debates in contemporary China.

Despite the contradiction between the central government's ideologically-based desire to limit the private sector, and its economically-based desire to promote it, China's private sector has experienced dynamic growth. Kraus (1991) attributed this growth to the Chinese leadership's commitment to the resurrection of the private sector in political statements, decrees, regulations and laws. These formal pronouncements have given ordinary citizens the confidence to embark on new business ventures without immediately facing the risk of opposing state priorities. According to Young (1991), the policy changes were being driven by economic pressure to create jobs. By the time of Young's research, rural reforms had released a great deal of surplus labour from agriculture, and young people who had been "sent down" during the Cultural Revolution began returning to cities and towns. With the state policy of allowing private business to develop, people started to find jobs in this emerging sector (Young 1991: 10).

### **1.1 The development, history and present situation of Chinese private enterprises**

In the early stages of the People's Republic, private enterprises underwent "socialist transformation." At the end of 1957, there were about one million people in cities and towns engaged in the individual, industrial and commercial sectors (the predecessor of private enterprises). Following the Great Leap Forward (1959-1961) this number declined. During the Cultural Revolution (1966-1976), when chaos occurred

nationwide and government policies had a strong bias against private ownership (a strategy designed to "cut off the tails of capitalism,"<sup>3</sup>) the individual industrial and commercial sector came under continuous political attack. Consequently, by 1978, there were only 140,000 individuals (0.01% of the population) engaged in the private sector. In short, before the reform and the open door policy began in 1978, the individual industrial and commercial sector was on the brink of extinction, and the private economy had lost its legal status.

The situation has changed since 1978. China's market-oriented reforms have produced impressive results, and perhaps the most important result is the emergence of a significant private sector. The important role of private enterprises has recently been formally recognized by the Chinese government. This can be seen in the changes in the legal status of private enterprises, and the enforcement of reform policies.

#### **1.1.1 Legal status of private enterprises: from "a supplement to the socialist publicly-owned economy" to "an important component of the economy"**

The Third Plenum of the Chinese Communist Party's (CCP) Eleventh Conference in December 1978 marked the beginning of market-oriented reforms in China. Although the plenum itself made no specific announcements concerning private business, it emphasized economic development and individual incentives that gave impetus to the revival of private business. The private sector was officially recognized as a supplement to the public sector. Following the recovery of private business, in 1981 the number of people engaged in the individual industrial and commercial sector increased to 2,279,000, or about 1,829,000 households in all.

The private economy then grew steadily. In 1988, the Tentative Stipulations on Private Enterprises (TSPE) was issued by the State Council to govern the registration and management of private firms. In this document a privately-run enterprise was defined as "a for-profit organization that is owned by individuals and employs more than eight

<sup>3</sup> "Cutting off the tails of capitalism" means the elimination of private ownership.

people.” From that time, large private enterprises started to emerge. During 1986-1988, the private economy grew rapidly, but some serious problems, such as products with poor quality and/or fake brand names, also surfaced. Following the Tiananmen Square Incident in 1989, the state became more involved in the administration of the private economy. That is, directed by state policies and influenced by the market mechanism, the private economy became stagnant. As a consequence, the growth of private enterprises slowed and the private economy entered a stage of adjustment and consolidation from 1989 to 1991.

Deng Xiaoping, in his famous southern tour in 1992, called for a broadening of reforms. This was a critical moment in China’s transition to the market. It was followed by a major ideological breakthrough at the Fourteenth Conference of the CCP. For the first time, the market-socialist economy was endorsed as China’s goal of reform, which was the turning point on the road to a fully fledged private sector. Recognition of the private economy commenced an era of rapid development, and attitudes towards private enterprises changed. The greatest change in official attitudes towards private ownership came in 1999, when private enterprises were recognized in the Chinese Constitution as an important component of the economy. Private enterprises have been legally recognized since that time. In 2001 private entrepreneurs were allowed to join the Communist Party, while legitimate private property was protected by the 22<sup>nd</sup> amendment to the Chinese Constitution on March 14, 2004, indicating that private property is now officially recognized in “socialist” China.<sup>4</sup>

### 1.1.2 Enforcement of reform policy

The dual-track approach (partial reforms within sectors) has been an important feature of Chinese reforms since 1979 (Gregory et al., 2000). Two-tier pricing was first introduced in rural areas along with the household responsibility system, and later applied to other sectors, including industry (through the contract responsibility

<sup>4</sup> However, the protection of legitimate private property differs from the protection of public property because public property is still specified as “sacrosanct and inviolable” in the Chinese Constitution (2004), while at the same time, it is difficult to define whether private property is legitimate or not.

system), the national budget (through the fiscal contract responsibility system), and labour markets (through the contract system for new employees in the state sector). The approach was adopted with respect to the development of private enterprises because transfer of ownership was not a part of political debate until well into the second decade of market reforms. In fact, private enterprises were tolerated and even encouraged in areas where large-scale state-owned enterprises (SOEs) did not exist, such as services, light industry, and agriculture.

A policy of ownership reform has been implemented since 1995, when the central government formulated a policy of “grasping the large ones and letting the smaller ones go” (*Zhuadafangxiao*) for SOEs (Gamaut et al., 2005). The central government decided to keep under its ownership 500 to 1,000 large state firms and to reform the smaller SOEs through a package of policy measures including reorganizations, mergers, acquisitions, leasing, and sales. At the same time, collective enterprises (mainly township-village enterprises (TVEs)) were also allowed to change ownership, predominantly through shareholding cooperative reform. When the ownership reform began, the essence of the policy was privatization. This favoured the development of private enterprises.

In conclusion, China’s unique approach to market-oriented reforms has influenced the manner in which the private sector has developed since its re-emergence in the late 1970s. Private enterprises first took hold in the rural sector as an outgrowth of the restructuring of the rural economy and in sectors such as trade and services, where there were a limited number of large state enterprises, and distortions from central planning created market opportunities for private enterprises. The scope of private sector activities then gradually expanded to various sectors. During the 1980s, larger private enterprises grew out of these rural and individual enterprises, and out of collectives and state-owned enterprises, although they were not officially recognized until 1988. In the 1990s, government policy placed increasing emphasis on building a market economy and shifted towards a rule-based framework, which paved the way

for rapid growth of private enterprises. This was given further impetus by policy changes that encouraged ownership reform of smaller, non-strategic state-owned enterprises, and which allowed collectives to transform into private enterprises.

### 1.1.3 Private enterprises as an unintended result of China's economic reform

The changes in the legal status of private enterprises and the enforcement of reform policies, together with the evolution of the definition of private enterprises, reflect the fact that the development of private enterprises was not a clear, careful design on the part of the central and local governments. At the beginning of the reform period, the government did not have a well-defined strategy or a clear blueprint, and did not envisage private enterprises as the driving force of economic growth. Rather, private business was revived in the period after the Cultural Revolution as a quick way to respond to the mounting pressures of unemployment and economic stagnation. As some scholars have argued, private business was an experiment, and for most of the reform period it evolved through cycles of unpublicized experimentation, followed by general "in principle" approval,<sup>5</sup> then by ratification and specific regulations (Gelb et al., 1993). Often, new regulations have been accompanied by "rectification" campaigns, which have impeded private enterprise development. In this manner, reforms are implemented over time, but several years may elapse from the beginning of a reform experiment in one region until it is endorsed by the centre or is imitated by other regions.

## 1.2 Contributions of private enterprises to the Chinese economy

### 1.2.1 General development of Chinese private enterprises

In general, private enterprises in China have developed rapidly since 1978. This is reflected in increasing numbers, registered capital, and employees in registered private enterprises, as shown in Table 3.1. At the same time, the number and employees in SOEs and TVEs has experienced a downward trend since the early

<sup>5</sup> The "in principle" approval is one feature of Chinese bureaucratic style of work, which means that a way of doing things (or a project) is approved but under some restrictions, usually without extant policies or regulations.

1990s (Blue Book of Private Enterprises, 2001, 2002).

Table 3.1 The General Development of Private Enterprises

Year	Privately-run Enterprises			Individual Businesses			Total Employees in Private Enterprises (million persons)
	Heads (millions)	Registered Capital (billions RMB)	Employees (million persons)	Heads (millions)	Registered Capital (billions RMB)	Employees (million persons)	
1978						0.14	
1981				1.83	0.50	2.27	
1989	0.091	8.40	1.64	12.47	34.70	19.41	21.42
1990	0.098	9.50	1.70	13.29	39.76	21.04	22.74
1991	0.11	12.32	1.84	14.17	48.82	22.58	24.92
1992	0.14	22.12	2.32	15.34	60.10	24.67	26.99
1993	0.23	68.03	3.72	17.67	85.49	29.39	33.12
1994	0.43	144.80	6.48	21.87	131.90	37.76	44.24
1995	0.66	262.20	9.56	25.29	168.90	46.14	55.70
1996	0.82	375.20	11.71	27.04	216.50	50.17	61.88
1997	0.96	514.01	13.49	28.51	257.40	54.42	67.91
1998	1.20	1,020.10	17.09	31.20	312.03	61.14	78.24
1999	1.51	1,028.70	20.22	31.60	343.90	62.41	82.63
2000	1.76	1,330.80	24.07	25.71	331.50	50.70	74.77
2001	2.03	1,821.20	27.14	24.33	343.60	47.60	74.74
2002	2.44	2,475.60	34.09	23.78	378.20	47.43	81.52
2003	3.01	3,630.50	42.99	23.53	418.70	46.37	89.36
2004	3.65	4,793.60	50.17	23.51	505.80	45.87	96.04

(Source: Statistical Yearbook of China, 1990-2005; Yearbook of State's Industrial and Commercial Administration, 1992-2005)

Notes: 1. Registered capital in this table is calculated at current prices.

The private sector that grew the fastest was the one containing the new firms or 'green-field' enterprises. In this paper, these firms represent what is called 'raw entrepreneurship' in order to distinguish them from the rest of the private sector that has emerged from older firms that have been converted from SOEs. The definition of raw entrepreneurship or green-field enterprises included two types of genuine private firms: *geti gongshanghu* (individual businesses, employing no more than eight

people) and *siying qiye* (privately-run enterprises, employing more than eight people). In recent years, privately-run enterprises have developed more rapidly than individual businesses. Although the absolute number of privately-run enterprises is smaller than that of individual businesses, registered capital of privately-run enterprises had surpassed that of individual businesses by 1994, and their employees also exceeded employees in individual businesses by 2004.

### 1.2.2 Contributions of private enterprises to the Chinese economy

Table 3.2 Contributions of Private Enterprises

Year	Output		Retail Sales		Tax Revenue	
	Privately-run Enterprises	Individual Businesses	Privately-run Enterprises	Individual Businesses	Privately-run Enterprises	Individual Businesses
1978						0.33
1989	9.70	56.00	3.40	1147.00	0.01	11.97
1990	12.20	64.20	4.30	127.00	0.20	13.20
1991	14.70	78.20	5.70	152.60	0.34	15.08
1992	20.50	92.70	9.10	186.10	0.46	17.66
1993	42.20	138.70	19.60	271.00	1.05	31.47
1994	114.00	163.80	51.30	421.10	1.75	36.04
1995	229.50	279.10	100.60	535.60	3.56	40.13
1996	322.70	353.90	145.90	670.60	6.02	39.78
1997	392.30	455.30	185.50	807.40	9.05	46.05
1998	585.30	596.00	305.90	978.00	16.38	53.69
1999	768.60	706.30	419.10	1,200.00	25.50	57.58
2000	1,074.00	716.20	581.30	1,135.00	41.44	76.27
2001	1,232.00	731.70	624.50	1,149.00	66.09	91.76
2002	1,534.00	796.80	792.90	1,222.00	94.56	100.50
2003	2,008.30	874.10	1,060.30	1,342.30	138.83	104.75
2004	2,295.04	809.80	1,303.90	1,225.20	199.50	121.20

(Source: Yearbook of State's Industrial and Commercial Administration, 1991-2005; Taxation Yearbook of China, 1991-2005)

Notes: 1. The data in this table are calculated at current prices.

The increasingly important role of private enterprises is reflected in the rapid increase in their share of output, employment and even tax revenue in the national total. Initially only allowed to operate on the fringes of the economy, it is estimated that about one-quarter of gross domestic product (GDP) was produced by the domestic private sector in 2005 (Yearbook of State's Industrial and Commercial Administration, 2005), while total employees in private enterprises accounted for 12.8% of the national total in 2004 (Statistical Yearbook of China, 2005). In recent years, new employment in private enterprises has exceeded the combined total for state, collective, and township-village enterprises (Report of China's Citizen-run Enterprises, No.1, 2004).

As shown in Table 3.2, from 1990 to 2004 (deflated by the Consumer Price Index, 1990=100), the output of private enterprises increased in real terms from 76.4 billion RMB to 1478.5 billion RMB, with an average annual growth rate of 23.57%. At the same time, retail sales increased from 131.3 billion RMB to 1204.3 billion RMB, with an average annual growth rate of 17.15%, and tax revenue increased from 13.4 billion RMB to 152.7 billion RMB, with an average annual growth rate of 18.98%.

From official data, it appears that private enterprises have achieved impressive growth with relatively few resources; that is, private enterprises have in general made more efficient use of capital (Gregory et al., 2000). Regarding the share of tax revenue of private enterprises in the national total, it was as low as 8% in 1995 while SOEs and TVEs accounted for 56% and 15% respectively. However, there are several considerations which should be noted. First, there has been an upward trend in the taxation share of private enterprises since 1990 when it was at 6.8%, indicating their potential contribution to tax revenue. Second, because the data exclude "red-hat" firms (fake collectives)<sup>6</sup>, the actual share of private enterprises should be higher than the official data indicates. Third, considering the input-output ratio, although the state

<sup>6</sup> Also known as hang-on enterprises (*dai hongnaozi, guahua qiye* in Chinese). These can best be described as privately-owned firms that find it convenient to adopt the appearance of being state or collective enterprises.

generally does not invest in private enterprises since the re-emergence of private enterprises, private enterprises still pay tax to the government. Therefore, the contribution to tax revenue by private enterprises is fairly impressive. Private enterprise share of total tax revenue increased 5.7 percentage points from 1990 to 2004 and was 12.5% in 2004.

In summary, private enterprises are the most dynamic component of the domestic economy, and the development of private enterprises constitutes an important component which has contributed to the rapid economic growth in China for more than two decades.

## 2 The Development of Private Enterprises in Zhejiang Province

The development of private enterprises in Zhejiang province generally corresponds to the evolutionary trend of private enterprises in China, as discussed above. According to a Report of Zhejiang Statistical Bureau (2003), at the beginning of the foundation of the People's Republic, there were 600,000 individual businesses with 990,000 employees, and 7,650 privately-run enterprises with 107,000 employees. After the socialist transformation and the Cultural Revolution, there were only 2,086 individual businesses on the eve of market reform in 1978. Since the commencement of the reform period, Zhejiang private enterprises have developed more rapidly compared with many other provinces. The characteristics of the development of Zhejiang private enterprises constitute the so-called "Zhejiang model," which is best exemplified by the notion of *raw entrepreneurship* and now used as a reference by other provinces to achieve high and sustainable economic growth. This section discusses the historical development, current state, and some stylized facts of Zhejiang private enterprises since 1978.

### 2.1 Historical development of Zhejiang private enterprises

Chronologically the development of Zhejiang private enterprises spans three periods since 1978. The first period was from the commencement of reforms in the late 1970s

to the early 1990s, when private enterprises re-emerged and experienced an initial spurt of market-oriented development. In 1978, the share of GDP produced by private enterprises was only 5.7%. Since then, private enterprises in Zhejiang have developed rapidly. However, initially many private enterprises claimed they were collectives to avoid government predation and ideological harassment. Therefore, this period was characterized by the development of collective enterprises, many of which were "red-hat" firms, while registered private enterprises represented a small proportion of the provincial economy. In 1990, the share of GDP produced by private enterprises was still low at 15.7% (while the share of GDP by collective enterprises was high at 53.1%) (Zhejiang Statistical Yearbook, 2005).

Table 3.3 The General Development of Zhejiang Private Enterprises

Year	Privately-run Enterprises			Individual Businesses			Total Employees in Private Enterprises (million persons)
	Heads (thousands)	Registered Capital (billions RMB)	Employees (million persons)	Heads (millions)	Registered Capital (billions RMB)	Employees (million persons)	
1990	11.00			1.00		1.53	
1991	11.00	0.73	0.15	1.00	4.00	1.55	1.70
1992	11.50	1.10	0.18	1.12	5.22	1.74	1.92
1993	19.40	4.29	0.26	1.24	8.07	1.97	2.23
1994	46.00	13.67	0.68	1.43	12.20	2.32	3.00
1995	72.00	25.12	1.05	1.54	17.30	2.54	3.59
1996	87.70	34.70	1.17	1.68	22.70	2.65	3.82
1997	91.80	47.01	1.36	1.53	21.99	2.56	3.92
1998	100.20	78.80	1.53	1.58	22.67	2.68	4.21
1999	146.40	97.60	1.92	1.64	25.03	2.81	4.73
2000	178.80	136.90	3.00	1.59	29.96	2.72	5.72
2001	208.80	179.50	3.47	1.58	31.11	2.77	6.24
2002	247.30	205.70	4.04	1.53	33.23	2.76	6.80
2003	302.20	286.00	4.84	1.59	40.75	2.98	7.82
2004	333.20	390.60	5.09	1.68	49.83	3.21	8.30

(Source: Zhejiang Statistical Yearbook, 1990-2005; Yearbook of State's Industrial and Commercial Administration, 1992-2005)

The second period was from the early 1990s to the late 1990s, when registered private enterprises obtained prominence. Following Deng Xiaoping's 1992 speech, private



enterprises began to enter the period of the first “leap,” while many “red-hat” firms took off their “red-hats” and registered as private enterprises. As shown in Table 3.3, from 1991 to 1997, registered individual businesses (*geti gongshanghu*) and privately-run enterprises (*siying qiye*) increased from 1 million to 1.53 million firms, and from 11,000 to 92,000 firms, respectively. At the same time, their workforce increased from 1.56 million to 2.56 million and from 0.17 million to 1.36 million employees, respectively. In 1997, the share of GDP produced by private enterprises accounted for 33.7%; that is, one third of provincial GDP (while the share of GDP by collective enterprises declined to 36.7%) (Zhejiang Statistical Yearbook, 2005).

The third period is the latest period of development for private enterprises dating from the late 1990s. As shown in Table 3.3, the number of privately-run enterprises reached 333,200 firms in 2004, which placed Zhejiang third among China’s provinces in terms of number of enterprises,<sup>7</sup> while the number of Zhejiang’s individual businesses reached 1.68 million, which ranked second among China’s provinces.<sup>8</sup> The registered capital of privately-run enterprises accounted for 390.6 billion RMB, while that of individual businesses was 49.83 billion RMB in 2004, with average real annual growth rates since 1991 of 53% and 15% respectively. In addition, the workforce in private enterprises increased to 8.3 million employees in 2004. The share of GDP produced by domestic private enterprises continued to increase, and reached 55.1% of the provincial total in 2004 (while foreign-invested enterprises accounted for only 7.4%) (Zhejiang Statistical Yearbook, 2005). In short, private enterprises now underpin more than half of the provincial economy.

## 2.2 Current state of Zhejiang private enterprises

### 2.2.1 Standing at the forefront of private enterprise development in China

Zhejiang stands at the forefront of private enterprise development in China’s

<sup>7</sup> The first was Jiangsu province with 401,000 privately-run enterprises, and the second was Guangdong province with 389,800 privately-run enterprises (Report of China’s Citizen-run Enterprises, No.1, 2004).

<sup>8</sup> The first was Guangdong province with 1.7 million (Report of China’s Citizen-run Enterprises, No.1, 2004).

provinces. This is reflected not only in the figures presented above, but also the increase in industrial output, retail sales of social consumer goods, tax revenue, and export value, as shown in Table 3.4. Calculated in real terms from 1990 to 2004 (deflated by the Consumer Price Index, 1990=100), the output of private enterprises increased from 14.1 billion RMB to 471.9 billion RMB, with an average annual growth rate of 28.5%. At the same time, retail sales increased from 7.1 billion RMB to 159.8 billion RMB, with an average annual growth rate of 24.9%, and tax revenue increased from 0.8 billion RMB to 15.4 billion RMB, with an average annual growth rate of 23.5%. The average annual growth rates in Zhejiang for these three indicators are higher than the corresponding national average annual growth rates during the same period at 4.9%, 7.7%, and 4.5%, respectively. The development of private enterprises in Zhejiang has become an important component of the provincial economy (Report of China’s Citizen-run Enterprises, No.2, 2004).

Table 3.4 Contributions of Zhejiang Private Enterprises

Year	Industrial Output (billions RMB)	Retail Sales (billions RMB)	Tax Revenue (billions RMB)	Export (billions US Dollars)
1990	14.10	7.10	0.80	0.05
1991	17.30	7.80	1.00	0.07
1992	20.90	8.70	1.60	0.10
1993	28.70	12.60	2.32	0.06
1994	79.00	32.90	2.89	0.22
1995	173.30	89.20	2.85	0.45
1996	238.80	121.60	3.95	0.58
1997	257.90	125.00	3.90	0.71
1998	317.30	128.80	4.88	1.30
1999	399.30	154.40	6.04	2.82
2000	573.70	200.60	9.00	6.50
2001	645.30	222.50	12.69	8.24
2002	742.70	267.70	16.98	8.91
2003	827.10	290.80	22.05	9.94
2004	990.98	335.60	32.36	14.90

(Source: Zhejiang Statistical Yearbook, 1990-2005; Yearbook of State’s Industrial and Commercial Administration, 1992-2005; Taxation Yearbook of China, 1990-2005)

In summary, following two decades of private enterprise development in Zhejiang, the industrial output, sales revenue, retail sales of social consumer goods, and exports of private enterprises have shown a continual upward trend, strongly contributing to the provincial economy. Zhejiang was ranked first nationwide in terms of absolute numbers in each of these categories over seven years from 1998 to 2004 (Report of China's Citizen-run Enterprises, No.2, 2004, p.182). In 1978 Zhejiang's GDP was only 12.4 billion RMB, which ranked twenty-fourth nationwide, while in 2004 its GDP reached 1,124.3 billion RMB, which placed it fourth in China. At the same time, it was estimated that Zhejiang's per capita GDP also ranked fourth in China in 2004, as shown in Table 3.5.

Table 3.5 Zhejiang's Economic Indices and Position among China's 31 Provinces, Autonomous Regions, and Direct-Jurisdiction Cities in 2004

Economic Indices	Zhejiang's Level	National Average level	Zhejiang's Ranks in China
Population (million persons)	47.20	1,299.88	--
GDP (billion RMB)	1,124.30	13,687.59	4
Per Capita GDP (RMB)	23,942.00	10,561.00	4
Disposable income of Urban Residents (RMB/per person)	14,546.38	9,421.61	3
Net income of Rural Residents (RMB/per person)	5,944.06	2,936.40	3
Consumption Expenditures of Urban Residents (RMB/per person)	10,636.14	7,182.10	4
Living Consumption Expenditures of Rural Residents (RMB/per person)	4,659.11	2,184.65	2

(Source: Statistical Yearbook of China, 2005)

### 2.2.2 The industrial distribution of Zhejiang private enterprises

The scope of private sector activities has expanded from sales, services, and small transportation, to almost every industrial sector, except for a few industries prohibited

by state policy such as basic energy and military industries. At present, Zhejiang individual businesses (*geti gongshanghu*, employing no more than eight people) are concentrated in tertiary industry while privately-run enterprises (*siying qiye*, employing more than eight people) are mainly concentrated in secondary industry, which has become a new area of provincial economic growth. In 2004, among the total incremental industrial output produced by private enterprises, secondary industry accounted for 65.2%, while tertiary industry accounted for 30.6% and primary industry accounted for only 4.2% (Report of China's Citizen-run Enterprises, No.2, 2004, p.182). In general, the industrial distribution of Zhejiang privately-run enterprises has shifted from "primary, then secondary, and then tertiary industries" at the beginning of the reform period to "secondary, then tertiary, and then primary industries" at present. That is, secondary industry is the main area in which private-enterprise production is concentrated.

### 2.2.3 Emergence of large enterprises and diffuse ownership structure

Many large private enterprises have emerged and developed recently, meaning that Zhejiang had 183 firms in the largest 500 private enterprises in China in 2003, which was the highest of any of the Chinese provinces (Report of China's Citizen-run Enterprises, No.1, 2004, p.584).<sup>9</sup> Meanwhile, private enterprises have developed a more diffuse ownership structure. There were 140,000 limited liability companies, which accounted for 59% and 84% in terms of firm number and registered capital respectively in total private enterprises in Zhejiang province in 2004 (Report of China's Citizen-run Enterprises, No.1, 2004, p.587). The reasons for this are twofold. The first is that when private enterprises grow, they have the incentive to merge, acquire, and cooperate with others. Taking industrial privately-run enterprises with annual sales revenue over 5 million RMB for example, in 1998, there were 952 solely-run companies and 937 limited liability companies in Zhejiang province, accounting for 42.3% and 41.6% of total private enterprises, respectively. In 2004, limited liability companies increased to 7,467, accounting for 72.5% of total private

<sup>9</sup> The second was Jiangsu with 105 firms, and the third was Shandong with 45 firms.

enterprises, while the ratio of solely-run companies declined to 21.9% (Report of China's Citizen-run Enterprises, No.1, 2004, p.587). The second reason is the ownership reform of SOEs and TVEs. By the end of 2002, 92% of SOEs and 96.5% of TVEs had transferred to registered private enterprises in Zhejiang province (Report of Zhejiang Statistical Bureau, 2003).

However, in general, the expansion of Zhejiang private enterprises relies heavily on quantity, so that most of them are characterized by sparse, small, and low technology. Within the secondary industrial private enterprises, there were 18,000 firms with annual sales revenue over 5 million RMB in 2004, accounting for only 5% of total private enterprises (Zhejiang Statistical Yearbook, 2005). Consequently, most private enterprises are still small firms owned and managed along family lines. This will be further examined in the next section, as part of the discussion of ownership structure in private enterprises (see Section 2.3.3).

## 2.3 Some stylized facts of Zhejiang private enterprises

### 2.3.1 From the Wenzhou model to the Zhejiang model

The development of Zhejiang private enterprises constitutes the so-called "Zhejiang model," which is derived from the well-known Wenzhou model. Wenzhou is a prefecture-level municipality located in the south-east corner of Zhejiang. The Wenzhou model is a pattern characterized by the development of *green-field* private enterprises, which differs from the Sunan pattern that characterized the development of collective TVEs. The notion of the Wenzhou model first appeared in 1985 because of the impressive economic achievement of Wenzhou.<sup>10</sup> Since then, the Wenzhou model has expanded to typify the ownership characteristics of private enterprise province-wide and is frequently cited in the literature (Yuan, 1987; Sun, 2000; Blue Book of Private Enterprises, 2001, 2002).

<sup>10</sup> See "Three-hundred Thousand People Engage in Family Industry in Wenzhou" in *Shanghai Revolutionary Daily*, 12 May, 1985.

At present, there are about 350 thousand private enterprises (including privately-run enterprises and individual businesses) in Wenzhou, accounting for 98.8% of total industrial firms. Industrial output produced by private enterprises in Wenzhou accounts for 96% of total industrial output, tax revenue from private enterprises accounts for about 70% of total fiscal revenue, exports of private enterprises account for more than 95% of total exports, and employees within private enterprises account for about 80% of total employees. Calculated in real terms, between 1978 to 2003 Wenzhou's real GDP increased from 1.32 billion to 43.45 billion RMB with an average annual growth rate of 15%, real fiscal revenue increased from 0.14 billion to 5.43 billion RMB with an average annual growth rate of 16%, and average net real incomes of rural residents increased from 114 RMB to 1,981 RMB with an average annual growth rate of 12%. From 1981 to 2003, average disposable real incomes of urban residents also increased from 423 RMB to 5,939 RMB, with an average annual growth rate of 13% (Report of China's Citizen-run Enterprises, No.1, 2004, pp.183-184).

In terms of institutional arrangements, the Wenzhou model is famous for three innovations. The first was the practice of individual household firms "wearing a red hat" during the period from the late 1970s to the mid-1980s. The second innovation was the formation of joint-stock cooperatives from the mid-1980s to the mid-1990s (Sun, 2000). The third innovation was the transformation of joint-stock cooperatives to limited liability companies or joint-stock companies that occurred from the late 1990s. In general, the Wenzhou model is acknowledged as a typical case of "reforming from below," that is, the radical nature of these innovations and their subsequent evolution was a result of individuals, households, and government officials at the local level pursuing their pragmatic interests, rather than following "top-down" directives (Sun, 2000).

### 2.3.2 The role of the government

The role of central planning in the Zhejiang economy has been weak relative to many

other provinces, which leads Zhejiang enterprises to rely on the market for survival. Driven by the profit motive, private enterprises, most of which operated with little investment but produced good economic results, have developed in Zhejiang. Due to the relatively weak planned economy, the correspondingly lenient government administration has provided a sound environment for economic institutional changes. However, prior to Deng Xiaoping's 1992 speech and subsequent ownership reform in the mid-1990s, the development of private enterprises was restricted and strongly influenced by central government policy. In this sort of situation, every level of the Zhejiang government offered tacit consent and even encouragement of institutional innovation. This was manifest in the practice of "wearing a red hat" to retain an affiliation to an established collectively-owned or state-owned enterprise (Sun, 2000). In this respect the role of government was to mainly serve as protection for burgeoning private enterprises.<sup>11</sup> In the second innovation of the Wenzhou model, the government mainly served as a market promoter and withdrew its ownership shares in private enterprises, meaning that there was almost no community shares in joint-stock cooperatives (Sun, 2000). In the third innovation of the Wenzhou model, the government generally served as a regulator to facilitate the emergence of limited liability companies and joint-stock companies in private enterprises.

In summary, the government has played a pivotal role in the Zhejiang model, as well as in recent ownership reform, because ownership reform in SOEs and TVEs in Zhejiang was implemented at every level of government. In general, the role the Zhejiang government played in the development of private enterprises is represented by the fact that local governments not only colluded with private entrepreneurs to pursue local interests, but also functioned as an active market regulator to promote the access of private enterprises to capital, and to champion the reputation of Zhejiang private enterprises' products in national and international markets (Sun, 2000; Report of China's Citizen-run Enterprises, No.2, 2004). In recent years, the Zhejiang

<sup>11</sup> Of course, a "red-hat" firm could also enjoy some preferential policies such as taxation and bank loans under the title of a "collective" firm in the 1980s and early 1990s.

government has issued several policies and regulations such as "Some Opinions of Promoting a New Leap of the Citizen-run Economy" (13 July, 2004),<sup>12</sup> in which it emphasizes that the role of government is to guide the development of the private economy. Thus, the role of the Zhejiang government has shifted from active participant in the firm's economic activities to regulator and service provider that facilitates the market environment. This provides a conducive external environment for the development of private enterprises.

In Zhejiang most private enterprises evolved naturally from primitive self-accumulating capital while only a few are from Hong Kong, Macao, and Taiwan or have foreign capital. From 1980 to 2001, non-government investment increased from 1.7 billion to 151.8 billion RMB, with an average annual growth rate of 25.2%, which is 0.6 and 2.5 percentage points higher than the average rates of overall fixed assets investment and state investment, respectively (Zhejiang Statistical Yearbook, 2002). In 2004 non-governmental investment accounted for 66.8% of total investment (Zhejiang Statistical Yearbook, 2005), becoming the main source of overall fixed assets investment. This differs not only from the Sunan pattern in Jiangsu province, where private enterprises are mainly spin-offs from state and collective enterprises, but also from the Pearl River Delta pattern in Guangdong province, where private enterprises are often promoted by Hong Kong, Macao and foreign capital.

### 2.3.3 The prevalence of family businesses

While a more diffuse ownership structure in Zhejiang private enterprises has emerged and developed in recent years, it is estimated that about 90% of total private enterprises are family businesses (Blue Book of Private Enterprises, 2001, 2002; Gan, 2002).<sup>13</sup> This includes solely-owned, family-owned, and family-holding firms. Family

<sup>12</sup> The phrase of "citizen-run economy" is a pseudonym of the private economy.

<sup>13</sup> There is no commonly accepted definition of family business (Gan, 2002). The narrowly defined family business refers to a firm in which there are at least two generations of family members working in the same firm and they have effective control (say, with 50% of total property rights) of the firm, while the broadly defined family business refers to a firm in which family members, including those with blood and marriage links, have effective control of the firm. The estimation of family business here takes an extremely broad definition, including single-person type of firms because these firms represent non-separation of ownership and control in terms of

businesses in fact can take any legal forms as registered solely-run companies, partnerships, or limited liability companies. In short, family businesses constitute the majority of private enterprises. Therefore, most private enterprises are in a stage of family management, where ownership and control in these businesses are not separated in terms of corporate governance (Fama and Jensen, 1983; Chandler, 1990; Gan, 2002).

Markets in China are generally accepted as underdeveloped relative to Western countries (Singh, 2003). The capital market is immature in China and the banking system is less efficient. Most banks in China are state owned, particularly the central bank and the four commercial banks that play the principal role in the Chinese financial system. Failure to recover loans from SOEs is often not considered as a loss of state assets, but a failure to recover loans from private enterprises is considered a serious problem. This illustrates a "lending bias" against private enterprises (Perotti, 1993; Chow and Fung, 1998). It was difficult for private enterprises to obtain bank loans, especially in their early days, when they were seriously short of capital. Banks were only willing to grant loans to large private enterprises. Private enterprises of all sizes often needed to pay rebates demanded by bank officers to secure loans. Due to an immature financial system in China, self-accumulation or retained profit is the basic source for private enterprises to raise capital.<sup>14</sup>

At the same time, the lack of both qualified managers and skilled workers is a common problem facing private enterprises (Blue Book of Private Enterprises, 2001, 2002). Due to the relatively long history of the planned economy in China, a group of entrepreneurs has not yet emerged (Zhang, 1999). While more people with high

educational qualifications are engaging in private enterprises, many private entrepreneurs have low levels of education.<sup>15</sup> There are two main reasons why many college graduates do not want to work in a private enterprise, even if it pays a higher wage than a state firm. The first is that state firms are generally able to offer greater job security and social benefits. The second reason is a reflection of family management in most private enterprises, in which the owner of a firm gives more opportunities to family members. Therefore, in many cities and towns, the first choices for university graduates are foreign companies, joint ventures, and government institutions (Gregory et al., 2000).

Therefore, private enterprises face both underdeveloped capital and labour markets, while family members provide cheap and flexible resources to fill the void created by these markets (Roberts and Zhou, 2000; Sun and Wong, 2002). There are two main advantages of family businesses, both of which are represented in transaction cost theory and agency theory. The first is that family relationships can reduce market transaction costs, due to self-enforced implicit contracts, and the second is that family members whose interests are expected to be closely aligned with those of the owner can significantly reduce agency costs (Qin, 2007). However, there are also disadvantages associated with family businesses. The first is the lack of access to outside resources such as bank loans that are critical for their development. The second disadvantage for family businesses is succession planning (James, 1999; Gan, 2002), and disputes relating to succession are a problem for many family businesses (Blue Book of Private Enterprises, 2001, 2002). At present, however, the advantages of family businesses seem to outweigh their disadvantages due to the imperfect market in China, as discussed above. Even though there is a potential problem with succession planning, this has not yet emerged as a major constraint because many private enterprises are still young.

corporate governance, the same as in family businesses (Fama and Jensen, 1983).

<sup>14</sup> According to a study of 724 medium and large private enterprises in China (including those in Zhejiang) by the Asian Development Bank (ADB) and the China General Chamber of Commerce (CGCC) in 2001, the principal capital source of private enterprises was individual and household saving (accounting for 49.4%), followed by retained earnings (41.9%), while bank loans accounted for 37.2%. (In this study by ADB and CGCC, the data had relative value and each data set indicated the proportion of enterprises that selected the relevant item as one of their principal capital sources. The data were obtained by totalling the first three fund sources, and thus the proportions do not add up to 100%.)

<sup>15</sup> Gregory et al. (2000, p.23) claim that, according to a 1999 study of 1,900 medium and large private enterprises in China (including those in Zhejiang) administrated by the Chinese Academy of Social Science (CASS) and the National Association of Industry and Commerce (BAIC), only 40% of entrepreneurs could read a balance sheet.

### 3 Conclusion

Chinese private enterprises have re-emerged and flourished since the late 1970s, along with the reform and open door policy. Initially allowed only on the fringes of the economy, private enterprises now account for nearly one-quarter of gross domestic product (GDP) in China, strongly contributing to its impressive economic growth. The important role of private enterprises was formally recognized by the Chinese constitution in 1999, which gave impetus to the rapid growth of private enterprises in recent years.

The rise of private enterprises generally confirms the commonly accepted wisdom in the property rights literature that well-defined property rights are a prerequisite of economic prosperity. In comparison with SOEs, the reason for the success of private enterprises is the difference in ownership. This is evident in Zhejiang province. However, the development of Chinese private enterprises also confirms one view in the literature that there is no universally accepted approach to achieving private ownership, particularly in different cultural contexts (Qin, 2007). This can be seen in the fact that not only is the development of Chinese private enterprises an unintentional result of market-oriented reforms, but also that there is significant government involvement in private firms, as in the Zhejiang model.

It has been argued that standard property rights theory needs to incorporate the social and cultural context in which firms operate (Qin, 2007). Regarding the development of private enterprises in Zhejiang, there are two main players defined by traditional Chinese culture, i.e., government and family, thus giving rise to two different development patterns for private enterprises. One is the phenomenon of “red-hat” enterprises in which there is a significant government involvement, and the other is the phenomenon of family businesses in which family involvement is significant.<sup>16</sup> In

<sup>16</sup> Of course, one can deduce that there are three cooperative patterns for a private entrepreneur; that is, cooperation with either the government only, or family only, or both the government and family. These are the basic facts of cooperative arrangements.

fact, there have been almost no “red-hat” enterprises registered recently, while family businesses are still prevalent and constitute the majority of Chinese private enterprises. Family businesses, which represent *raw entrepreneurship* with non-separation of ownership and control, thus seem to be an appropriate governance form taken by private enterprises, subject to the constraint of currently underdeveloped markets in China.

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