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The Political Economy of Private-Sector Development in China

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A central theme in the current literature on the political economy of growth is the relationship between the government and the private sector. Governments that create the appropriate conditions for private risk taking foster capital accumulation, efficient allocation of resources, and sustained growth. Governments that arrogate "too much" economic activity to themselves risk low levels of investment, inefficiencies in the state sector, and defensive private strategies, such as capital flight and nonproductive investments.

There is substantial debate, however, on how to structure business–government relations in an optimal way, or even what dimensions of the relationship might be consequential (Maxfield and Schneider, 1997). One strand of the institutional economics literature emphasizes the importance of the government's role as a protector and enforcer of private property rights (Barzel, 1997, for an overview). Such protections, if credible, provide assurances to private agents that assets and income will not be expropriated and thus incentives for investment. A growing body of empirical literature attempts to document these claims. These studies show the role that property rights protection and other aspects of the institutional setting that support these protections, such as transparency or even democracy, might play in checking the predatory tendencies of the state (Keefer, 2004).

However, a very different body of theoretical and empirical literature identifies the key barrier to growth not in an overbearing state, but in the capture of public institutions by private actors and the introduction of various policy-induced distortions (e.g., Murphey, Schleifer, and Vishny, 1993). This literature on rent seeking suggests that it is the private sector, as well as the state, which must be checked, either through the design of policy (e.g., through liberalization of markets)

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or by various political and institutional mechanisms (e.g., laws on corruption and campaign financing).

These broad themes have been replayed in the literature on East Asia's growth (for an overview, see Haggard, 2004). Neoclassical interpretations of East Asia's growth emphasize the self-restraining characteristics of East Asian governments, such as their relatively small size and extensive incentives for private capital accumulation. Other accounts, however, have noted that "strong" states were an integral component of the East Asian model and that at least one component of this "state strength" was the capacity to check, or in Alice Amsden's felicitous phrase "discipline," the private sector (Amsden, 1989; Haggard, 1990).

China's rapid growth has posed a very similar set of questions, and thus provides an opportunity to place the country in a wider regional context. References to China as another newly industrialized economy (NIE), following a development path similar to those pioneered by South Korea, Taiwan, Hong Kong, and Singapore, are increasingly common. Despite obvious differences, there are at least some superficial similarities, beginning with the growth record itself. China's growth in the 1980s and 1990s rivaled the performance of the East Asian NIEs in the 1960s and 1970s. The Chinese economy also appeared to take off following the adoption of a more open, export-oriented development strategy. Despite its large size, the trade/gross domestic product (GDP) ratio of the country is extraordinarily high. Yet another similarity is political. China's remarkable economic transformation has occurred in an authoritarian political context. As with respect to the NIEs, there have been ongoing debates over whether single-party rule was a necessary condition for such rapid economic transformation.

In this chapter, we address these issues by presenting an empirical examination of the Chinese government's relationship with the private sector. To what extent has the government retained direct control over productive activities rather than delegating them to private actors? To the extent that it has relied on the private sector, how have the respective roles of local and foreign firms changed over time? We offer two major empirical observations, one more controversial and less noted than the other. The first is that despite the well-documented process of economic reform in China, the domestic private sector remains relatively small and subject to a variety of policy and economic constraints. In the early reform period, the role of the private sector underwent a quite substantial change, but this fundamental shift in policy was not sustained. State firms continue to occupy an important role in the Chinese economy, and the growth of mixed property forms that maintain central or local government ownership and control has far outstripped the growth of private firms, narrowly defined.

The second observation is that to the extent that the Chinese government has provided a space for private capital, it has shown a revealed preference for foreign over domestic firms. The rapid growth of foreign investment in the Chinese economy and its overall role in the growth process is well documented, and we therefore spend somewhat less time in documenting it. However, the revealed preference for

foreign over domestic private firms is somewhat unusual given that governments more typically demonstrate so-called home-country bias: various restrictions on foreign investment designed to protect domestic firms. This observation raises the intriguing political economy question of why the growth of foreign investment in China has not been matched by an equal expansion of the domestic private sector.

This pattern of growth suggests some striking differences with the growth trajectory of other countries in the region. Except for the case of Singapore, the growth of the "first tier" of the East Asian NIEs – Korea, Taiwan, and Hong Kong – was driven by the development of indigenous private sectors. In the East Asian NIEs, the relationship between the state and the private sector was not always cozy. But in Taiwan and particularly in Korea, the government aggressively promoted the growth of the private sector. In the case of China, however, the image of a reformist government has led analysts to overlook the extent to which the state has imposed substantial constraints on the development of private Chinese firms.

We begin by providing a detailed exposition of the policy environment facing the domestic private sector in China in the 1980s and 1990s. We make a distinction between policies *permitting* the operations of private firms and policies actively *supporting* private-sector growth. China took considerable steps to allow private firms to operate, for example, by providing some property rights security, reducing the ideological stigma associated with the private sector, and thereby granting political legitimacy to its activities. The government has also undertaken at least some privatization. But the government has been much less forthcoming in actively supporting the private sector, particularly through such crucial policies as the investment approval process necessary for firms to enter new activities and the provision of finance. We show that biases in investment and financing have not abated significantly during the reform era since 1978. In fact, some of our measures show that these policy constraints increased sharply in the 1990s when compared to the 1980s.

The second section assesses our findings against the prevailing literature on the Chinese political economy. We focus on two strands of argument in particular. One is the observation that China has considerably liberalized its financial sector in the course of the 1990s. The other is the claim that China's growth, and growth model, resembles that of the other East Asian NIEs. We argue that both of these perspectives require significant qualification.

The conclusion returns in a somewhat more speculative way to some of the political economy questions posed by our empirical analysis. One possible objection to our findings is that they are not particularly surprising. Given that China remains under Communist Party rule, we would expect a certain aversion to the growth of private economic power. State control over the means of production – or at least the "commanding heights" of the economy – has long been a key political pillar of the socialist model. More recently, support for the state sector also reflected internal political pressures to protect declining sectors dominated by state-owned enterprises (SOEs). But this explanation does not account for the apparent change

in policy over time, from an initial opening to the private sector to a partial retreat during which some crucial supporting policies have, in fact, become less generous.

We speculate that this change has something to do with the availability of foreign direct investment (FDI). In the early reform period, China lacked credibility with foreign investors. Of necessity, the government relied on reform of the state sector and a larger space for domestic private firms to reinvigorate the economy after the long disruption of the Cultural Revolution. During the 1990s, however, as the reformist turn gained credibility and the government experimented successfully with the special economic zones, foreign interest boomed. The huge inflow of FDI eased capital constraints, offset entrepreneurial shortcomings of the centrally planned economy, and thus reduced the political leadership's need to cater to private-sector concerns. We show that this pattern was very different than the political dynamic in the East Asian NIEs during the 1960s and 1970s, where at least tacit support from the private sector was seen as a prerequisite for successful political rule more generally. We close our chapter by assessing some of the more recent policy changes in China and what they suggest about the possible future of state–private sector relations in the future.

THE POLICY ENVIRONMENT FOR THE PRIVATE SECTOR IN CHINA

Defining China's private sector is not straightforward, in part because the reforms have spawned a variety of hybrid and highly ambiguous ownership forms. The most common measure in the literature is the nonstate sector, which some analysts have equated with the private sector.[2] These nonstate firms include collective enterprises, de jure private firms, shareholding enterprises, domestic joint-ownership firms, and foreign-invested enterprises (FIEs). In some studies, SOEs that have issued shares on stock exchanges are also counted as a part of the nonstate sector.

This definition is very imprecise and has been used in dramatically different ways. When wanting to illustrate the extent of economic reform, as in a study undertaken by a research institute under the State Planning Commission (SPC), the government has equated a term commonly associated with the private sector in China (*minying qiye*, literally translated as "people-run enterprises") with the nonstate sector more generally (Wang, 2002). When seeking to prove that the reforms have not undermined state control, as in a manual prepared by the National Bureau of Statistics (NBS), the government assigns firms typically classified as nonstate, such as collective firms and shareholding firms in which the state maintains a substantial equity interest, to the state sector (National Bureau of Statistics, 1999a).

The two methodologies produce vastly different estimates of the size of the nonstate sector. Under the SPC's definition, the share of the nonstate sector in

[2] See Lin et al. (1996) for an earlier usage. More recently, Bai et al. (2003) used the growth of the nonstate sector as a measure of the progress of the reforms.

industrial output (by value) was 68.4 percent in 1997.[3] Under the NBS's definition, the nonstate sector accounted for only 21.2 percent of industrial value added in the same year. Even if we acknowledge the substantial difference between output value and value added, the difference between these two definitions of the nonstate sector is obviously quite large.

For much of the 1990s, equating the nonstate sector with the private sector clearly overstates the size of the private sector. While the revenue rights of many collective firms are private, their control rights are not. This is apparent even to those who rely on the nonstate sector as a measure of private-sector development. Bai et al. (2003, p. 99) acknowledge this point explicitly: "In reality, collective enterprises are under close control of a government. Major investment and employment decisions could not be made without government direction or approval."

The alternative is to rely on a narrower and a more conservative measure of the private sector. These are firms – or households in some of the data series – which are registered as explicitly private in the Chinese system. They are either individual businesses (*getihu*) or privately operated enterprises (*siying qiye*). The distinction between these two types of entities has become more blurred in recent years, but the most important nominal difference has to do with the size of employment. *Getihu*, by tradition, employ eight or fewer outside employees; *siying qiye* employ more than eight employees.

In this chapter, we rely on this narrower definition of the private sector, which we call the de jure private sector. The advantage of this definition is that it is straightforward and unambiguous. The disadvantages are that it is conservative and narrow. Our definition does not include private firms with an ambiguous registration status. These firms are registered as collective firms, such as township and village enterprises (TVEs), rather than as private firms but are, for all practical purposes and from a control perspective, under private control. For example, as is well known to Chinese researchers, many Chinese entrepreneurs have registered their firms under the more politically acceptable category of "collective firms" to alleviate policy constraints associated with purely private status. These so-called red-hat firms enjoy political protection, the ability to enter into businesses otherwise off-limits to de jure private firms, and easier access to credit and financing. Our registration-based definition also does not include those collective firms or SOEs that have been privatized but have retained their previous registration status as either collective firms or SOEs. According to various estimates, the number of "red-hat" firms and privatized firms in the 1990s was substantial.

The omission of the ambiguous private firms from our data is a problem only if our objective is to measure the "true" size of the private sector in the Chinese economy. In this chapter, we sidestep this question; instead, our principal objective is to characterize the policy environment facing the domestic private sector over time. For several reasons, the de jure private sector is in fact a good measure of the policy

[3] Table 4.5 in Bai et al. (2003).

environment. First, the focus on the de jure private sector has certain analytical advantages for examining the Chinese reform process. One of the most influential ideas in the comparative study of socialist transitions is that China succeeded by adopting a "gradualist" approach to reform. According to this argument, China purposely encouraged the entry of new private firms rather than undertaking the politically costly and economically uncertain privatization programs characteristic of the transition in Russia and the other former Soviet Republics.[4] A logical upshot is that the policy stance toward these new private-sector entrants – de jure private firms in our terms – should be more supportive over time. We can thus assess the "gradualist" hypothesis by examining how the policy environment facing de jure private firms has (or has not) changed over time.

Our second rationale for focusing on de jure private firms begins with the observation that there are costs as well as benefits associated with an ambiguous ownership status. Some mixed property firms arise precisely because de facto private firms face a variety of regulatory and other barriers, and private entrepreneurs thus register their firms as collectives (so-called red-hat firms) to access markets and financing that are exclusively reserved for state-controlled firms. The resulting distortions introduced by ambiguous ownership rights are well documented, however, and include a variety of transactions costs and the potential for conflicts of interest between the government and private owners. If the business is well run and profitable, government owners and bureaucrats have incentives to seize control of the firm. The Chinese press is full of such horror stories.[5] As a result, managers have incentives to keep finances and operations opaque, often maintaining three sets of books: one for the government, one for the bank, and one for themselves.

The fact that some entrepreneurs are willing to incur these risks suggests that there are offsetting benefits associated with mixed property forms. These benefits include easier access to credit and other policy favors and the political and legal protection required to operate in a biased policy environment (Li, 1996). If the Chinese state has liberalized entry for private-sector firms, reduced policy biases against them, and withdrawn support for the state sector, then all else being equal, the benefits accruing to mixed and ambiguous property forms would also fall. As

[4] The idea is that the reforms have apparently improved the welfare of the population across the board, by creating conditions for entrepreneurial growth, while no significant segment of the population suffered an absolute loss. According to a noted formulation, the Chinese reform has been "Pareto optimal" in that it has created winners without creating losers (Lau et al., 2000).

[5] According to one, a private entrepreneur registered his firm as a collective, and in a side – and most likely under-the-table – agreement, he gave 30 percent of the equity stakes to the local government, even though he provided all the equity capital. After paying out all the agreed dividends and taxes, he used a portion of the residual profits to settle a loan, which led to an embezzlement charge. He was sentenced to death by a lower-level court. The case went all the way to the country's Supreme Court and his life was spared only when the State Administration of Industry and Commerce, the branch of government in charge of registering firms, confirmed that the firm was in fact privately owned (Zhang and Ming, 1999).

a result, we would see an increase in the size of the de jure private sector relative to other property forms. A focus on the de jure private sector allows us to test whether this is in fact the case through explicit comparison with other ownership forms.

The output measure commonly used in the literature to define the private sector has another disability: the problem of distinguishing the effects of policy on the growth of this sector from a variety of other firm-level characteristics that might also be at work. Let us explain by an example. Many analysts have used output data as an indicator of the extent of the reforms. Since 1978, the share of the private sector in total output has increased steadily, leading to the widespread perception that the policy environment for the private sector has improved correspondingly. In 1985, de jure private firms accounted for only 1.85 percent of gross industrial output value; in 1997, this ratio rose to 17.9 percent, a dramatic change in only twelve years.[6]

However, this output-based measure of reform incorporates the consequences of two very different effects. One is the "policy effect": the increase in the private-sector share that resulted from a more favorable policy environment toward private activity. But this measure also incorporates what might be called the "efficiency effect." If private firms are more efficient than SOEs – and there is evidence they are – then they generate more value added per unit of input. An increase in the output share of private firms can therefore occur without any improvement in the policy environment as long as there is competition between private firms and SOEs. As an illustration, in 1985, the industrial output of the private sector (by value) was about 2.9 percent of that of the state sector; by 1997, this ratio had risen to 70.2 percent. While the policy environment no doubt improved for the private sector during this period, it would be highly misleading to conclude that the policy environment facing the private and SOE sectors had nearly converged.

In this chapter, we do not use the standard output-based measures of private-sector growth but rely on two measures that more cleanly capture government policies. The first measure consists of a number of indicators about financing constraints from private-sector surveys, one conducted in 1992 and one in 2002. These surveys provide direct evidence on the perceptions of private entrepreneurs about the policy environment. The second measure consists of a number of indicators based on fixed-asset investment data. Fixed-asset investment – whether undertaken by SOEs, mixed forms, or purely private entities – typically involves government approval and thus provides a second way of assessing policy biases.

There are obvious a priori reasons to believe that these two measures should be strongly correlated: firms that report themselves as financially constrained are unlikely to engage in substantial fixed-asset investment. Thus, we would gain confidence in our findings if we found that subjective indicators from surveys and the

[6] The ratios are calculated on the basis of the data provided in Table 13.3 in National Bureau of Statistics (1998).

data on investment moved in parallel and told a broadly similar story; we find that this is in fact the case.

Private-Sector Survey Data on Financial Constraints

In one cross-country survey, private firms in China are found to be among the most constrained in the world in terms of their access to capital. Batra et al. (2003) provide survey evidence on over 10,000 firms in eighty-one countries around 2000. The subjective perceptions of Chinese entrepreneurs of the financial constraints they face are quite similar to those prevailing in other transitional economies, such as such as Croatia, the Czech Republic, Romania, and Slovak Republic, or in poor economies, such as Ghana and Ethiopia. Indian entrepreneurs fared far better in this regard than their Chinese counterparts. The same study also shows that Chinese firms relied more substantially on retained earnings and informal finance than firms in India.[7]

The surveys organized by the Chinese government reach similar conclusions. A research report based on a private-sector survey conducted in 2002 concludes as follows[8]:

> In the survey, many private firms say that financing is difficult. This is an old problem. Government, banks, firms, All-China Federation of Industry and Commerce have made many efforts but the results are not obvious. We can see from the survey that lending to the private firms is scarce and that informal sources represent a substantial part of a firm's finance.

In this section, we focus on the financing environment facing China's private firms. There are several reasons to focus on the financial nexus. The most obvious is that systems of financial intermediation and firms' access to long-term and working capital are an essential component of the growth process.[9] A focus on finance also gets at important elements of the political economy story we seek to capture.

As elsewhere in Asia, the Chinese government has controlled the bank-dominated financial system (Lardy, 1998). As a result, the allocation of financial resources is a good indicator of the fundamental policy orientation of the state.

To provide more detail on this issue, we focus on the findings from two surveys, one from 1993 and one from 2002.[10] These two surveys were a part of the regular survey efforts organized by the All-China Federation of Industry and Commerce to solicit information and views from the Chinese private sector. Altogether, there have been six such surveys – in 1993, 1995, 1997, 2000, 2002, and 2004; the results from the 1993 and 2002 surveys provide the perspective of a decade and

[7] See tables A2.1 and A2.4a (Batra, 2003). It should be pointed out that China fares much better when it comes to labor and licensing regulations.

[8] See the report downloadable from http://www.china.com.cn/chinese/zhuanti/283076.htm.

[9] See the influential papers by King and Levine (1993) and Levine (1997).

[10] The data sets are obtained from the University Service Centre of the Chinese University of Hong Kong. The assistance provided by Jean Hung of USC is deeply appreciated.

are also nationwide in scope.[11] These surveys provide information on (1) firm size, status of development, organization, and operation; (2) management system and decision-making style; (3) socioeconomic background of enterprise owners; (4) social mobility and network of owners; (5) source and composition of employees and employee–employer relations; and (6) incomes, expenditures, and assets of entrepreneurs. Of most interest to us, however, they also provide information on entrepreneurs' views on a range of issues related to government–business relations, the overall business environment, and the availability of financing. Both the 1993 and 2002 surveys contain questions about access to bank credits on the part of the respondent firms. We rely on these questions to assess the financial treatment of the private sector in the 1980s and 1990s.

Both the 1993 and 2002 surveys are nationwide; that is, they covered all the provinces in China. The survey instruments are quite similar, although there are important differences that will be noted later. Both surveys were organized by the Department of the United Front – the branch of the Communist Party in charge of managing relations with the non-Communist components of Chinese society and economy – and the All-China Federation of Industry and Commerce, the organization that represents the private sector. The surveys were designed with input from researchers and academics from the Chinese Academy of Social Sciences, Beijing Academy of Social Sciences, and Renmin University. All the surveyed firms were selected from the registration lists maintained by the local bureaus of industry and commerce. Thus, these firms were explicitly registered as private firms at the time of the survey, which means that they include both private start-ups and enterprises converted from SOEs or collective firms.

One difference is that the 1993 survey is smaller, covering 1,440 firms, whereas the 2002 survey covers 3,258 firms. The second difference is that the 2002 survey apparently is more heavily focused on larger firms than the 1993 survey. In a document reporting on the 2004 survey results, the Chinese researchers revealed that the 2002 survey included many firms that were members of the All-China Federation of Industry and Commerce, which are relatively large, whereas other surveys focused on "ordinary private firms." The survey data bear out this point. In the 1993 survey, there are 568 firms that are classified as *siying qiye*, privately operated firms. This is about 39.5 percent of the full sample. Privately operated firms are usually larger than individual businesses, which employ only up to eight employees. Almost all the firms in the 2002 survey appear to be *sying qiye* rather than individual businesses. Also, the average employment of firms in the 1993 survey appears to be in line with the registration data published by the Chinese government, whereas the 2002 survey indicates a substantially higher level of average firm

[11] There was another private-sector survey in 1991 but that one was limited to what is termed as "individual businesses," that is, small single proprietorships with a few employees. The 1993 and the private-sector surveys thereafter began to focus on larger private firms that have multiple shareholders and a large number of employees. The data from the 2004 survey have not been released, although the Chinese press has made references to its summary findings.

Table 10.1. *Perception of credit bias: 1993 private-sector survey*

	(1) Percentage of firms reported receiving formal finance				(2) Percentage of firms reported receiving informal finance			
Year	(1a) Most important	(1b) Second important	(1c) Third important	(1d) Average	(2a) Most important	(2b) Second important	(2c) Third important	(2d) Average
1980	8.6	23.1	33.3	21.7	17.1	26.9	53.3	32.5
1981	14.8	28.6	71.4	38.3	11.1	33.3	14.3	19.6
1982	3.6	35.3	70.0	36.3	17.9	29.4	10.0	19.1
1983	5.9	29.4	18.4	17.9	20.6	29.4	42.1	30.7
1980–1983 average	**8.2**	**29.1**	**48.3**	**28.5**	**16.7**	**29.8**	**29.9**	**25.5**
1984	15.7	24.1	31.5	23.8	15.7	34.8	32.9	27.8
1985	21.7	23.1	26.2	23.7	18.8	31.7	44.6	31.7
1986	5.6	19.0	34.1	19.6	16.9	42.9	38.6	32.8
1987	18.3	18.9	36.7	24.6	18.3	34.7	40.0	31.0
1988	9.7	24.4	19.7	17.9	21.1	30.3	46.1	32.5
1989	8.0	17.1	31.6	18.9	17.2	38.2	38.0	31.1
1984–1989 average	**13.2**	**21.1**	**30.0**	**21.4**	**18.0**	**35.4**	**40.0**	**31.2**
1990	13.8	17.6	22.8	18.1	22.9	37.6	42.1	34.2
1991	13.6	11.3	18.4	14.4	17.5	41.3	38.8	32.5
1992	8.5	19.6	28.1	18.7	15.5	43.3	36.8	31.9
1990–1992 average	**12.0**	**16.2**	**23.1**	**17.1**	**18.6**	**40.7**	**39.2**	**32.9**

Source: Based on question 22 in the 1993 Private-Sector Survey.

employment.[12] In comparing the results from these two surveys, we should bear in mind the differences between these two surveys. We will first report the findings from these two surveys and then discuss some complications related to them.

Table 10.1 presents the findings from the 1993 survey and Table 10.2 presents the findings from the 2002 survey. Both tables present historical data, stretching back to the early 1980s. The 1993 and the 2002 surveys contain retrospective questions about access to bank credit at the time of the founding of the firm and we use these questions as the basis to assess the historical evolution of the financial treatment of private firms. (There are, however, complications related to the retrospective questions and responses, which we will address later.) Question 22 of the 1993 survey asks the respondents to pick up to three sources of their start-up capital and to rank the importance of each source, from most important to second and third most important. Nine choices are offered: (1) inheritance, (2) savings, (3) equity capital from business partners, (4) overseas investments, (5) loans from relatives, (6) loans from banks, (7) loans from credit unions, (8) loans from collective units, and (9) loans from individuals. We classify loans from banks, credit unions, and collective units as formal finance and loans from relatives and individuals as informal finance. Because our primary interest is to understand the financial environment facing private firms and the relationship between the state and the private sector in particular, we mainly focus on external sources of capital and the relative importance of formal and informal external sources of capital. We do not include equity financing in part because of the uncertainty over its classification and also because it is easier to compare credit financing between the 1993 survey and the 2002 survey.

The figures in Table 10.1 are percentage shares of firms that reported receiving formal or informal finance during their start-up year out of the total number of firms that have provided a response; averages for three different periods (1980–1983, 1984–1989, and 1990–1992) are highlighted in bold. There are two very interesting findings. First, the early years of the reforms in the 1980s are by no means a dark era for the de jure private sector, nor is the subsequent period of reform one of improved access to finance. In fact, almost the opposite is the case. While only 8.2 percent of firms reported that formal finance was their most important source of start-up capital during the 1980–1983 period, a very high portion of firms reported formal finance as their second (29.1 percent) or third most important (48.3 percent) source of start-up capital. On average, 28.5 percent of private firms reported receiving formal finance ranked as most important, second most important, or third most important source of their start-up capital during the 1980–1983 period. This is higher than the figure for 1984–1989 (21.4 percent) and

[12] According to the government's registration data, in 1993, the average number of employees in a *siying qiye* was 16.62 persons in 1992 and 13.4 persons in 2001. (Notice that the average employment declined.) In the 1993 survey, the average employment was 15 but in the 2002 survey, the average employment was 97 persons.

Table 10.2. *Perceptions of credit bias: 2002 private-sector survey*

	(1) Percentage of firms reported receiving bank loans in the start-up year		(2) Percentage of firms reported receiving informal loans in the start-up year	
	(1a) Privately founded firms	(1b) Privately founded firms in rural areas	(2a) Privately founded firms	(2b) Privately founded firms in rural areas
1984	25.0	36.4	29.2	18.2
1985	26.5	50.0	20.6	33.3
1986	23.3	15.8	27.9	15.8
1987	29.0	38.5	34.2	46.2
1988	27.0	27.8	23.8	16.7
1989	16.2	27.3	23.5	27.3
1984–1989 average	**24.5**	**32.6**	**26.5**	**26.3**
1990	21.3	25.0	27.7	28.1
1991	16.2	16.7	27.0	30.0
1992	23.8	25.0	27.8	22.5
1993	18.8	26.4	34.2	18.9
1994	18.2	27.6	33.2	36.2
1995	19.6	25.7	32.9	29.7
1996	19.1	25.6	31.3	30.8
1997	20.9	29.2	35.6	29.2
1998	22.3	34.3	30.9	31.4
1999	21.8	34.6	34.6	34.6
2000	18.4	28.0	28.6	24.0
2001	15.0	13.8	27.0	41.4
1990–2001 average	**19.6**	**26.0**	**30.9**	**29.7**

Source: Based on question 8 in the 2002 Private-Sector Survey.

1990–1992 (17.1 percent). In 1992, a year widely believed to have ushered in a series of liberalizing reforms, only 18.7 percent of private firms reported receiving formal finance ranked at least as the third most important source of start-up capital. This is substantially lower than 1981 (38.3 percent), 1982 (36.3 percent), 1984 (23.8 percent), 1985 (23.7 percent), and 1987 (24.6 percent).

The second finding follows directly from the first: informal finance increased in relative importance over time. Under column 2d (Table 10.1), the proportion of firms receiving informal finance increased linearly. During the 1980–1983 period, it was 25.5 percent, 31.2 percent during 1984–1989, and then 32.9 percent during 1990–1992. In 1980–1983, the share of firms reporting that they received formal and informal finance was approximately equal. During 1984–1989, 10 percent more

firms reported receiving informal finance than formal finance, and this gap grew to be 15 percent in the 1990s.

How should we interpret the increasing reliance on informal finance and the seeming reduction in the role of formal finance? One interpretation is that the emergence of informal finance itself indicates the government's tolerance of a greater play for market forces and private decision making outside of its direct control. This is the framework used by Tsai (2002) to explain the prominence of informal finance in some regions of China. Another way to say this is that formal and informal finances are complements.

But this is not what we observe in the data. In the 1990s, the role of formal finance declined and that of informal finance increased. The changing composition of sources of finance suggests an alternative interpretation that these two sources of finance are substitutes. Although more research would be needed to establish this point empirically, it is likely that private entrepreneurs turned to informal finance as they faced diminishing access to formal finance. The reason is not hard to understand. Informal finance is much more expensive than formal finance. According to one study, the curb market rate in Beijing for small private firms in the late 1990s was as high as 18 percent, compared with 6 percent on the formal loans (Fang, 2005).

The findings based on the 2002 survey show exactly the same trends: the importance of formal finance declined and the importance of informal finance increased. Question 8 in the 2002 survey asks the respondents to check off their sources of start-up capital from the following choices: (1) savings from running small businesses, (2) savings from running small-scale production, (3) donations from friends and relatives, (4) wages, (5) informal loans, (6) bank loans, and (7) inheritance. We adopt a conservative classification scheme and classify bank loans as formal finance and informal loans as informal finance. Table 10.2 reports the percentage of firms that have checked off either formal loans or informal loans as a source of initial capital. Period averages are highlighted in bold. Very few firms in the 2002 survey were founded before 1984 and thus we omitted data on those firms. We report only on those private firms that were founded as such and exclude privatized firms. We do not have information about when these firms were privatized, and therefore cannot know their ownership status when they received formal or informal finance. Moreover, the question contains an important ambiguity in asking for information about the firm during its "start-up stage": we do not know whether respondents interpreted the question to mean the start-up of the original firms or their start-up as privatized firms.

Nonetheless, the results are remarkably similar to the data based on the 1993 survey. The number of firms reporting a reliance on formal finance, at least for the subset of firms founded as private firms, declined over time. During 1984–1989, an average of 24.5 percent of private firms reported receiving formal finance; this ratio declined to 19.6 percent during 1990–2001. For firms founded in 2001, the year touted as a breakthrough for the private sector because of Jiang Zemin's

invitation for capitalists to join the Communist Party, only 15 percent of private firms reported receiving formal finance (see Table 10.2, column 1a). In 1984, 25 percent of firms did so and in 1987 as many as 29 percent of firms did so.

Over the same period, the number of firms reporting a reliance on informal finance increased dramatically. For firms founded during 1984–1989, on average, 26.5 percent of firms reported receiving informal finance; for those founded in 1990–2001, 30.9 percent did so. The gap between those reporting a reliance on formal and informal finance increased substantially in the 1990s as well. For firms founded in 1984–1989, the number of firms relying on formal and informal finance during the start-up period was roughly similar. For the firms founded in 1990–2001, 30.9 percent of firms reported receiving informal finance as we have seen, but only 19.6 percent reported receiving formal finance. The 1990s therefore witnessed a decline in the share of private firms able to tap resources through the formal financial sector and a corresponding growth in firms' reliance on the informal sector.

The finding that fewer private firms had access to formal finance in the 1990s than in the 1980s is striking but we should be cautious about how to interpret this finding. In the 1980s, private firms were smaller and it did not take much capital to start up a firm. Moreover, the absolute number of private firms was less and the boom was of more recent origin. In the 1990s, by contrast, the size of the average private firm had almost certainly grown and the number of firms seeking to enter was higher as well. (It should be noted, however, that the individual size of private firms in the 1980s was in fact surprisingly large as compared with that in the 1990s.) As a result, demand for financial resources in the private sector was probably larger. Our finding does not necessarily suggest that there were clear policy reversals in the 1990s. But it does suggest that the formal financial sector lagged in its capacity to supply capital to emerging private firms. As we will see in comparing China with other countries in the region, other Asian governments faced similar circumstances but moved more actively to channel financial resources to the private sector.

We also need to sort out four complications related to our data. One is that the survey questions refer to loans extended during the start-up years of the respondent firms, not during their subsequent operations. It is possible that Chinese banks have reduced their lending to start-up ventures but have stepped up lending to those enterprises already in operation. Chinese banks may have become more risk averse over time and thus increasingly preferred to lend to established firms rather than new entrants. Thus, the dynamic reported in Tables 10.1 and 10.2 may reflect this change in banks' behavior, with no implications for the availability of credit to private firms that are already established.

If loan availability is contingent on the operating history of a firm, then older firms should receive more favorable treatment from the banking system than younger ones. In addition to the questions about whether they received loans during the start-up years, both the 1993 and 2002 surveys also contain questions about whether firms were carrying bank debt at the time of the survey. We use

these questions to examine the hypothesis that Chinese banks may have been more willing to lend firms with an operating history in 2002 than they were in 1993.

There is no evidence that operating history mattered more in 2002 than it did in 1993. Of those firms in operation for four years in the 1993 survey (i.e., firms founded since 1989), 35.6 percent reported carrying bank debt at the time of the survey. For the 2002 survey, this number is almost identical, 35.5 percent. In the 1993 survey, 35.1 percent of firms with three years of operation reported carrying bank debt, compared with 34.1 percent in the 2002 survey. For firms with two years in operation, 32.7 percent of them reported carrying bank debt in the 1993 survey as compared with 33.6 percent in the 2002 survey. These simple comparisons do not control for firm-level characteristics, but it is unlikely that firm-level characteristics should affect the results substantially. In fact, given that the 2002 survey sampled the larger firms in the private sector, the finding that the ratio of firms receiving bank loans hardly changed at all between 1993 and 2002 is all the more remarkable.

A second potential objection to the conclusion that the availability of formal finance decreased over time has to do with the combination of liberalizing regulatory changes and the entry of greater numbers of private-sector firms. In the 1980s, one can hypothesize that the regulatory environment was highly restrictive and thus only well-connected private firms could gain access to formal-sector finance. In the liberalized regulatory environment of the 1990s, all sorts of private firms were established. Fewer of them could gain access to formal financing, but this was an artifact of the combination of a more liberal environment and the entry of more firms into the market rather than an indication of any policy change.

We can examine this hypothesis only indirectly because we do not have any direct measures of the number of new entrants, the extent of financial market liberalization, or the extent of political privilege. However, it is safe to assume that private firms located in townships or rural areas should be less politically connected when compared with private firms located in large- and medium-sized cities. The reasoning is that the urban firms are closer to both the decision makers and the banks themselves. Also in the larger urban areas, it is more difficult to gain entry due to the dominance and the incumbency of SOEs as compared with the rural areas. Thus, those private firms that did gain entry can be presumed to be more politically powerful and connected. This political hypothesis predicts that urban private firms would have greater access to finance.

Column 1b of Table 10.2 reports the share of firms located in the rural areas, reporting that they received bank loans during their start-up years. Except for two years, 1986 and 2001, far higher proportions of rural firms received bank loans in the start-up years as compared with the sample as a whole (Table 10.2, column 1a). On average, in both the 1980s and 1990s, 7 percent more rural firms received loans as compared with the sample as a whole. This finding casts at least some doubt on the hypothesis that bank lending to the private sector was driven by the political power of urban private firms. Rather, this finding is consistent with a commonly acknowledged fact about the Chinese reforms that economic liberalization started

earlier and went deeper in the rural areas than in the urban areas (Naughton, 1996).

A third objection to our survey evidence has to do with a potential survival bias in the data. Those private firms that were better financed in the 1980s were endogenously more competitive than other firms that were denied financing. Thus, better-financed firms in the early period had a higher probability of making it into the 1993 and 2002 surveys. The higher ratios of firms with bank loans in the 1980s can reflect this survival bias, rather than any underlying changes in the banks' policies or practices.

There are both conceptual and empirical difficulties with this interpretation. At a conceptual level, what is most evident in the data provided in Tables 10.1 and 10.2 is the change in the *composition* of loans rather than the level of lending. In the 1980s, private firms drew more loans from the formal financial sector but less from the informal financial sector. In the 1990s, it was the other way around. If the level of financing, rather than its composition, determined firm competitiveness, there is no reason to believe that private firms with greater access to formal lending in the 1980s should necessarily be more competitive than those with less access to formal lending in the 1990s.

Second, the survival-bias interpretation would predict a linear pattern in the data. Firms that were founded earlier should be better financed. However, while the period-average data in both the 1993 and 2002 surveys do exhibit clean linearity, the annual data within a given period do not. For example, in the 1993 survey, very few firms in the early 1980s ranked formal lending as the most important source of capital. In the second half of the 1980s, the ratios were moving around quite a bit annually rather than constantly declining as the survival-bias view would predict. One way to minimize the survival bias is to examine those years close to the time of the survey. By this indicator, there is no evidence at all that access to credit improved substantially for the de jure private firms in the early 1990s, as reported in the 1993 survey, or in the late 1990s, as reported in the 2002 survey.

Fixed-Asset Investment Indicators[13]

We now turn to our second measure of the policy environment: fixed-asset investments or investments made by firms in new property, plant, and equipment.[14] As

[13] The data on fixed-asset investments used in this section come mainly from a series of publications by NBS specifically devoted to covering fixed-asset investment activities. We have checked the data in these specialized publications with those published in the annual Yearbooks. In comparison with the Chinese data on output, Chinese data on fixed-asset investments are remarkably consistent across a number of publications. The data used in the text come from National Bureau of Statistics (1987, 1989, 1991, 1992, 1997a, 1997b, 1999b). The data on some of the latest years are from National Bureau of Statistics (2003).

[14] In the Western accounting system, this is known as investments in property, plants, and equipment (PPE), as distinct from investments in stock or bonds, which denominate existing assets.

compared with similar activities in a market economy and with other economic activities in the Chinese economy, fixed investments are heavily controlled by the government. All investment projects above a fairly low threshold require government scrutiny and approval. For this reason, fixed-asset investment is a superior measure of the policy environment than the output-based measures that are so frequently used.[15]

Table 10.3 provides the ownership breakdown of fixed-asset investment activities from 1980 to 2003 for four types of firms: SOEs, collective firms, "individual economy," which includes households and the de jure private firms in our definition, and firms of other ownership.[16] These four types of firms are exhaustive and mutually exclusive, and thus their totals add up to 100 under column e of Table 10.3.

Despite the widespread impression that China has undertaken substantial economic liberalization, the de jure private sector's share of total fixed-asset investment in the 1990s was actually smaller than it was in the 1980s. In the first six years of the 1980s, between 1980 and 1985, the "individual economy" already accounted for 20.7 percent of total fixed-asset investments. This share climbed slightly in the second half of the 1980s. Between 1986 and 1990, this sector accounted for 21.9 percent of total fixed-asset investment. In contrast, during 1991–1995, the "individual economy" accounted for only 13.2 percent of the total fixed-asset investments, rising only slightly to 13.9 percent during 1996–2000. Panel B of Table 10.3 provides annual data for selected years. In 1993, the "individual economy" accounted for only 11.9 percent of total fixed-asset investments, a drop of a full 10 percent from what was prevailing in the second half of the 1980s (at 21.9 percent). Since 1993, this ratio climbed up slowly to 15 percent in 2002 and then fell back to 14.1 percent

[15] There is a great deal of economic evidence that the governmental control of the investment process has remained substantial during the reform era. A telling piece of evidence, as marshaled by Thomas Rawski, is that China's seasonal investment recycles, as recently as the 1999–2001 period, matched almost perfectly those prevailing during the centrally planned era. Since fixed-asset investment is a large component of China's GDP, the fluctuations of investment levels have a substantial impact on GDP. Here, Rawski shows that China's quarterly GDP growth patterns differed substantially from those in South Korea, Taiwan, and Hong Kong, an indication that factors such as weather or traditional Chinese holidays are not the principal determinant of China's GDP's seasonal rhythm. Rawski (2002) quotes from a Chinese economist in his overall assessment of Chinese investment process:

> Many basic components of a pure market economy are still in their incipient stage in China, although market-oriented reform started two decades ago. Government-guided investment mechanisms, a state-controlled banking system and dominant state-owned enterprises . . . still run in a framework molded primarily on the previous planned economy.

[16] Individual economy refers to what we term as de jure private sector in this chapter. We use private sector rather than private firms for a reason because individual economy also encompasses households, which are, by definition, private. We will come back to the issue of households later on but for now let us focus on the changes in the fixed-asset investments during this period.

Table 10.3. *Ownership composition of fixed-asset investment*[a]

Year	(a) SOEs	(b) Collective firms	(c) Individual economy: urban and rural	(d) Of individual economy: urban only	(e) Other ownership	(f) TOTAL
			Panel (A): Period data			
1980–1985	66.7	12.7	20.7	1.6	0.0[b]	100.0
1986–1990	64.8	13.4	21.9	2.9	0.0[b]	100.0
1991–1995	59.0	16.3	13.2	2.7	11.0	100.0
1996–2000[c]	52.5	15.0	13.9	4.1	18.7	100.0
2001–2003	42.7	14.1	14.4	7.6	28.8	100.0
			Panel (B): Annual data			
1993	61.5	17.9	11.9	2.7	8.8	100.0
1997	52.5	15.4	13.8	3.0	18.3	100.0
2000	50.1	14.6	14.3	5.5	21.0	100.0
2001	47.3	14.2	14.6	6.6	23.9	100.0
2002	43.4	13.8	15.0	7.8	27.9	100.0
2003	39.0	14.4	13.9	8.1	32.7	100.0
2004		14.1	14.2			100.0

[a] Values are in percent.
[b] Constructed to be zero, as this category did not exist prior to the 1991–1995 period.
[c] In 1997, the government made a change in the investment reporting/approval procedure. Beginning in 1997, the investment reporting threshold was revised from 50,000 yuan to 500,000 yuan, but this change only applied to SOEs and urban collective firms. The effect of this change is that the published amount of fixed-asset investment in the state and the urban collective sectors is smaller than the actual amount. For 1996, the government published both the revised and unrevised data. In the unrevised data, the SOEs invested 1,205.6 billion yuan in fixed assets and the collective firms invested 366 billion yuan. In the revised data, the SOEs invested 1,200.6 billion yuan and the collective sector invested 365.2 billion yuan. The difference is about 0.4 and 0.2 percent, respectively.
Sources: Based on various sources on fixed-asset investment compiled by NBS. See the text for a detailed explanation.

in 2004, just one percentage point higher than at the very onset of the reforms in 1980.

Because our measure covers only fixed-asset investment activities in the de jure private sector, we must return to the question of whether this measure is too narrow. In particular, the "other" ownership category exploded from effectively zero in the second half of the 1980s to 11.0 percent in 1991–1995 and then to 18.7 percent during 1996–2000. To what extent are these "other" ownership forms effectively capturing domestic private investment?

Table 10.4 further decomposes firms in the "other" ownership category into four types of firms: (1) joint-ownership firms, (2) shareholding firms, (3) foreign-invested enterprises, and (4) unclassified firms. Shareholding firms and foreign-invested firms dominate this category of firms. During 1996–2000, shareholding

Table 10.4. *Composition of fixed-asset investment by firms in the "other ownership" category*

Year	(a) Joint-ownership firms	(b) Shareholding firms	(c) FIEs	(d) Unclassified category of firms	(e) TOTAL
		Panel (A): Period data			
1996–2000	1.94	42.0	53.2	2.9	100.0
2001–2003	1.11	68.2	29.0	1.8	100.0
		Panel (B): Annual data			
1993	5.1	21.2	71.2	1.9	100.0
1997	2.7	30.4	63.3	3.6	100.0
2000	1.4	58.8	37.8	2.0	100.0
2001	1.1	63.6	33.7	1.6	100.0
2002	1.1	68.7	28.5	1.6	100.0
2003	1.0	70.1	27.0	1.9	100.0

Note: Values are in percent.

Sources: Based on various sources on fixed-asset investment compiled by NBS. See the text for a detailed explanation.

firms accounted for 42 percent of the fixed-asset investments of firms in the other ownership category, and FIEs, another 53.2 percent. Since then, shareholding firms have become dominant, accounting for 70.1 percent in 2003. FIEs accounted for about 27 percent.[17]

To what extent are shareholding firms effective vehicles for private-sector investment activities? At least until the late 1990s, the answer appears to be "not much." Of China's largest shareholding firms, that is, those listed on China's two stock exchanges, only 6.97 percent were private initial public offerings (IPOs) between 1990 and 2003. The rest were SOEs that issued minority shares but in which, managerial control remained very clearly in state hands.[18] Put differently, many shareholding firms in China have private revenue rights, but their control rights still rest with the government and they should properly be considered state firms.

[17] Although there are complications, it is safe to say that FIEs are private firms, although in the foreign sector. This chapter is primarily concerned about the domestic private sector, so we will not discuss FIEs in great detail here, except to make two points here. One is that in the early 1990s, FIEs absolutely dominated the other ownership category of firms. They accounted for 71.2 percent of all the fixed-asset investments by these firms in 1993. Second, this juxtaposition of the seemingly liberal policy toward de jure private but foreign firms and the substantial restrictions on the de jure domestic private firms is a fascinating topic, to which we will return later.

[18] See http://www.baidu.com/s?cl=3&wd=http://news.xinhuanet.com/stock/2004–09/07/content_1952118.htm.

Other researchers have corroborated this finding that listed firms are effectively controlled by the state. According to a detailed study of over 600 firms on the Shanghai and Shenzhen Stock Exchanges in 1995, the three main groups of shareholders – the government, legal persons, and private individual investors – each controlled about 30 percent of outstanding shares. However, Xu and Wang (1997) report that, on average, individual shareholders controlled only 0.3 percent of the board seats of those listed firms, while the government retained 50 percent of the board seats and state-owned institutions controlled the rest.

That said, many of the small shareholding firms – for example, a category known as "shareholding cooperatives" – should properly be classified as private firms. Shareholding cooperatives are converted from TVEs and small SOEs and are typically majority owned by their employees. As such, they should be classified as private firms, but in the fixed-asset investment data they are lumped together with other shareholding firms. Thus, there is no question that our "individual economy" category understates the importance of the private sector in fixed-asset investment. But this bias cannot be very big. As of 2002, the shareholding cooperatives accounted for only 2.89 percent of China's industrial output by value, as compared with 11.7 percent by privately operated enterprises (*siying qiye*).[19] According to a recent study by researchers at the International Finance Corporation, privatization of small SOEs and TVEs became significant only after 1998.

A partial solution to this attribution problem is to compare the *de jure* private sector with the state sector and the collective sector. This approach produces ratios that approximate investment approval odds of the private sector relative to the state sector and the collective – or ambiguously private – sector. A decrease in the ownership biases should be associated with a rising ratio; an increase in the ownership biases should be associated with a declining ratio.

Table 10.5 presents data on fixed-asset investment in the de jure private sector as a ratio of fixed-asset investment in the state sector, collective sector, and firms of other ownership category. Data under columns 1a, 2a, and 3a of Table 10.5 show the same trend as that of Table 10.3. In the 1980s, the fixed-asset investments undertaken by the de jure private sector in both urban and rural areas already amounted to about one-third of fixed-asset investments in the state sector. The ratio of individual economy to SOEs, under column 1a (Table 10.5), was 0.31 in the 1980–1985 period and 0.34 in the 1986–1990 period. But this ratio declined sharply between 1991 and 1995, to only 0.22. Between 1996 and 2000, this ratio rose moderately, to 0.27. Between 2001 and 2003, despite a period of rapid growth and at least the perception of bold economic reforms, the ratio of fixed-asset investment by purely private to state firms managed to recover only to the level prevailing at

[19] It should be noted that NBS stopped using "individual economy" for its data series on industrial output, although it is using "individual economy" category for its fixed-asset investment reporting. The 11.7 percent quoted in the text referred only to *siying qiye* and presumably does not include industrial *getihu* (see National Bureau of Statistics, 2003, p. 459).

Table 10.5. *Fixed-asset investment ratios of individual economy to firms of other ownership types*

	(1) Individual economy/SOE ratios		(2) Individual economy/collective firm ratio		(3) Individual economy/other ownership ratio	
Year	(1a) Urban and rural	(1b) Urban only	(2a) Urban and rural	(2b) Urban only (urban collective only)	(3a) Urban and rural	(3b) Urban only
			Panel (A): Period data			
1980–1985	0.31	0.024	1.64	0.13 (0.41)	–	–
1986–1990	0.34	0.045	1.64	0.22 (0.51)	–	–
1991–1995	0.22	0.045	0.80	0.16 (0.58)	1.15	0.23
1996–2000	0.27	0.078	0.93	0.27 (1.24)	0.74	0.22
2001–2003	0.34	0.18	1.02	0.54 (2.9)	0.50	0.27
			Panel (B): Annual data			
1993	0.19	0.044	0.66	0.15 (0.56)	1.35	0.31
1997	0.26	0.056	0.89	0.19 (0.93)	0.75	0.16
2000	0.29	0.11	0.98	0.38 (1.8)	0.68	0.26
2001	0.31	0.14	1.03	0.47 (2.4)	0.61	0.28
2002	0.35	0.18	1.09	0.57 (3.1)	0.54	0.28
2003	0.36	0.21	0.96	0.56 (3.1)	0.43	0.25
2004						

Sources: Based on various sources on fixed-asset investment compiled by NBS. See the text for a detailed explanation.

the very onset of the reform era. For much of the 1990s, there is no evidence that ownership biases disappeared, as private/state investment approval odds in fact declined.

A comparison between the "individual economy" and the collective sector tells a more dramatic story (Table 10.5, column 2a). Throughout the 1980s, the de jure private sector was responsible for more fixed-asset investment – about 64 percent more – than the collective sector. In the first half of the 1990s, however, the de jure private sector's share contracted substantially relative to the collective sector. By 2000, the private sector achieved parity with the collective sector, as indicated by the ratio around 1 in 2001, 2002, and 2003. But it should be stressed that this is 64 percent less than the level prevailing in the 1980s. Thus even if it is true that much of the collective sector is effectively under private control, it is also the case that the liberalization of the 1990s had a greater impact on the growth of these mixed or ambiguously defined private firms than it did on de jure private firms. The ratios of de jure private sector to other ownership also dropped in the course of the 1990s (Table 10.5, column 3a).

As in other areas of the Chinese economy, there may be substantial differences in the urban and rural areas. This is especially true in the case of private-sector development. In the 1980s, a majority of private entrepreneurs originated from or were based in the rural areas. Almost all the private fixed-asset investments in the 1980s occurred in the countryside. For example in 1982, of 21.1 billion yuan in fixed-asset investments attributed to the so-called individual economy, 19.9 billion yuan, or 94 percent, occurred in the rural area. The massive entry of rural private entrepreneurship was due to a combination of a preexisting market economy in China's countryside even before the reforms and to the deep and substantial liberalization of the agricultural sector.

Both Tables 10.3 and 10.5 present data on fixed-asset investments by the urban de jure private sector. Column d of Table 10.3 presents the percentage shares of fixed-asset investments by private units located in the urban areas only. Columns 1b, 2b, and 3b of Table 10.5 present fixed-asset investment ratios of the urban private sector to those of SOEs, collective firms, and other ownership units, respectively. These data together suggest a fascinating pattern. While the policy treatment of the whole private sector deteriorated in the 1990s compared with the 1980s using this measure, the position of the urban private sector improved in the 1990s, especially in the second half of the decade and even more after 2001. As a percentage share of total fixed-asset investments, the urban private sector was very small in the 1980s, only 1.6 percent for 1980–1985 and 2.9 percent for 1986–1990. The first half of the 1990s witnessed a decline to 2.7 percent but the share rose to 4.1 percent for 1996–2000 and then to 7.6 percent for 2001–2003. Relative to the SOEs and collective sector, the position of the urban private sector shows a considerable improvement if we compare the period since the late 1990s with the 1980s. The first half of the 1990s, again, turned out to be a low point as compared with the second half of the 1980s.

These findings suggest three larger substantive points. One is that the position of the private sector registered a relative decline mainly in China's countryside. Our survey data bear out this point as well. Table 10.2 shows that the financing constraints increased more for the firms located in the countryside than for firms located in the cities. The second point is that it is not clear whether the relative improvement of the position of the private sector in the cities was due to liberalization, more active support measures, or simply benign neglect. However, it is important to underscore the major finding: in 1993, the urban private sector accounted for only 2.7 percent of all fixed-asset investments and after a decade of further reform, this had risen to only 8.1 percent. The third point is that the widespread impression among academic researchers about private-sector growth in the 1990s may have been driven by this boom in the *urban* private sector. But because of the far larger incipient role of the private sector in China's countryside, lags in agricultural reforms in the 1990s – widely acknowledged in China and by Western researchers – had a disproportionately negative effect on China's private sector as a whole.

As with the survey research findings, there are methodological issues with the fixed-asset investment data that should be addressed before drawing any firm conclusions about government policy toward the private sector. One problem with the data on fixed-asset investments attributed to the so-called individual economy is that it incorporates investment activities in the household sector. This presents two problems. One is the apple–orange problem, in which investment activities in the SOEs and collective firms are all in the corporate sector. The other problem is that if the private sector engaged in more housing investments in the 1980s than in the 1990, then the declining share of the private sector in total fixed-asset investments may not indicate a policy change but simply a change in the composition of corporate and household investments.

Unfortunately, we do not have an unambiguous breakdown between fixed-asset investments taking place in the corporate and household sectors. But there are clues. One approach is to calculate the share of the stock of fixed assets held by private firms. This approach will net out household investments from our data. In 2002, the total book value of fixed assets in all industrial firms with sales of at least 5.0 million yuan was 9.4 trillion yuan. If we subtract from this figure the value of fixed assets in (1) the SOEs and state-holding enterprises, (2) collective firms, and (3) FIEs, we arrive at the value of fixed assets in the domestic private sector. This calculation would yield a figure of 704 billion yuan. This is about 7.5 percent of the book value of all industrial fixed assets in China, which is about half of the private sector's share of fixed-asset investment flows during this period. We draw two conclusions. One is that both the flow and stock data are consistent with each other in that the fixed-asset investment activities in the private sector have been very small. Second, household investment activities probably comprise a substantial portion of the fixed-asset investments attributed to the "individual economy" in the Chinese data.

An alternative approach is to rely on the Chinese data that break down investment activities by their uses. One is a distinction between expenditures on "construction and installation" and expenditures on "equipment and machinery." A second is a distinction between production-related and non-production-related investment activities. One should bear in mind some of the problems with these statistical categorizations in interpreting the following findings. Construction and installation includes residential housing but also factory buildings and facilities. Nonproduction-related investment activities refer to construction of facilities that supply social services (such as schools or hospitals). While these facilities themselves reflect investment in social infrastructure and are not production related, it should be kept in mind that the firms that construct these facilities derive income from their construction.

One benefit of this breakdown is that we can construct a set of measures that are based on the same underlying economic activities. Table 10.6 reports on the ratios of investment expenditures on equipment and machinery under

Table 10.6. *Fixed-asset investment in equipment/machinery purchases and production-related purposes: individual economy compared with SOEs and collective firms*

	(a) Equipment and machinery purchases		(b) Production-related fixed-asset investment	
	Relative to SOEs	Relative to the collective firms	Relative to SOEs	Relative to collective firms
	Panel (A): Period data			
1980–1985	0.24	1.12	0.13	0.62
1986–1990	0.09	0.34	0.11	0.47
1991–1995	0.055	0.166		
	Panel (B): Annual data			
1991			0.10	0.47
1992			0.08	0.27
1996	0.065	0.365		
1997	0.07	0.166		
1998	0.068	0.168		
1999	0.15	0.315		
2000	0.148	0.33		
2001	0.18	0.36		
2002	0.24	0.395		
2003	0.338	0.43		

Sources: Based on various sources on fixed-asset investments compiled by NBS. See the text for a detailed explanation.

column (a) between the de jure private sector and SOEs or collective firms. Table 10.6 also provides data on a similar set of comparisons of production-related investments.

Table 10.6 confirms the findings that we have reported earlier. Expenditures on equipment and machinery by the de jure private sector are a fraction of these expenditures in the state and collective sectors throughout the reform era. Production-related investments in the de jure private sector are also small compared with the state and collective sectors. An additional confirmatory finding is that these ratios declined in the 1990s compared to the 1980s and that they began to rise only modestly in the late 1990s. One difference from the previous finding is that the private sector's share of equipment expenditures and production-related investment declined sooner than overall fixed-asset investments. In the case of expenditures on equipment and machinery, the de jure private sector's share began to decline sharply in the second half of the 1980s relative to the state and collective sectors, rather than in the 1990s. Why this measure declined so much sooner than the other measures is worth exploring further.

DISCUSSION

In the foregoing sections we have tried to track the evolution of the policy environment for private sector in China since the onset of the reforms, using survey and investment data. Although imperfect, these indicators are more accurate measures of policy biases than the standard output measures commonly used in the literature. The findings are robust across different indicators and go against the grain of the standard view of the Chinese reforms as well. The private sector has grown throughout the reform era but its growth has occurred against substantial and even growing financing constraints and apparent limits on the range of its investment activities.

In this section of the chapter, we will first put our findings in the context of existing work on the financing of private-sector development. Some economists believe that the financial constraints we have documented here have been alleviated over time. We revisit some of the themes and findings in that genre of work. We then take up a second line of analysis that seeks to compare China's development path to the growth experience of the other East Asian NIEs. We dispute this characterization and show that profound differences existed between China and the NIEs with respect to the relationship of the state to the domestic private sector.

State and Private Sector in China: Reconciling with Existing Research

There is general agreement among China scholars that the country's financial sector is closely tied to the SOE sector. As a result, it suffers from a number of inefficiencies, manifest in the extraordinarily high level of nonperforming loans even at a time when the economy was growing rapidly. Nonetheless, some have argued that Chinese banks became more market oriented and profit driven in the 1990s and therefore more supportive of the emergent private sector. We first address this seeming discrepancy between our findings and those in the literature, and then will report other research findings that are consistent with what we have found here.

Shen and Park (2001), for example, report that more bank managers ranked profitability as important in 1997 than in a 1994 survey. But this finding per se does not conflict with ours. If licensing policies restrict private firms to low-margin businesses, then TVEs or SOEs would in fact appear more profitable. Shen and Park (2001) also note that the authority to issue new loans became highly centralized in the 1990s. Again, this finding does not conflict with ours, as higher-level government officials often favor SOEs at the expense of private firms.

Another strand of the literature stresses that financing constraints varied considerably across different regions in China, either in the formal financial sector (Brandt and Li, 2003) or in the informal financial sector (Tsai, 2002). Our findings do not confirm or reject this view, but there is no reason why an increase in financing constraints facing private firms over time could not be accompanied by

a degree of cross-sectional heterogeneity. However, it is worth noting that if we look beyond three or four liberal provinces, credit availability to the private sector in the 1990s in fact did not vary much across different provinces. In 1999, the short-term bank debt outstanding to the de jure private sector from all financial institutions (including rural credit unions) was 57.9 billion yuan (People's Bank of China, 2000). The top three provinces with the largest credit outstanding to the de jure private sector in 1999 were Zhejiang (11.4 billion yuan), Guangdong (8.4 billion yuan), and Fujian (3.4 billion yuan). *These three provinces accounted for 40.3 percent of the entire short-term bank debt outstanding to the private sector; Zhejiang alone accounted for nearly half of that.* The view that there is considerable regional heterogeneity is true only of a number of provinces.

Other researchers have obtained findings that are quite consistent with our results. International Fund for Agricultural Development (2002) and Nyberg and Rozelle (1999) reported that the state of China's rural finance has deteriorated in the 1990s, which is broadly consistent with our results. China's central banker, Zhou Xiaochuan, was reported to have said that 90 percent of China's nonperforming loans was generated in the 1990s, not in the 1980s.[20] A study by the International Finance Corporation, based on the survey in the late 1990s, shows that newer private firms faced greater financing constraints than older firms (International Finance Corporation, 2000).

There is also research showing considerable financial support for the private sector in the 1980s. Based on an extensive reading of numerous, internal bank documents, Huang (2008) has found instances where heads of Chinese banks, such as those of the Agriculture Bank of China and the Bank of China, issued detailed and specific instructions to branch managers to lend to private businesses as early as 1981 and 1982. A number of Chinese sociologists have reported that banks financed a very high proportion of private firms during their start-up phase in the 1980s, similar to our findings based on the 1993 and 2002 surveys. These findings are based on surveys conducted in the 1980s, which means that they are not based on retrospective evaluations and are not contaminated by issues, such as survival biases. Zhang Houyi and Ming Lizhi (1999) summarized findings from six large-scale surveys – all conducted in 1987. One survey, covering 97 firms in eleven provinces, shows that 40.6 percent of private firms received start-up bank loans. A survey of 281 firms in Hebei reported that 54.8 percent received bank lending; another survey of 56 firms in Hunan reported that 28.5 percent did so. The remaining three surveys reach similar conclusions from other parts of the country: 66.3 percent of 130 firms in Shaanxi received bank loans, one-third of ten firms in Guangdong, and 23.3 percent of 50 firms surveyed in Wenzhou. Even the survey that shows the smallest share of private-sector firms receiving formal-sector financing substantially exceeds the average number of such firms receiving such credit during their start-up phase in the 1990–2001 period, 19.6 percent.

[20] Steinfeld (2002) made this reference.

Comparison with the East Asian NIEs

For some time, it has been common to view East Asia's rapid growth as the result of a common regional model. This perspective on the "East Asian miracle" has been popularized by a series of World Bank publications, in particular.[21] The view that China is the most recent exemplar of this regional pattern is based on a few stylized facts that suggest commonalities with other countries in the region. These include rapid GDP growth, following a period of economic reform; the adoption of an export-oriented growth strategy; and attention to other "fundamentals," such as investment in education and the pursuit of relatively stable macroeconomic policies.

We suggest that there are, however, some quite substantial differences between China and the East Asian NIEs in the growth models they pursued. For the purpose of this chapter, we focus on two closely related differences that are germane to our political economy interests. First, while China's policy stance toward the private sector was at best ambivalent – and remained so throughout the reform era, as we have shown – governments in the rest of East Asia showed much greater political acceptance of the role of the private sector in the economy and society. The main exception to this rule was Singapore. Moreover, many governments not only adopted passive policies that permitted the private sector to emerge and flourish, but also pursued more active forms of support for private-sector development, including the provision of preferential finance.

Second comparison with the rest of the region suggests a hypothesis that we explore in more detail in the conclusion that the Chinese government's posture toward the domestic private sector is related to its stance with respect to foreign capital. In the 1990s while China continued to impose substantial restrictions and constraints on the development of the domestic private sector, it substantially liberalized FDI. Chinese policy appeared to follow the unusual course of favoring foreign private investors over domestic ones. In the rest of the region, one observes a quite different mix, again with the important exception of Singapore. The opening to FDI was cautious and typically contained provisions designed to protect the domestic private sector from head-to-head competition with foreign firms.

The takeoff into sustained growth in the East Asian NIEs was accompanied by a steady increase in the private-sector share of investment and output. SOEs survived well into the 1980s and even 1990s in a number of strategic industries, particularly in intermediate goods (Korea's POSCO) and the nontraded services sector (Singapore's Singtel, state-owned banks in a number of countries). Privatization – the sale of state assets – played some role in the gradual decline in the weight of the SOE sector across the region, but the main reason was the rapid growth of domestic private firms (Helleiner, 1989; Lim and Fong, 1991).

[21] World Bank (1993), Stiglitz and Yusuf (2001), and Yusuf and Evenett (2002).

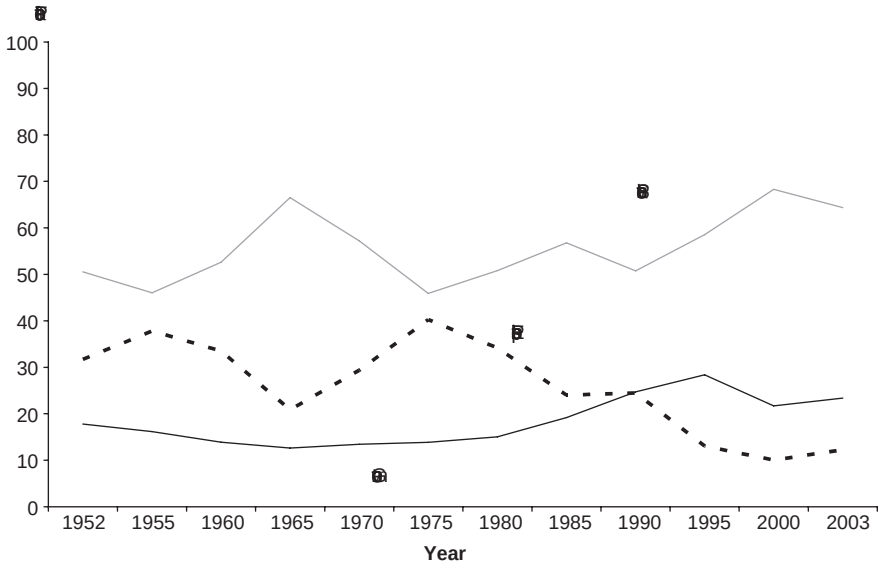

Figure 10.1. Taiwan: gross fixed capital formation, by owner (*Source: Taiwan Databook*, 2004)

This fundamental difference with China can be highlighted by considering briefly the evolution of the government's posture toward the private sector in Korea and Taiwan. We focus on developments through the mid-1980s in particular. The first four decades of postwar development are somewhat comparable in that they encompass periods of fundamental economic reform and also correspond to the period when both countries were under authoritarian rule: a dominant party in Taiwan and an alternation between semidemocratic rule and more overt forms of authoritarianism in Korea. These two cases are frequently juxtaposed on a number of dimensions, including the policy instruments used in supporting domestic firms. But when compared to China, the two countries exhibit important similarities.

Under Kuomintang (KMT) rule, Taiwan inherited a long tradition of direct state involvement in productive activities. In 1952 – the earliest year for which data are available – the government accounted for 17.7 percent of gross domestic capital formation (GDCF) and public enterprises another 31.7 percent; the private sector accounted for the remaining 50.6 percent. By 1965, the private sector accounted for 66.5 percent of GDCF. This was to vacillate somewhat in subsequent years, as Figure 10.1 shows; the government turned to SOEs as an instrument for pushing select heavy industries in the mid-1970s, and the government's direct role in fixed capital formation shows a trend increase after 1980. But unlike in China – where basic investment and financing decisions still fell under government control to a large extent – such barriers to private-sector activity fell steadily throughout the

period. If we focus only on the private and SOE sectors, the trends are unmistakable: the SOE role in GDCF shows a steady decline and in the Taiwan case. From 1978 to 1985, the SOE sector accounted for only 7.4 percent of economic activity; for the 1986–1991 period, this falls to 6.4 percent.

A brief comment on the political economy of this process provides a comparative backdrop to developments in China. Differences between statists and those favoring promotion of the domestic private sector were an important undercurrent of economic policy debates throughout the 1950s in Taiwan. As in China, concern about the rise of private economic power was at least one consideration, particularly given the divide between the ruling party that had relocated from the mainland and the indigenous sources of capital (Cheng, 1993). The shift toward a more outward-oriented development strategy in the late 1950s and early 1960s saw a resolution of this debate in favor of support for the growth of the domestic private sector.

The 1960 Statute for the Encouragement of Investment is emblematic of this change. The statute offered tax relief to companies in "pioneering" industries and placed particular emphasis on the promotion of exports. In the early years of industrialization, light industries such as textiles, consumer electronics, and components were favored, but over time, investment in labor-intensive industries was discouraged in favor of more skill- and capital-intensive products.

In a small number of capital-intensive industries where domestic firms were unable or unwilling to shoulder the risk, including steel, upstream petrochemicals, and certain capital goods, the government did revert to the establishment of new SOEs during the 1970s. However, the establishment of this new generation of SOEs was designed in major part to supply inputs to downstream private firms. A similar pattern can be seen in the establishment of research consortia, such as those that have been well documented in the electronics sector, which supported private companies through R&D and were thus complementary to private-sector growth rather than a competitor to it (Kuo, 1995).

The allocation of credit followed a broadly similar path. The state-owned banking system in Taiwan was initially a conduit for financing the SOE sector, and the government never used preferential finance as a tool of private-sector development to the extent that the Korean government did. Private firms therefore had to rely on what we have called informal financial arrangements to a greater extent. But these differences should not be overstated, particularly when we compare the evolution of the financial sector in Taiwan to what has occurred in China. As Kuo, Ranis, and Fei (1981, pp. 80–81) observe, "[I]n the 1960s, as a result of the government policy to encourage private industry, the composition of loans given by all banks was modified to favor private enterprises. The percentage of loans going to private enterprises increased from 24% in 1953 to 77% in 1979."

Government–business relations in Korea appear to follow a somewhat different path. In contrast to the KMT, which was dominated by mainlanders and maintained some political distance from Taiwanese firms, domestic political elites in Korea

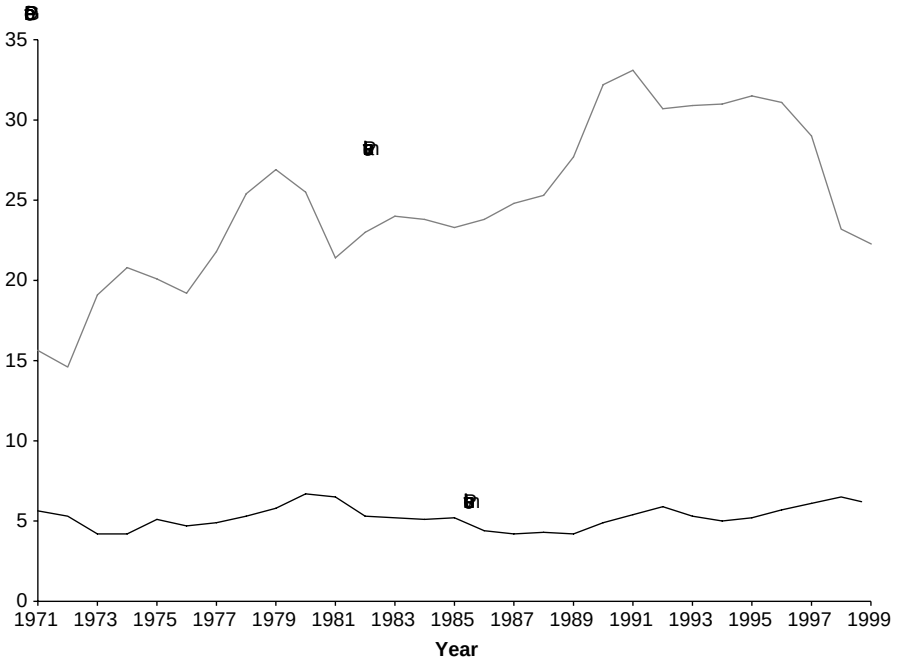

Figure 10.2. Korea: public and private investment (*Source:* Everhart and Sumlinski, 2001)

forged close relationships with existing entrepreneurs. As a result, the support of the private sector took a more active form. But for our purposes the most important point remains the support extended by the government to the private sector. Figure 10.2 shows trends in public and private investment over time. The public-sector share of total GDCF is more constant than that in Taiwan, accounting for roughly 5 percent of GDP throughout the period. The SOE share of total output is also more constant than that in Taiwan, accounting for 9.7 percent of economic activity in 1978–1985 and even rising to 10.3 percent in 1986–1991. But as in Taiwan, these levels are much lower than those in China. And as in Taiwan, what is striking is the explosion of private investment, which nearly doubles between 1971 (15.6 percent of GDP) and 1991 (33.1 percent). Comparable historical data on the share of bank lending to the public and private sector are not available, but in 1990, bank claims on official entities – including local governments, government investment institutions, and state-owned enterprises – were only 4.5 percent the size of the claims on the private sector.

Again, a brief sketch of the political economy of private-sector growth in Korea helps establish some contrast with China. Privatization of Japanese assets initially played a more direct role in the growth of the private sector, but trade protection and preferential contracting relations with favored firms also fueled private-sector growth in the immediate aftermath of the peninsular war. These networks of rent

seeking were one object of both the 1960 popular uprising against the Syngman Rhee government and the military coup that occurred only a year later. Initially, the military junta considered a strategy that imposed much greater constraints on the private sector. But a combination of pressure from the United States and recognition of the political dependence of the military leaders on private investment pushed in the direction of more symbiotic relationship.

As in Taiwan, the transition to export-led growth was accompanied by a new battery of incentives to private firms. Central to these was the aggressive use of financing as a tool for supporting export-oriented firms and favored sectors (Woo, 1991; Choi, 1993). This financing came directly from state-owned banks and relied to a much greater extent than in Taiwan on foreign borrowing. As in Taiwan, the government was not immune from the use of the SOE as an instrument of policy; the steel and petrochemical sectors are, again, the best-known examples. The government also maintained monopolies of key service sectors such as telecommunications until the 1980s and 1990s. But the dominant force behind Korea's overall and export growth was the rapid expansion of a relatively small number of highly diversified industrial groups, the *chaebol*. This process of concentration reached its apogee during the heavy and chemical industry drive of the late 1970s, when the state-owned banking sector was used most aggressively to push into a variety of new activities, including shipbuilding, chemicals, capital goods, and the electronics sector.

The close nature of business–government relations in Korea can be demonstrated not only by following the changing balance between the public and private sectors or the course of industrial policy, but through a political economy lens as well. As important work by Woo (1991), Kang (2002), and others has shown, the flip side of industrial policy was extensive corruption and the "reverse flow" of rents from the private sector back into the ruling party's campaign financing and other political needs. In Taiwan, the KMT controlled independent sources of funding, through both its own network of quasipublic corporations and its effective control of the state apparatus. Although the government fostered the development of the local private sector, it was not until the onset of political liberalization in the 1980s that KMT (as well as opposition) politicians began to actively court private-sector support and the KMT became a party of business. In Korea, the political relationship between the government and the private sector was more incestuous throughout the postwar period.

In sum, whatever other similarities might be drawn between China and the other newly industrializing countries of East Asia, the relationship between the government and the domestic private sector appears quite different. Not surprisingly, the SOE sector remained a favored instrument of policy for much longer in China. When liberalizing factions of the government did favor privatization and restructuring, they faced a much more entrenched and politically challenging task than was the case in the other NIEs. Governments in both Taiwan and Korea exhibited a strong revealed preference for the development of the domestic private sector, which quickly came to dominate overall economic activity.

Finally, it is worth noting that while government support for the private sector did amount to an effective form of risk sharing and created problems of moral hazard, we do not find evidence of the mixed property forms that became such a dominant feature of Chinese development. Debt financing from state-owned banks in Korea in particular could be seen as a form of "quasiequity" that resulted in bailouts *ex post*. Yet, ownership was private. Indeed, the willingness of the government to extend massive public assistance to these private firms – and their owners – provides even more convincing evidence of the very different political economy of these cases.

CONCLUSION

Let us summarize our empirical findings. First, we have argued that the debate about the development of the private sector in China could benefit from a more narrow focus on what we call the "de jure" private sector: those firms that are actually registered as private entities under Chinese law. This definition is narrow to be sure, but it also has a number of significant advantages over the standard measurements, such as nonstate sector. Second, we have suggested two alternative ways of capturing the policy environment facing the private sector: surveys of private entrepreneurs about their financing constraints and data on fixed-asset investments. These measures, we believe, are superior to the output-based measures common in the literature. Third, using these alternative measures, we have not found evidence to support the standard interpretation of a more-or-less linear evolution in the Chinese government's posture toward the private sector. In fact, there is evidence that those "support" policies – such as financing or granting investment approvals – became less favorable in the 1990s as compared with the 1980s.

An even more difficult question is why this distinctive pattern? It is not enough to simply note that China remains a Communist system antithetical to the private sector. As we have seen, the party made a strategic decision in the early 1980s to liberalize the domestic private sector and orient state-owned banks toward supporting the domestic private businesses, at least on the margin. The puzzle is that this policy course appeared to shift in the 1990s. We close with some broad, tentative, and speculative conjectures about why this occurred.

The first observation is that during the 1990s when the financing constraints on the domestic private sector appeared to have increased, the Chinese government was aggressively courting FDI through policy liberalization and conferrals of tax benefits on foreign firms. There is also evidence – based on survey data – that the policy treatment of foreign firms is substantially more favorable than that of domestic private firms. One hypothesis is that the Chinese leadership might have viewed FDI as a substitute for the domestic private sector. In the 1980s with almost no FDI, the Chinese state had to liberalize the private sector as an alternative to SOEs. In the 1990s, with a huge inflow of FDI this urgency eased considerably.

Probably the most dramatic example of this foreign bias is the policy treatment of domestic entrepreneurs and foreign investors in the wake of the 1989 Tiananmen crackdown. In 1990, the Chinese government stepped up its efforts to attract FDI, by, among other policy measures, dropping the provision in the 1979 Joint Equity Venture Law that required that the chairman of the board of any joint venture be Chinese. The central government designated all of Shanghai a special economic zone. FDI rose from $3.2 billion in 1988 to $3.4 billion in 1989 and to $3.5 billion in 1990.

By contrast, between 1989 and 1991, the conservative post-Tiananmen leadership launched a systematic assault against the domestic private sector. Both the number of individual businesses (*getihu*) and their employment fell dramatically between 1988 and 1991. In 1988, there were 14.5 million registered individual businesses; by 1990, this number was 13.3 million. Private-sector employment fell from 23.1 million to 20.9 million (Zhang and Ming, 1999). Throughout the 1990s, this bias against the domestic private sector persisted in financing policies as well. While the domestic private sector created far more jobs than the foreign sector, bank credits to the foreign sector ranged between two times (in 2002) to ten times (in 1994) those to the domestic private sector.[22]

Our second observation is related to the first. China's restrictive policy stance toward the domestic private sector, combined with a liberal policy toward foreign firms, forms another sharp contrast with Korea and Taiwan. In Taiwan, the opening to FDI was a component of a broader liberalization trend, and it was cautious.[23] Throughout the takeoff period, Taiwan's reliance on FDI was relatively low, as compared with China in the 1990s. As a share of gross capital formation, FDI peaked in the 1960s at around 3 percent. In contrast, in China in the 1990s the ratio was more than 15 percent.

In Korea, FDI policies were even more restrictive. The government showed a stated preference for foreign borrowing, much of which was channeled to building up domestic firms, over foreign direct investment (Haggard, 1990, pp. 197–208). Foreign firms accounted for an extremely small share of domestic capital formation: only 1.6 percent from 1966 to 1972 – the immediate postreform period – and even

[22] Huang (2003) explores the issue of FDI and private-sector development in great detail.

[23] The 1960 Statute and its subsequent amendments applied to foreign and domestic firms alike. At least with respect to this statute, Taiwan's regulatory framework was relatively neutral between domestic and foreign business. But the government restricted access to a number of sectors monopolized by the state, such as finance and telecommunications, which were not opened until the 1980s and 1990s and even then only slowly. Foreign investment in manufacturing was courted through the construction of export-processing zones. These zones are often seen as conferring a variety of benefits on foreign enterprises, for example, with respect to taxes or employment practices. But it is also the case that these enclaves can be used to provide protection for domestic firms since they typically require that all output be exported and thus limit foreign firms' access to the lucrative domestic market. Such restrictions were gradually lifted beginning in the 1970s, but only gradually and as we have seen the share of FDI in total capital formation was relatively small.

less than that during the heavy industry drive of the 1970s. These firms were generally confined to export-processing zones, had scant access to the domestic market, and faced a variety of sectoral restrictions well into the 1980s. In the 1980s and 1990s, even after some FDI liberalization, FDI as a share of GDCF was about half that of Taiwan: 1.2 percent during the 1986–1991 period and 1.3 percent during the 1992–1998 period. In fact, this low FDI dependency was found not only in the restrictive environment in Korea and Taiwan, but even in laissez-faire Hong Kong where the FDI/GDCF ratio was never above 6 percent through the 1970s. Only in Singapore, where the government had a similar skepticism toward the private sector, do we see a similar reliance on foreign investment to that seen in China in the 1990s.

Our third observation is that the political economy dynamics differed between China and the East Asian NIEs. Korea and Taiwan operated under authoritarian systems, and Taiwan was ruled by a dominant party that resembled the Chinese Communist Party (CCP) in important respects. But the state never exercised the kind of complete economic as well as political control as the CCP. Initially, Communist strategy provided little if any space for a private sector to operate, and at least until recently, the CCP did not allow independent private-sector organization. Moreover, the absence of even token forms of political competition meant that the CCP did not rely on the private sector for financial contributions and political support, as was the case in Korea in particular.

In contrast, in both Taiwan and Korea, state elites accommodated themselves to a preexisting private sector. In Taiwan, the KMT initially had only weak connections with domestic business, which was dominated by Taiwanese entrepreneurs and firms. Political conservatives saw Taiwan as little more than a staging area for retaking the mainland and were associated with a policy line that favored a large SOE sector and restrictions on the private sector. When it became unambiguously clear in the late 1950s that the KMT would get no American support for its revanchism, the leadership reached out economically, if not politically, and began to provide active support for private-sector development (Gold, 1986; Kuo, 1995). In Korea, the political relationship with the private sector was even closer. Operating in a semicompetitive, if not fully democratic, setting the succession of leaders from Rhee to Park to Chun developed very close political as well as economic relationships with representatives of the private sector as well as individual firms. The private sector not only provided investment and exports in return for incentives of various sorts, but was deeply implicated in financing the more purely political activities of the government. The full extent of this was revealed following the transition to democratic rule, when bribery scandals broke revealing direct presidential control over slush funds emanating from private-sector contributions valued in excess of $500 million (Kim, 2000).

We end our chapter by speculating about future developments. There is increasing evidence that the current Chinese leadership is rethinking its private-sector policies. While the privatization policies became more permissive in the late 1990s

under Jiang Zemin and Zhu Rongji, the leadership of Hu Jintao and Wen Jiabao has sought to improve the business environment for the de jure private sector. Their most significant policy measure –and one that clearly distinguishes them from the previous leadership – is that they have given more weight to agricultural reforms. Private entrepreneurship was most vibrant in China's rural areas in the 1980s and a deepening of agricultural reforms would be conducive to further private-sector development.

In March 2004, the Chinese Parliament passed a constitutional amendment that would enhance property rights security for private investors. The leadership also undertook significant regulatory liberalization to effect a more equal treatment between domestic private firms and foreign firms with respect to the sectors in which they can enter and invest. As an explicit acknowledgment that government policies had privileged foreign firms, a State Council directive issued in early 2005 declared that "all the economic sectors open to FDI should be open to domestic private participation." Domestic private firms, for example, are now allowed in energy exploration a right long monopolized by state-owned firms and given to foreign firms since the early 1990s. It is too soon to tell whether these cumulative policies will immediately and substantially improve the business environment for the domestic private sector, and much will depend on political as well as policy developments, but the current direction of policy change is quite clearly in the direction of more state support for China's private businesses.

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