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# Brief Report on the Development of the Non-state Sector of the Chinese Economy

The P.R China didn't encourage the existence of the non-state economy until December 1978, when the 3rd Plenary Session of the 11th Central Committee of the Party open the Chinese economy to private initiative. In a traditional communist society, everything should be owned by the state and shared by everybody. This concept was extended to the extreme in the Great Leap Forward from 1958-1960 and again for the ten years starting with the Cultural Revolution in 1966. To be engaged in a private company or to have a business of one's own was considered to be capitalistic. People were supposed to draw a clear line from capitalism, in order to cut off the 'capitalistic tail'.

Changes took place when Deng Xiaoping decided to open China to the outside in the 1980s. At the beginning of the reform, however, the state sector still remained dominant in China's economy. One policy of the reform, according to Deng Xiaoping, was to allow *some people to get rich first*, which was reflected in one of his very famous phrases, *no matter it is a black cat or a yellow one, as soon as it can catch mice, it is a good cat*. Thus the first group of private entrepreneurs emerged, expanding from the coastal area to the Chinese hinterland. There was a word vividly reflecting a typical phenomenon at the beginning stage of the development, *Wan Yuan Hu* , i.e, families who could make RMB 10,000 a year. And the non-state sector started to take part in the development of the China's economy since then, firstly with free markets of agricultural goods, then with other products as well. The development took off with quite a fast pace that the state government didn't anticipate.

## State vs Non-state

Traditionally the criteria China used to distinguish the enterprises was by the ownership type, not by the size, which was followed by most countries in the world. The concept of non-state sector didn't take into shape immediately.

The State Statistical Office used to present data for seven different classes of enterprise ownership: individual ownership, private ownership, foreign ownership, joint ownership, shareholding corporations, collective ownership, and state ownership. The last two types are the vestiges of a socialist society on its way to communism as expressed by the ownership of the state or the ownership of its people. Very often, however, there was another frequently used category as *other types of ownership*. Therefore information was not uniformly available for these classifications for all of the indicator of interest to analysts. With the further development of the reform, the socialist stated owned economy switched to socialist market economy, many changes have subsequently taken place during the past 20 years, which make a distinction between the different types of enterprise ownership even more vague. Take as an example the reform of SOEs, some were closed down completely, some were bought out, and some became shareholding corporations. A mixed ownership has turned into a major form in the Chinese economy of today. Meanwhile, because the state government has loosened the restrictions to foreign investment in China, joint ownership is becoming *out of date*, said by an experienced Chinese consultant, a wholly foreign owned enterprise is more preferable to foreign investors. What's more, the central government released another new regulation at the end of 2004, enabling an existing WFOE to also be engaged in trading activities. Though it still takes some time for the new regulation to take effect, the move itself shows the intention of the Chinese government to adjust its original economic structure so to get close to international standards. All these changes meant that actually the concept of enterprise ownership is developing into a much simpler two categories from the original seven ones: state or non-state.

The Chinese government has started to apply international rules to distinguish enterprises by their size. Nowadays there is therefore the concept of large, small and medium sized enterprises. SMEs have been mentioned more and more often since the 1990s. A department of Small and Medium-Sized Enterprises was created in 1998, under the organisation of the State Economic and Trade Commission (SETC), now the Ministry of Commerce, to be in charge of all matters related to SMEs. In 2003, an updated provisional regulation was drawn up by several state organisations to further clarify the criteria on the size of SMEs (see annex).

Most of SMEs are privately owned (with state owned SMEs of around 14.8% of the total), including collective enterprises, town and village enterprises, individual enterprises, private enterprises, Hongkong, Taiwan, and Macaw enterprises and export processing enterprises. SMEs are the major playesr in the non-state economic sector. One could say to some extent, the development of SMEs is actually reflecting the development of the Chinese non-state economy.

## The role of SMEs

In 1999, the National People's Congress made a considerable amendment to the constitution, leading to the non-state economy being no longer just a complement of the socialist market economy, but a rather important component by its own right. A research on Chinese non-state economy produced by the Shenzhen Comprehensive Development Research Institution shows that the ratio of the **state economy* has dropped from 77% in 1978 to 25% in 1997, and the investment has dropped from 83% in 1980 to 52% in 1997.

** In the research, the state economy meant the SOEs. All the other types of ownership enterprises such as collective ownership, town ownership, private ownership were categorized the non-state economy, though not being private in nature.*

The growing significance of SMEs in China's economy is hard to ignore. According to the statistics provided by the departments in charge of SMEs, there are around 10 million SMEs in 2004, accounting for 99% of the country's total registered enterprises and employing 75% of the labour force. 60% of the national industrial output value and 40% of the national revenue same to have come from the SMEs.

Besides their overwhelming weights, SMEs are also pivotal to the current development of the Chinese economy because of their flexibility and resilience, its easy start of business, its potential to push the growth of domestic demands, their role as a catalyst for the deepening of industrial division of labour ( SMEs are the main destination for workers laid-off from state-owned enterprises that re-enter the workforce), etc.

## Financing the SMEs

Financing is always a headache for SMEs. In the past, the finance needed for the start-up was usually raised through indirect financing, primarily from the local community or from

family members. Financing by the community in the 1980s was often in the form of the socialist township enterprise which gave a supplementary protection in a yet unclear direction of development for private companies. Retained earnings are another key source of financing. With the recognition of the role of private enterprises in Chinese development, state banks became also more open to them. They used to be very generous when loaning money to SOEs because of their government guarantees.

The central government has realised the problem and the importance of SMEs to the Chinese economy, measures have been taken to improve the financial situation. For example, state-owned banks have been advised to set up credit departments catering for SMEs. A unified credit guarantee system is setting up to aid SMEs in their pursuit for credit guarantee, more than 100 Chinese cities have established credit guarantee institutions, which are expected to help guarantee some US$ 4.8 billion of bank loans for the SMEs.

The VAT (Value Added Tax) rate for small commercial firms has been cut down to 4%, and so on.

Support also comes from some international organisations. In late 2001, CPDF, a multi-donor to SME facility managed by the International Finance Corporation (IFC) and the private sector arm of World Bank Group (WBG), commenced operations. The core donors are Australia, Switzerland, the UK and the IFC. CPDF was designed to respond to the Chinese government’s Western Development Program. It has three major programs: access to finance, capacity building and sustainable development initiatives, and business enabling environment.

However these measures are far from sufficient, not to mention the difficulties encountered when implementing them into practical operations. It is said that less than 1% of China’s small and medium firms actually qualify to use the credit guarantee system, according to the criteria set by the central responsible departments in central government.

## Situation after the accession to the WTO

The Chinese SMEs will face more intense competitions after China’s enter into WTO. They face many problems for further development, in addition to the difficult access to bank loans, their low hi-tech level, outdated technology and equipment, and above all, weak awareness of how to integrate themselves into the global market. Another factor limiting SME’s development is the mindset of their managers. The long tradition of family-based businesses often has a negative impact on the further expansion of China’s SMEs

However SMEs were better positioned to adapt to the WTO economy other than the SOEs, because they lacked the social, managerial, and financial baggage of large state enterprises. On the other hand, SMEs can take advantage of China’s WTO entry by further integrating themselves into multinational companies’ supply chains, providing parts and services for the world’s top 500 companies. In this case, the flexibility and strong competitivity of small firms make them more responsive partners of foreign companies than large state owned enterprises.

The Chinese government is thus making efforts to improve the policy environment for the SMEs. Besides offering more financial support, the government is opening more investment fields to small and medium firms. All sectors that permit foreign investment are

also open to private investment although restrictions remain in some sectors such as the defence industry. In Shanghai, according to the Municipal Development and Reform Committee, a new documentary consisting of 38 new regulations on encouraging, supporting and guiding non-state economic sectors is under discussion. It is considered to be the most complete and systematic official documents compared with the other more than 60 ones issued in the past.

It can be foreseen that the Chinese SMEs will keep developing rather rapidly and will play a more and more important role in a sustained growth of the Chinese economy.

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## Criteria for Chinese Small and Medium Enterprises

| Industry | General criteria for SMEs | | | Criteria for medium-sized enterprises | | |
|---|---|---|---|---|---|---|
| | Employees | Sales | Total asset | Employees | Sales | Total asset |
| Industrial | < 2,000 | < RMB 300 million (or) | < RMB 400 million (or) | > 300 | > RMB 30 million (and) | > RMB 40 million (and) |
| Constuction | < 3,000 | < RMB 300 million (or) | < RMB 400 million (or) | > 600 | > RMB 30 million (and) | > RMB 40 million (and) |
| Whole Sale | < 200 | < RMB 300 million (or) | | > 100 | > RMB 30 million (and) | |
| Retail | < 500 | < RMB 150 million (or) | | >100 | > RMB 10 million (and) | |
| Communication& transportation | < 3,000 | < RMB 300 million (or) | | > 500 | > RMB 30 million (and) | |
| Post service | < 1,000 | < RMB 300 million (or) | | > 400 | > RMB 30 million (and) | |
| Lodging, F&B | < 800 | < RMB 150 million (or) | | > 400 | > RMB 30 million (and) | |

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