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Two questions for National Day: How big is the private sector? and why should we care?

We are often asked a very simple question – what percentage of China's economic output comes from the private sector? In the past, we usually replied that the answer is so complex that the question is hardly worth asking. China quite deliberately constructs its statistics so as to make it impossible to derive from them a precise figure on the private sector contribution to anything. To cite the most obvious example, the National Bureau of Statistics (NBS) publishes two series on industrial output. Until last year, one series showed the private sector share growing steadily, while the other showed nothing (because the ownership breakdown did not include a private-sector line). Now both series have a private-sector line and they show the private share at 15 percent and 16.5 percent. Neither figure is very accurate.[1]

Take a bow, Prof Zhong

Ironically, we ourselves were among the very first to try to give a sensible answer to this question, back in May of 1999.[2] At the time, conventional wisdom put the private sector's share of output at around 25 percent. Our analyst, Zhong Jiyin from the Chinese Academy of Social Sciences, concluded on the basis of some well thought-out but necessarily sketchy estimates that the true figure was 53 percent for the economy as a whole, and 44 percent for the non-agricultural business sector.

About 18 months later the International Finance Corporation trumpeted what it called (rather immodestly, we thought) "the first analysis of the private sector in China."[3] IFC concluded that the private sector accounted for 33 percent of GDP and the state sector for 37 percent. Depending on how various intermediate forms of enterprises (mainly collectives) were counted, the private sector could rise to as high as 62 percent.

Now, thanks to some heroic effort, it is possible to answer the question (and it turns out that Professor Zhong was impressively close to the mark). The OECD has just published its first

[1] CEQ has published a comprehensive breakdown of the official data on key economic indicators by enterprise ownership. (*China's economy: who owns it?*, May 2004; pdf or hardcopy available to subscribers on request). While it does not answer the contribution-to-GDP question it does shed useful light on the trends of private sector growth and state-sector consolidation.

[2] "The private economy," *China Economic Quarterly* Q2 1999. Available to subscribers in pdf in the CEQ online archive or by request.

[3] *China's Emerging Private Enterprises: Prospects for the New Century*. Available at http://www.worldbank.org.cn/English/ifc/overview_ifc_research.htm. Incidentally, this report was the source of the oft-quoted statistic that less than one percent of bank lending in China goes to private enterprises. This was probably true in the late 1990s but has not been remotely true in the past four or five years. Changed circumstances have not prevented many seat-of-the-pants analysts from quoting this archaic data point as current fact.

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comprehensive survey of the Chinese economy, comparable to the surveys it does of OECD member economies. Based on an NBS database of detailed financial information from more than 160,000 companies for the period 1998-2003, the OECD very persuasively argues that the private sector accounted for 59 percent of overall economic output and 57 percent of non-farm business output, up from 50 percent and 43 percent respectively in 1998 – the latter figures being quite close to Professor Zhong's estimate from the same period.[4]

Figure 1.
Private share of the Chinese economy, 1998-2003
% of value added by firm ownership

	1998	1999	2000	2001	2002	2003
Non-farm business sector (79% of GDP)	43.0	45.3	47.7	51.8	54.6	57.1
Total business sector (94% of GDP)	53.5	54.9	56.3	59.4	61.5	63.3
Total economy	50.4	51.5	52.8	55.5	57.4	59.2

Source: NBS, OECD

The OECD data are persuasive because they are drawn from an extremely detailed data set, and because their analysts went to great lengths to establish the true controlling ownership interest in the surveyed firms. This latter point is crucial because the official ownership classifications are obscure and overlapping, making it impossible to conduct an ownership analysis from data published in the statistical yearbooks. Many state-controlled companies, for instance, are counted twice – as "state owned/controlled" companies and as "shareholding companies," if they happen to have a shareholding structure. The category "shareholding companies" comprises both state and private firms, and NBS makes no effort to disaggregate the two.

Private enterprises' share of individual sectors is shown in Figure 2, overleaf. It shows that private firms now account for the majority of value added in every major sector with the exception of "miscellaneous commercial services" and utilities. In industry, private companies dominate the small-scale sector but, impressively, have also recently taken over leadership in large-scale industry as well. This conclusion should not be overstated: the threshold for a "large scale" industrial enterprise is annual sales of Rmb5m per year (US$620,000), and truly large private industrial enterprises do not really exist.

Two other interesting points emerge from the OECD analysis, both of which provide welcome quantitative confirmation of patterns that were widely, but vaguely, held to be true. First, private enterprises are far more efficient users of capital than state firms, measured both by return on equity and by capital intensity (see Figure 3, overleaf). In all sectors, private firms use 50 percent less capital per unit of output than state firms, but enjoy very nearly equal labour productivity. In industry, private firms achieve labour productivity just 15 percent below that of state firms, with a capital intensity of just one-third the state-firm level. This

[4] *OECD Economic Surveys: China* (16 September 2005). Available at http://www.oecd.org/document/21/0,2340,en_2649_201185_35331797_1_1_1_1,00.html

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Figure 2.
Private share of economy by sector, 2003
%

Sector	Sector share of GDP	Private share of sector	Contribution to private share of GDP
Agriculture	14.6	96	14.1
Industry*	45.3	61	27.6
Above cut-off	*35.1*	*52*	*18.4*
Below cut-off	*10.2*	*90*	*9.2*
Construction	7.0	76	5.3
Transport, post and telecoms	5.7	16	0.9
Distribution	7.7	80	6.1
Miscellaneous commercial services	13.3	39	5.2
Government services	5.7	0	0
Total	**100.0**		**59.2**

*Above cut-off: enterprises with at least Rmb5m in annual sales. Below cut-off: enterprises with less than Rmb5m in annual sales
Source: NBS, OECD

confirms what we have repeatedly stated: that China's recent high growth rates are in part a function of increased capital efficiency stemming (in part) from a shift of productive capacity from the state to the private sector. The continuation of this process over the next several years provides a very strong underpinning for further high growth.

Private enterprises are also far less reliant on debt finance than their state counterparts. It has long been a nostrum that private firms have a difficult time securing bank loans. This is less true than it used to be, especially for bigger private firms (private conglomerate D'long had several billion Rmb in bank debt when it collapsed last year), and in addition private firms have been skillful at tapping non-bank sources of debt finance, notably cash-rich state enterprises. Even so, the OECD found that private companies boast far lower debt ratios than did state companies (Figure 4, overleaf), although these ratios have steadily fallen for both types of firms. The conclusion is that, unlike in the previous investment boom of the early 1990s, the majority of the economy is in the hands of companies that do not principally rely on bank finance. This conclusion is supported by macro data showing that enterprise reliance on bank finance has declined since the mid-1990s (see CEQ Q3 2005, pp. 40-44).

Figure 3.
Efficiency of private and state-controlled industrial enterprises, 1999-2003
%

	1999	2000	2001	2002	2003
Pre-tax return on equity					
Private	8.6	11.9	11.8	13.0	14.4
State	3.4	7.6	6.9	7.5	10.2
Total capital, % of value added					
Private	3.2	2.9	2.7	2.6	2.4
State	6.4	5.7	5.7	5.3	4.7

Source: NBS, OECD

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Figure 4.
Financing of private and state-controlled industrial enterprises, 1999-2003

	1999	2000	2001	2002	2003
Net debt, % of value added					
Private	122.7	108.0	92.0	80.1	72.7
State	302.2	252.2	238.9	222.9	193.9
Debt/equity ratio, %					
Private	64.0	61.6	52.4	47.7	40.6
State	89.5	79.7	73.6	72.9	71.5

Source: NBS, OECD

Don't get too excited

Some qualifications need to be made to the picture of private-sector dominance that emerges from these figures. First, the OECD notes that foreign-owned firms account for one-third of private sector output and two-thirds of private sector exports; however the OECD aggregate figures do not break out the foreign contribution in any greater detail.

For many purposes, it is important to distinguish between the foreign and domestic private sector because the two operate in substantially different regulatory environments, with foreign companies enjoying lower tax rates, import-duty exemptions and – until the beginning of this year – the ability to operate in business sectors off-limits to domestic private firms. It is probably more accurate to think of China's economy as 40 percent state, 40 percent domestic private sector, and 20 percent foreign private sector.

The second point, related to this, is that while domestic private firms generate a lot of output, they are individually tiny. This is part because of discriminatory practices limiting private firms' access to outside finance (either via banks or the stock market), and partly because of more general barriers to capital mobility and M&A activity. Only two percent of "large scale" private firms (i.e. those with at least Rmb5m in annual revenue) in the NBS/OECD database had more than a thousand employees.

This matters for two reasons. One is productivity: the OECD data clearly show that total factor productivity rises with the size of the firm. As fast as private firms have improved their productivity, they could improve even faster if artificial size constraints were removed. A second is political: a lot of tiny firms are likely to have far less influence on economic policy than a small number of large firms. The incentive for the Communist Party leadership of keeping private enterprise highly fragmented hardly needs spelling out. Until the regulatory landscape changes to enable the creation of much larger private-sector enterprise groups, the influence of the private sector on economic policy will remain far smaller than the private-sector share of total output would imply.

Finally, the state sector, though less productive and shrinking, is not merely a charnel house of hopeless zombies. Total state enterprise assets are about 85 percent of GDP, far higher than

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the 25-30 percent figures for the most state-dominated major European economies (France and Italy) and well above the rate for other transitional economies.

More important, state-sector productivity and profitability have steadily improved. The return on equity at state industrial firms rose from 3.4 percent in 1998 to 10.2 percent in 2003, driven by a rise in total factor productivity from around zero to nearly 5 percent during the same period. This is still below the private-sector rate of return but is still respectable by international standards.

One should not overstate this conclusion. Good returns are heavily concentrated in the largest 20 percent or so of state enterprises, with the remainder seeing very low rates of return by any standard. Moreover, non-industrial state firms perform very poorly, with a return on equity of just 2.8 percent in 2003.

Why should we care?

All very interesting, but why should we care? Principally, because the rate and nature of private-sector growth have large implications for how economic policy is constructed and how effective it is. Some of our friends in the investment bank economist universe have taken the view that the economy has now been effectively seized by a dynamic private sector over which the government has little influence, and therefore Beijing's traditional dirigiste macro-economic controls are far less effective than they used to be. Others retort that the commanding heights of the economy are still firmly in government hands and that traditional macro controls still work reasonably well.[5]

Our view, implied from the discussion above, is that the private sector definitely produces the majority of economic output in China. However this does not even remotely imply that economic policy is "driven" by the private sector or that the effectiveness of government macro-economic management has been seriously impaired. The goal of the wildly successful marketisation and state-sector reforms of the past decade, as we have often argued, was not to undermine state control of the economy but to make that control more efficient. Relative to the past, the private sector is enormously important in China today. Relative to any other major country (Russia perhaps excepted), China remains by far the most state-driven economy in the world today.

To understand the link between private-sector activity and government economic management, the right question is not "*how much* of the economy comes from the private sector?" but "*which parts* of the economy are in the private sector?" As the OECD analysis clearly shows, the private sector contributes the majority of output but it is highly fragmented at the firm level. The state share is shrinking, but is highly concentrated in crucial upstream or linchpin sectors. In 2002, according to our research, 368 of the 500 biggest enterprise groups were state-controlled, and the state-controlled groups accounted for 96 percent of the asset

[5] For pungent expressions of these divergent views, see CLSA, "China's Capitalists" (September 2005) and UBS, "How to think about China: State economy or market economy?" (January 6, 2005) and "State sector drives business cycles" (September 15, 2005).

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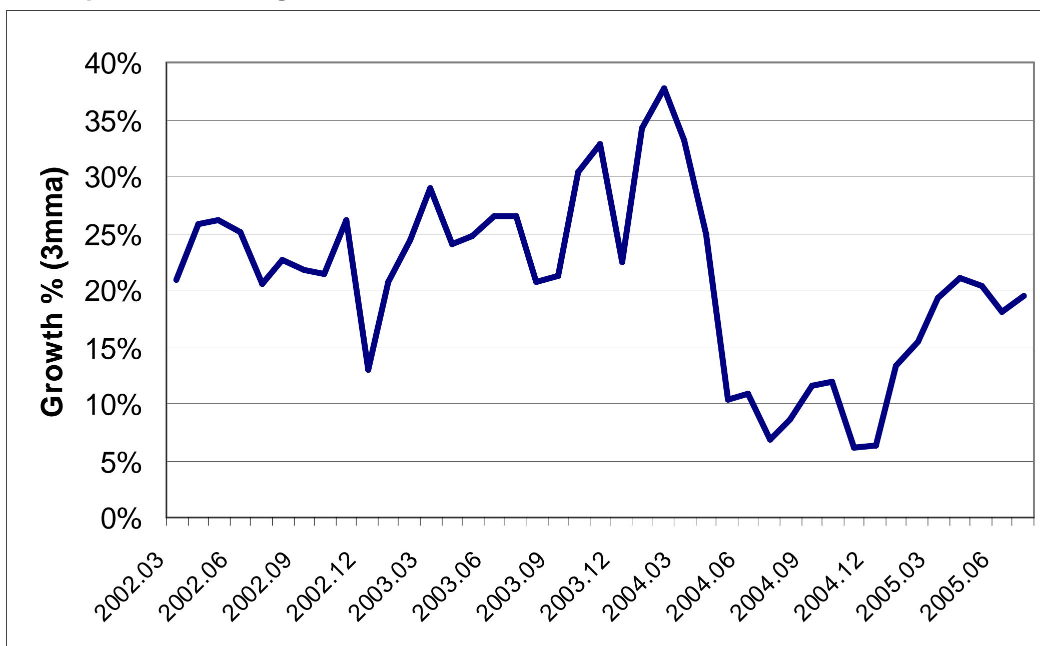
value of those 500 firms. This may have shifted a bit in the past few years, but not so as to make a substantial difference.

A couple of examples show how analysis of the economic cycle needs to take a nuanced view of the balance between market and dirigiste forces. Consider the steel industry. Is it "controlled by the state?" or "controlled by the private sector?" That depends on which part of the industry you look at. The upper end of the market, production of rolled steel, has about 40 players, most of whom are state-owned. The lower end, which produces construction steel, has about 400, many of them private. Across the board, there is excess capacity and a need for consolidation, but government policy for the two bits of the industry differs. Consolidation in the upper echelon is achieved by the tried-and-true state planner's method of enforced mergers – notably the recent agglomeration of Anshan Steel and Benxi Steel. Consolidation in the lower end will occur mainly through market forces, when steel prices fall and weaker players are forced to exit. The government can nudge this process along by raising costs for small producers (e.g. by prohibiting them from importing iron ore directly, or by reducing export VAT rebates).

Credit controls still matter

Another argument frequently made is that because more companies are private and companies in general rely less and less on bank loans to finance investment (true), therefore government credit controls are ineffective at curbing investment (false). The simplest way to see this is in the construction industry, which according to the OECD is at least 76 percent controlled by private companies. Yet as the chart below clearly demonstrates, construction activity fell off a cliff in May 2004 when the government imposed draconian credit curbs on the industry, and

Figure 5.
Floor space of buildings under construction, 2002-2005



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recovered smartly early this year when credit began to flow again. Clearly, window guidance is alive and well in the Chinese banking system, and it can be very effective in limiting investment even in a private-dominated sector.

Bottom line: life is complicated

The bottom line, sad to say, is that there is no bottom line. The private sector is clearly growing rapidly, and market forces rule (often ruthlessly) in wide swathes of the economy. The increased reliance of firms – both state and private – on internal funds rather than on bank loans for finance means that there is no longer a one-to-one correspondence, as there used to be in the 1990s, between government credit policy and investment growth rates. But this does not mean that the correspondence has gone to zero, as our construction example shows. More important, the fragmentation of private firms, and the increased consolidation of the state sector in key industries, means that state-sector interests will continue to exercise an influence on government economic policy far out of proportion to their share of overall output for many years to come.

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