

which the SFs are integrated into national and international markets is still limited—for most of the SFs, their customers, suppliers, and employees remain primarily local.

In the past 3 years, governments at all levels have taken steps to reduce obstacles to the growth of private firms that are both acknowledged and appreciated by the SFs. Nevertheless, private firms still see themselves as disadvantaged by local idiosyncrasies in policy implementation; and they are constrained in their activities by lack of access to formal sources of finance; inadequate information in all areas; difficulties in recruiting highly qualified personnel, especially senior managers and technicians; and deficiencies in the way markets work. Not too surprisingly in a survey of CGCC members, the SFs have a positive view of the contributions of the CGCC, its local chapters, and industry associations. At the same time, they would appreciate, and be prepared to pay for, more and better services from the CGCC and its LCs.

Section 3: Constraints on Growth of Private Firms

The IFC report provided a comprehensive list of the factors that either actually or potentially constrain the growth of private firms in the PRC,⁴¹ grouped according to whether those factors relate primarily to private enterprises themselves, to the financial sector, or to governments. (See Table 3.1) The list builds from the measures that governments have already introduced to promote private enterprise, most notable among which was the constitutional amendment in 1999 that formalizes the private sector role, as well as those that are implicit in the promises made for membership in the World Trade Organization. The sense of the study teams is that all of IFC’s factors continue to impede the development of the enterprises in the PRC, and many are likely to do so in the foreseeable future.

Table 3.1 Issues for the Future Development of Private Enterprise

For Enterprises		For Financial Sector	For Government
Corporate governance	Market entry and competition	Private firms’ access to bank lending	Protection of private property rights
Financial disclosure	Labor relations	Alternatives to bank lending	Openness of markets
Subsidiaries and conglomerates	Financing	Private equity markets	Commercial legislation
Supplier and customer relationships	Government relations	Private firm access to public equity	Rule-based tax system
	Management capacity		

Source: “An Agenda for the Future,” Chapter 6 in International Finance Corporation (2000) *China’s Emerging Private Enterprises, Prospects for the New Century*, pp. 60-73.

For enterprises, the IFC report emphasizes how firms must adapt to their management and governance practices in order to adopt an organizational form appropriate to an enterprise system that will be based on much more formal rules. The survey reported in this study indicates that the private firms are shifting more or less rapidly to limited liability corporations, albeit with a reluctance to forego the tradition of individual ownership, implying only slow separation of ownership and management. The IFC report identifies corporate finance and professional management as areas urgently needing improvement for firms to grow beyond the size that their informal structure can support. It emphasizes standardized accounting practices as an essential

⁴¹ In particular, see IFC, *op.cit.* Chapter 6: An Agenda for the Future, pp. 60-73.

prerequisite for disclosing the true financial situations of firms. Without accounting transparency firms will be unable to finance themselves easily through the financial and capital markets.

The IFC report assigns to governments the responsibility to build market-supporting institutions: that involves safeguarding the security of private property rights, relaxing entry restrictions faced by private enterprises, erecting a transparent regulatory environment, and implementing a rule-based tax administration. To accomplish this, the most important action required is to enforce the rule of law, which in many instances means implementing laws that already exist. In other cases, laws and regulations should be simplified to reduce the scope for bureaucratic discretion in their application. As we have seen, these are areas to which officials at all levels attach greater urgency; unfortunately, however, implementing all of these actions is going to take time, and some will be the work of a generation.

Although the IFC report analyzes almost all potential sources of financing for private firms, it points to bank lending as the area where rapid improvements will provide most impetus to private sector growth. (We agree with that assessment.) The report goes on to recommend measures primarily designed to encourage banks to lend more to private firms. It gives a guarded endorsement of credit guarantee schemes, subject to sound management principles based on international experience, to remove some of the lending risk from the banks.

Some recent research on transition economies indicates that the experience of private firms in the PRC is far from unique. McMillan and Woodruff (2001)⁴² show that, to overcome the lack of such formal institutions as financial markets, courts, and credit bureaus, entrepreneurs in economies making the transition from command to market systems have resorted to extensive use of relational contracting, trade credit, and other modes of self-help. The authors conclude that, in the early stage of the transition to the market, governments can contribute most by avoiding interference with entrepreneurs. But as the private economy matures, governments have to involve themselves more actively in all the areas that the IFC study has identified to develop formal market-supporting institutions.

For McMillan and Woodruff (2001), the most important institutional support required from governments is to create (i) a legal system that ensures the enforceability of contracts, and (ii) formal financing sources that are accessible to small private firms. The findings from the survey discussed in Section 2 strongly suggest that the PRC has reached this stage in the development of its private sector. Private firms still deal primarily with clients in their own locality. They need greater assurance that they can buy and sell in more distant markets without the costly services of intermediaries. And as all of the SFs have indicated, they need greater access to financing from banks.

What Needs to be Done First?

The discussion in Section 2 of the DC's survey of enterprises and the supplemental fieldwork by the IC identified the main immediate concerns of entrepreneurs. Those concerns fall into five categories: (i) access to finance, (ii) availability of managerial and technical skills, (iii) availability of information, (iv) nontransparent and/or inconsistent implementation of policies and regulations, and (v) inappropriate competition policies and other deficiencies in the organization of (aspects of) markets. The first of these—access to finance—is a concern of all

⁴² John McMillan and Christopher Woodruff (2001), "Entrepreneurs in Economic Reform," Working Paper No. 102, Center for Research on Economic Development and Policy Reform, Stanford University.

enterprises, not just those that are privately owned; private entrepreneurs uniformly voice the opinion that lack of appropriate funding is the major obstacle to the growth of their enterprises.

Access to Finance

Inability to obtain financing applies equally to all types of credit from banks, access to both the equity and bond markets, and so on. The immediate priority, however, is to enable small private firms to establish themselves as valued customers of the banks. To a certain extent, the slow development of banking relations is a function of the poor condition of the large banks' portfolios, which has made them reluctant to lend in general; it also stems from the unreliability of many private borrowers, who borrow for one purpose and use the money for something else.⁴³ The Government's reluctance to license more banks, especially foreign ones to conduct local currency business, has also contributed, though the promises made for WTO membership are likely now to change things fairly rapidly.

But the investigations conducted for this study point to administered interest rates as the main constraint to bank lending to private firms. At the time of the fieldwork by the IC, the 1-year term lending rate was 5.85%, with the banks free to vary it up to plus or minus 10% of the mandated rate for state-owned enterprises, plus or minus 30% for small- and medium-sized enterprises, and plus or minus 50% for rural cooperatives.⁴⁴ There is excess demand for credit at even these high real rates—countless entrepreneurs would be delighted to borrow at 130% of the base rate, but banks see the return as inadequate to compensate them for the risks they incur in lending to small private firms.⁴⁵ Hence, banks still direct most loans to state enterprises, a tendency reinforced by the recent introduction of heavy penalties for bank officials who make bad loans, especially to nonstate borrowers.

Enterprises compound their problems by failing to take steps to make themselves reliable clients of banks. They provide unreliable (and unaudited) data on their performance. They disguise profits. They often have ambiguous claims on assets that might be used as collateral or security for loans. As noted, some firms use loan funds for purposes other than those for which banks lent them. In many cases, firms seem to avoid using banks for working accounts, including management of payroll and of day-to-day receipts and payments, which might naturally develop into more extensive commercial relations. To ease the finance constraint, some firms even group together to set up (quasi-legal) "credit cooperatives" to substitute for the services of banks (see Box 3.1). By each of these actions, firms might be trying to avoid providing information that would make them more liable to taxes and fees, but to the extent that they become reliable payers of legitimate taxes they increase their likelihood of becoming attractive clients of banks.

For their part, governments have been tardy in taking steps to clarify property rights and establish timely processes under which creditors can take recourse against delinquent borrowers. They are belatedly emphasizing the need to develop an appropriate "banking culture," which

⁴³ There was a refreshing frankness in the way the owner of one firm stated that this practice had made firms their "own worst enemies" in dealing with bankers.

⁴⁴ The one-year deposit rate at the time was 2.25%. In February 2002, the People's Bank of China (PBC) lowered the one-year lending rate to 5.31%, and the corresponding deposit rate to 1.98%. This was the seventh in a series of interest rate reductions since 1996.

⁴⁵ One branch of a private bank indicated that it would lend to private firms only with the guarantee of a reliable SOE, even if the private firm had satisfactory collateral (as recovery of collateral in the event of default was too costly and time consuming). Another branch of the same bank suggested that it would lend more to small private firms if it could charge fees and interest rates adequate to compensate it for its transaction costs and risks.

Box 3.1 Easing the Financing Constraint

The international consultant visited one local chapter (LC) of the CGCC in a town of some fifty thousand people that illustrated starkly both the impediments to small business development in rural PRC, and the dynamism that private enterprise imparts to the rural economy. Officials of the LC stated that governments underestimated its value: the local government ignores the LC, and there is no official interest in its activities; the LC is uninvited to local policy meetings; and the local Bureau of Industry and Commerce does not take the LC seriously. The LC relies on its members for resources, which are in short supply. With more resources the LC would provide more and better information as well as more training opportunities to the membership.

Lack of finance constrains members' ability to expand their businesses and take up attractive new business opportunities. To ease the constraint, the LC established, in 1997, its own credit cooperative. Initially, it accepted deposits from all comers, and soon had a deposit base of 10 million yuan but when the People's Bank of China prohibited public fund-raising it was constrained to raise resources only from its 88 members (26 enterprises, 62 individuals, with 14 applications for membership pending approval by the county level chapter). At the time of the visit, the cooperative had a deposit base of 4-5 million yuan. Depositors received interest of 5.2% on a one-year term deposit (banks were paying 2.5% at the time); and borrowers paid 90 basis points over the banks' one-year lending rate (then at 7.31%). Loans were for 3 months, with a minimum amount of 1,000 yuan, and a maximum of 200,000 yuan. No fees were charged for loans, but loans could only be made with the guarantee of the largest "shareholder" (depositor). In the event of a default (which has happened at least once), the guarantor is required to repay the loan amount. A staff of three handles day-to-day operations, assisted by some of the LC members, and the services of a lawyer are available for complicated transactions and to settle disputes with people living outside the township.

According to officials of the LC, its articles permit the establishment of a credit cooperative, which has no need for formal registration because its activities are restricted to the membership! The objective of the fund is to help members invest in new ventures or expand existing ones. Project proposals are reviewed by the officers of the cooperative, and voted on by a five-person board of directors, any one of whom can veto the project. The members of the board were elected at the outset from among the largest contributors to the fund. Officials claimed that the board had performed well. The requirement of unanimity in loan approval reduced risks; no complaints had been received from members about the directors' decisions, even from those whose loan applications had been denied. Board meetings took place every Sunday, with attendance compulsory. For missing a meeting, the fine was 200 yuan without notification, and 100 yuan if the other directors had approved the absence.

Despite a good track record, sensible governance arrangements, and the satisfaction of the membership, the risks are obvious. In discussing their business plans, officials indicated that they anticipated acquiring or starting up businesses on behalf of the membership—what might be termed a "collective conglomerate." They would probably serve the membership better by continuing to manage their funds conservatively, and emphasizing the provision of liquidity to members' firms.

would base lending decisions on the fundamentals of banking practice, including sound credit analysis, prudent risk management, appropriate pricing of loans, and so on. Governments have been slow, as well, to develop the legal infrastructure required for banks to base lending decisions on the cash flows of borrowers.⁴⁶ They have emphasized insufficiently the disclosure of accurate information on enterprise performance, and the associated need to adopt adequate accounting standards in preparing financial statements. They have continued, even after dismantling the credit plan, to encourage banks to lend to poorly performing SOEs. To their credit, they have recognized the importance of the activity of SMEs in the economy, and the need to stimulate the flow of formal credit to them, but in our view they have overemphasized the role of credit guarantees in trying to spur lending to SMEs (see Annex 4).⁴⁷

⁴⁶ The absence of the equivalent of uniform commercial code filing, as found in the United States, renders impracticable assignments and pledges of non-fixed assets, and encourages banks to rely predominantly on pledges of fixed assets to secure loans.

⁴⁷ These comments should not be seen as a condemnation of the many positive steps the Government and the PBC have taken to improve the performance of the PRC's banking system. From the scrapping of the credit plan to the introduction of lending bands, which give limited interest rate flexibility, to the establishment of asset management corporations designed to help the four large state owned commercial banks purge their portfolios of

Box 3.2 Why Guarantee Bank Loans to Small- and Medium-sized Enterprises?

Along with the Government's recognition of the invaluable contribution that smaller enterprises make to the PRC economy has come the impulse to help them contribute even more. But, as small- and medium-sized enterprises (SMEs) have thrived on inattention, governments at all levels need to ensure that efforts to nurture such SMEs enhance, rather than impede, competition among them. Although the initiative of the State Economic and Trade Commission (SETC) to support SMEs (see Annex 4) is not designed to promote private enterprise, it certainly could have that effect if privately owned ventures position themselves to take advantage of the programs sponsored by the SETC.

Chief among those programs are measures aimed at facilitating bank lending to SMEs. Establishing small enterprises as reliable and regular clients of banks is an admirable objective. At issue is how best to do it. All banks have been encouraged to set up departments that specialize in lending to SMEs, and the smaller banks are being encouraged to view SMEs as their natural client base. To make that happen quickly, business organizations, local governments, and even individuals are being encouraged to found credit guarantee companies (CGCs) to improve SMEs' access to bank credit. Because banks will be enabled to lower their risk in lending to SMEs by obtaining guarantees from the CGCs on (all or part of) their loans, the Government envisages a rising supply of formal finance to SMEs. For CGCs, in turn, to mitigate risks, options for re-guarantee would be provided, eventually possibly through a state re-guarantee agency.

There are almost certainly more than 300 CGCs already in the PRC and possibly more than 500, although no one seems to know the exact number, in itself a disquieting reflection of the absence of central regulatory oversight. Some of the larger CGCs were established initially under the supervision of the central bank (PBC), and were funded by central and local government agencies. After the supervision of banking and insurance companies was separated, oversight of these pioneer CGCs fell to industry associations.

The PRC's CGCs vary greatly in size, and in the scope and quality of their activities. Through field interviews, the individual consultant (IC) gained the impression that few of them are both sufficiently active and big enough to have a meaningful effect on the volume of bank lending. Although the larger CGCs could have outstanding credit guarantees amounting to several billion yuan; the smaller ones might have outstanding but only a few million. The smaller CGCs have such limited credibility with the banks that they have to use their own cash as collateral to induce banks to lend to them. The larger, more credible CGCs have issued guarantees that are a multiple of their paid-in capital, though the total of guarantees outstanding for any CGC is usually less than five times its capital. Because of the limitations imposed by their capital, CGCs typically offer to guarantee loans only up to 3 million yuan, with the smaller CGCs offering much more modest coverage. The guaranty fees range from 1-1.5% of the guaranteed sum each year.

All CGCs function by providing liquidity to borrowers through the local banks. Most of their guarantees are offered to private enterprises that have sound businesses but lack the assets and/or sufficiently convincing financial records to obtain bank loans independently. Although the CGCs employ project analysis and approval processes that are similar to those of banks, they tend to be more flexible in analyzing investment projects because they seek additional credit information to support their decisions. They sometimes also use local investigative agencies for supplementary information about the potential client.

To the extent that CGCs are more able than banks to evaluate a borrower's creditworthiness, CGCs could potentially improve the intermediation of bank deposits to SMEs, and to private firms in particular. Where that is not the case, the proliferation of CGCs will encourage moral hazard as banks shift the responsibility for due diligence to another agency. Even where the CGCs are thoroughly professional and perform well, if their presence both impedes the development of a commercial credit culture within banks and impairs the incentives for SMEs to prepare reliable financial records and other certification of their creditworthiness, the overall impact could be detrimental to the reform of the financial system. The view of the IC is that giving the banks a policy mandate to lend more to SMEs and supporting them with CGCs predisposes the initiative to fail. In conversation with the IC, officers of the CGCs said that a weeding out of the weaker CGCs and a consolidation of the remainder is inevitable; they expect many CGCs to be forced out of business in the next few years as nonperforming loans emerge and the guarantees are called.

Of course, there are situations in which guarantee agencies can contribute positively, but in a supporting rather than in starring role. Good design will help: the CGCs should cover less than the full amount of a loan; limit the amount of cover they extend to any single lending institution; and apply "sunset provisions" for guarantees to any single enterprise. A more efficient syndication market could improve the sharing of credit risk among CGCs, as the current deal sizes they can entertain individually are small. A national credit reporting (registration) system, to supply better, more timely information to banks and CGCs would help them control their risks, and they would reduce risk further by assisting SMEs to conform to approved standards in preparing reliable financial records to underpin their relations with banks. A national re-guarantee facility could also help with risk control. Finally, sooner rather than later, the Government should assign an agency to regulate and supervise CGCs of all kinds.

nonperforming loans, to the gradual introduction of greater competition from new banks, the Government has given clear signs of its intention to reform the banking system gradually.

Despite evidence suggesting that a few of the PRC's rapidly emerging credit guarantee companies (CGCs) are well designed and enjoying some initial success, the current vogue for guarantees of bank lending to SMEs seems based on a misperception of how commercial relations between small firms and banks usually develop. In addition are the CGC initiative risks introducing even more moral hazard to a banking system that is plagued by it due to the hangover from the credit plan. (See Box 3.2). By their nature, banks are ill-suited to the business of providing venture capital to small private businesses, many of which will fail. They should instead be in the business of supplying going concerns with liquidity, meaning (predominantly short-term) loans for diverse working capital needs, where those loans are secured by adequate collateral (e.g., discountable receivables, bank deposits or other financial assets, land use rights or other mortgageable real property, plant and equipment, etc.) As firms mature and the relations with banks develop (and as banks acquire expertise in project analysis that allows them to lend with confidence to established, reliable clients on the basis of projected cash flow), banks will naturally tend to become a source of some of the funds needed for capital investment and expansion of capacity.

Banks will have little incentive to invest resources to establish the creditworthiness of client firms or to ensure the quality and unencumbered nature of those firms' collateral, if they are able to pass along the risks to credit guarantee agencies, which themselves may be poorly equipped to assess risk in lending to SMEs. This is all the more the case when the interest rates that the banks can charge are insufficient to compensate for the costs of investigating the firms and recovering collateral in the event of a default, as well as for the risks that default will occur. The main rationale for introducing CGCs has to be that they will be better able to assess the creditworthiness of borrowing SMEs than will the banks. Even if this is the case, the whole purpose of reform in the banking sector is to develop in banks a better capacity to intermediate financial savings and, hence, the capacity to direct loans to the clients that will use the money best. Entrusting CGCs with part of the job could threaten the success of banking reform; moreover, one should fear that the performance of the guarantees will be no better than the corresponding loans, and that many of the CGCs will fail.

Recommended Measures

To encourage banks to focus greater attention on lending to private enterprises the Government and the People's Bank of China (PBC) should substantially *liberalize the interest rates* for bank lending to (especially small) private firms. That is a change in incentives greatly to be preferred over mandating lending to small enterprises, including those that are privately owned. Ideally, lending rates should be freed completely, but if that is seen as too drastic a change (because of the well-known risks of asymmetric information and adverse selection, or simply lack of experience and expertise in the banks) the PRC's tried-and-true gradual approach could be employed. Widen the flexible band for lending to SMEs to 100% of the administered lending rate, then monitor to see how lending activity responds.

Officials need to complement this action by encouraging more rapid emergence of an appropriate banking culture. In doing so, they should accept that banks are inappropriate sources of seed capital for small startups. But banks are an entirely appropriate source of short-term financing for all forms of working capital where loans can be secured by collateral.⁴⁸ As an

⁴⁸ Good collateral is a necessary condition for greater lending by banks even at higher lending rates.

alternative to agencies that guarantee loans, the Government might wish to encourage a shift in emphasis to *guarantees of collateral*, essentially a certification of the value of a firm's assets and against which the firm could borrow.⁴⁹ At the same time, banks and guarantee agencies could cooperate to establish a system of collateral registration that could certify that firms had not already pledged assets offered as security for a loan.⁵⁰ Banks would retain the incentive to develop their own capacity for credit analysis, but might be helped in the short term by the existence of agencies that would specialize in the valuation of firms' assets. To contain their risks, banks would determine their own policies on how much they would be prepared to lend as a proportion of the value of proposed collateral. Over time, as banks developed familiarity with particular firms and their payment experience, the proportion could be expected to rise. With sufficient time and familiarity, a guarantee would no longer be needed.

Of course, the value of any firm's collateral can change rapidly, especially for nonfixed assets. Some types of receivables and inventories might be unacceptable as security for even short-term loans because their value fluctuates quickly and unpredictably. But such other assets as production machinery, and construction and transport equipment retain appreciable and predictable value during the life of short-term loans, which might persuade banks to lend against them as collateral. A system of this kind could only work well if the banks and guarantee companies were able to gain title to the collateral immediately following a default. The Government needs to expedite the development of legal procedures, including those that recognize property rights and enforce contracts, to help settle disputes rapidly, transparently and consistently, and so contain costs and help to make small-scale lending an attractive line of business for both banks and guarantee agencies. Once small firms are sufficiently well established, banks increasingly would be willing to help finance capital expansion. To encourage this desirable outcome, firms would help themselves by maintaining an impeccable credit history in servicing short-term loans and by better financial record keeping.

Availability of Managerial and Technical Skills

Among the inputs that firms need, skilled managerial and technical personnel were second only to finance in the list of resources that constrain the development of private enterprise. As the survey indicated, firms in Nanhai and Wenzhou, in particular, commonly recruit for those skills outside the local area, and in Xi'an there is considerable recruitment of Chinese citizens who have been educated or are working abroad. Beijing and Xi'an enjoy a concentration of colleges and universities that assist firms in those cities to acquire well-educated personnel. As a result, the SFs in Beijing report that an average of 20% of their personnel comprises college graduates. The high demand for skills is evident as well in the emergence of a sizable and rapidly growing vocational training industry; there are numerous training centers in every good-sized city purporting to meet the clamor for qualifications in everything from language skills to all aspects of information technology

⁴⁹ An alternative that also might reduce moral hazard is proposed by Xu Jieqin of the People's Bank of China. Following the model of the Small Business Investment Program of the US Small Business Administration, she recommends that credit guarantees be reserved for bank lending to companies that take equity positions in (established) SMEs. See "Support for SME Financing in Transitional China," *mimeo*, March 2002.

⁵⁰ Along similar lines, the PBC and the banks might do well to establish a credit registration system that would allow potential lenders to screen an applicant to determine the status of any existing outstanding loans, as well as the applicant's debt-servicing record.

There are no short-term solutions to the shortage of skills; indeed, skilled personnel will be a constraint to the PRC's development in the foreseeable future. Nevertheless, there are many ways in which the constraints can be eased, specifically, by remunerating skills sufficiently to attract them away from their current employment (for example, in SOEs), and by appropriate training, both through formal courses and on-the-job training. Of course, these are precarious solutions for individual firms. Higher pay can be double-edged, as investment in training often results in employees departing for even more lucrative positions elsewhere. In a situation of general scarcity, firms needing similar skills will have every incentive to bid away talented managers and technical workers. Entrepreneurs can improve their chances by creating an environment and incentive system that rewards merit, which in some small firms requires a change in the prevalent attitude that favors family members for positions of responsibility irrespective of skills. Some skilled workers will also respond positively to the security that firms could provide through attractive pension programs, health insurance, and other nonwage benefits.

Recommended Measures

The longer-term solution to the skill deficiencies that private firms now confront involves sustained emphasis on training, remuneration based on merit, and a withdrawal of noncommercial influence on personnel decisions in all enterprises, irrespective of ownership. As well, there is a need to improve the working of labor markets nationwide, involving the promotion of greater mobility of skilled workers to enable them to move to locations where their skills are in greatest demand. An associated requirement is for flexibility in pay scales, and for non-wage remuneration, such as stock options or other forms of ownership participation, to reward managers for good performance.

Without impeding the dynamism of the emerging capacity to provide vocational and skills training, governments could help by ensuring that self-styled training institutions meet appropriate standards. In some cases, that function could be accomplished best through professional associations. For example, professional accounting bodies could certify that certain training courses meet required standards of course content and quality of instruction, so that those who complete the course would acquire valuable education in book-keeping. In addition, industry associations and local chambers of the CGCC could serve both to establish training programs in association with private training centers and educational centers to respond to the needs of member firms,⁵¹ and to screen the training providers for quality. The equivalent of "better business bureaus" might also emerge to deal with complaints about training services that fail to meet the quality requirements of those who enroll.

Availability of Information

Tackling the problems caused by a scarcity of skilled personnel requires better information about educational options, and the survey of individual firms has pointed both to the value SFs give to information of all kinds and the gaps in existing information that they would like to see eliminated. In broad terms, more and better information is required in two areas: the policies and

⁵¹ In the case of management training, for example, firms that could not afford to pay for a formal degree program still might be able to allow their managers to benefit from instruction from university faculty in shorter courses designed to equip them with specific management skills.

regulations applicable to business activity, and all aspects of relevant market characteristics. The first of these involves easy access to knowledge of the rules that govern the activities of private firms, as well as confidence that individual agencies of central and local governments have the same knowledge and will interpret it consistently in implementing policies and regulations nationally and at the local level (see below). The second area involves information about the availability of resources (including skilled labor, technology, capital equipment, and other inputs), prices of products in different domestic and foreign locations, quality standards required for products, the conditions of entry to domestic and foreign markets, constraints on operation (including local environmental regulations, etc.), sources of finance, the incidence of legitimate fees, levies, and taxes, and so on.

In dealing with the provision of information, two important concerns are: who should be responsible for collecting and disseminating information, and how best to disseminate it. In principle, there is nothing wrong with duplication, and information could be available from many sources, all of which could be equally accurate and authoritative. In practice, as we have seen in Section 2, the SFs obtain information from many sources, with the news media narrowly in the lead as the most frequently cited source, but the SFs still view the supply of information as inadequate overall. In part, this view seems to stem from a lack of awareness of the already rich array of information that is available, and it seems likely to change rapidly as firms become more aware of the potential of the Internet. The State Economic and Trade Commission, for example, maintains an attractive, informative web site, despite which the IC visited several firms and local chapters of the CGCC that were alike in their lack of knowledge of the SETC's major initiative to promote the activities of SMEs (see Annex 4).

Recommended Measures

Clearly, what is needed urgently is better information about where to obtain information! That could begin with better coordination between agencies to exchange information, agreement to allow one agency's information to be disseminated by another, and education of the owners of firms about where useful information can be obtained. For instance, the offices of the State Administration of Industry and Commerce could ensure that, when registering their firms, owners and managers are offered a short course on where useful information could be found, including a tour of web sites. And all relevant agencies (SETC, SAIC, CGCC, MOFTEC, the China Council for the Promotion of International Trade [CCPIT], IAs, financial institutions, taxation bureaus, and so on) could distribute a pamphlet listing sources of information relevant to private enterprises.

The provision of valuable information is a major area for potential expansion of CGCC's services to members. It could be done on a cost recovery basis, probably by providing a subscription service that would give members unlimited access to the CGCC's web site and other publications for a set fee. The CGCC and its LCs already inform members about the Government's directives, and selectively provide more commercially oriented information. Different LCs systematically could provide supplementary information about sources of professional services, training for employees, labor market conditions, conditions in specific input and output markets, changes in policies, laws and regulations governing enterprise operation, etc. Although some of the information would have national relevance and could be supplied centrally by the CGCC, most of it would need to be adapted to local market conditions. To do so, the LCs would need to develop improved capacities to manage and maintain databases, with evident implications for their recruitment and staff training needs.

Better Implementation of Policies and Regulations

Despite the widespread appreciation for the PRC's recent improvements in the business climate for private enterprise, in a host of areas there is plenty of room for further improvement. Two of those areas stand out. The first is the need for consistency in how policies are applied. Central Government officials in the PRC tend to give broad policy guidelines that allow for flexibility in implementation to reflect local conditions. At issue is how to retain that desirable characteristic of policy formulation without creating so much scope for local discretion that policies will become idiosyncratic and nontransparent to entrepreneurs and the public officials responsible for enforcing them. In particular, local officials need to guide the actions of officers of different departments to ensure that they interpret policies, laws and regulations consistently.

The second area concerns the extraction of "illicit" fees and levies from firms by local officials. The DC's survey revealed that illicit payments are common, and, somewhat surprisingly, that firms are not too concerned about them. The IC also observed a surprising degree of comfort with this type of more-or-less informal payment. In particular, firms were slow to brand these payments as "corruption" and indeed, in many situations, the illicit payments might supplement fiscal resources and permit local authorities to supply valued infrastructure or public services.⁵² Nevertheless, there is every reason to replace unofficial payments with formal taxes that are transparent to all and result in revenues that flow formally to the budget, either locally or at the center. To underline the need to reform the bureaucracy, the 2001 survey conducted by the Chinese chapter of the US Chamber of Commerce in Beijing identified bureaucratic inefficiency (1), lack of transparency of regulations (3), and corruption of officials (4) as three of the top five impediments to doing business in the PRC.⁵³

As well, there is need to involve enterprises more actively in evaluating both the need for policies, laws, and regulations and how effectively they are implemented. At the same time, avenues for feedback from firms are needed so governments can be aware of difficulties that firms encounter either because of government measures or because of the way they are interpreted in practice. To ensure more consistent implementation of policies requires better training of officials at all levels, as well as constant attention to how different departments in the same localities interact with enterprises. The current emphasis on training for officials countrywide so that they will understand their responsibilities after the PRC joins the WTO could serve as a model for less momentous policy changes.

Recommended measures

The Government needs to continue its efforts to reduce bureaucracy and to eradicate the ubiquitous corruption of officials. One important way to do this is to reduce, as far as possible, the extent to which the activities of enterprises are regulated, and thereby limit the scope for bureaucratic discretion in implementing policy. The survey firms would appreciate, in particular, actions to streamline licensing requirements and inspection procedures. Especially for small

⁵² The SFs report that, on average, they pay 60,000 yuan annually in "illicit fees." The DC confirmed that the SFs do not equate these fees with bribes. Rather they represent unscheduled, and possibly illegal, levies on firms by local authorities. In only one instance did the IC encounter a specific acknowledgment that sometimes bribes were paid to obtain local officials' approval for the desired actions of firms. Of course, the person acknowledging the existence of corrupt practice denied taking part in it.

⁵³ Reference cited in footnote 6 (see Exhibit 9, page 35). The other two impediments in the top five were: availability of human resources (2), and market access (5).

firms, dealing with factory visits, which often seem simply to be excuses to extract fees, occupy an entirely disproportionate amount of their managers' time. At all levels of government, there is need for better guidance on how policies, laws, and regulations are to be interpreted and implemented, as well as better coordination of the activities of individual agencies of governments to ensure that their rulings are consistent.

Traditionally, the CGCC has acted as a conduit through which the Government and the Party inform enterprises outside the state system, and grant them a voice in national deliberative bodies. There is increasing scope for the CGCC to also play a valuable role in advising governments on the opinions of its members about the ways in which bureaucratic requirements and the actions of bureaucrats exert a negative influence on their business activities. As well, it can advocate changes to laws regulations and policies that would improve the climate for private enterprise in the PRC.

Deficiencies in the Organization of Markets

Almost universally, the SFs expressed discomfort with the highly competitive nature of the markets in the PRC. This is not a cause for concern. To the contrary, the cause for concern is that local officials might intervene to limit competition for established ventures that pay taxes and otherwise support the costs of local governments. The widespread tendency for local authorities to protect local markets is well established; and the PRC's WTO membership could prove valuable to domestic firms, as well as foreign ones, in removing entry barriers to markets throughout the country (see footnote 48). Whether or not that is the case, the SFs identify "local protectionism" as a continuing problem and more should be done to simplify the conditions for market entry and exit. In some places, licenses to operate in markets can be withheld due to bureaucratic whim.

Although the SFs seem comparatively relaxed about the enforcement of contracts and the security of their property rights, the attitudes of the bankers that spoke to the IC suggests that more needs to be done to improve laws governing these areas. The survey did uncover a major concern about "unfair competition," especially with respect to "fake products." There is a need to distinguish legitimate competition from situations in which producers are defrauded by those who sell products under proprietary labels that are not their own. Without restricting the consumer's freedom to choose, there is a clear argument for better enforcement of standards, and for harsher penalties for firms that knowingly infringe the copyrights, patents, brands or other market assets of their competitors. Those penalties might be extended also to officials who turn a blind eye to the violations, especially when to do so favors locally based producers.

Besides the goods markets, the PRC needs to improve the way in which its factor markets work. There are well-recognized impediments to the development of an efficient labor market in the PRC, though the Government has taken cautious measures to improve the situation without adding to the incentives that already exist for a massive rural to urban influx. Evidence from the five-city survey suggests that recruitment outside of the location of an enterprise is becoming more common. That tendency would be accelerated by measures that would increase the portability of pension or social security benefits; clarify the ownership rights to houses and apartments, and make houses easier to sell; and provide more universal coverage of such benefits as health insurance and unemployment insurance. The reforms needed to contribute to a functioning housing market are part of a broader agenda of reform that would establish more security for land use rights, which would enable the holders to sell their assets at need or to pledge them as collateral for loans.

Recommended Measures

On the part of governments, the actions needed are mainly those discussed in the three preceding paragraphs. In almost all cases the remedies are known and under implementation; at issue is to what extent reforms can be implemented more rapidly. Greater vigilance is needed to penalize those who violate the property rights of others. The widespread efforts to move against violators of foreign intellectual property rights should serve as a useful model for action to protect domestic producers from similar damage.

In tackling these problems, the CGCC can again be an important voice for the interests of its members. Several LCs already intercede selectively with local officials to underline complaints by its members. A more systematic dialogue could be encouraged, with regular meetings allowing officers of the CGCC to alert local officials to instances of market disorganization, as well as to broader membership concerns. Where disputes arise at the level of individual firms, especially where the adversaries are all members of the CGCC, there is scope for the CGCC to extend a service it already provides in some cases to arbitrate those disputes. This service appeals as a cost-effective alternative to formal legal action.

Implementing Recommended Measures

Almost all of the measures that would improve the climate for private enterprise are already included in the broad reform objectives of the Government. In particular, governments at all levels are concerned about improving the access of small firms to formal sources of finance, and improving the security of contracts and property rights through improvements in laws and the way the legal system functions. These are essential prerequisites for small private firms to achieve optimal economic size, especially as they increasingly face competition from international firms, as well as from firms located elsewhere in the PRC. Nevertheless, greater urgency could be given to measures in many areas that would ease rapidly the constraints on private enterprise.

Table 3.2 Action Plan for Relaxing the Constraints on the PRC's Private Sector

Priorities	Short Term (within a year)	Medium Term (1 to 3 years)	Long Term (beyond 3 years)
1. Improving Access to Finance			
<ul style="list-style-type: none"> • Make interest rates more flexible 	<ul style="list-style-type: none"> * Expand lending rate band to 100% for SMEs 	<ul style="list-style-type: none"> * Free lending rates for loans to SMEs 	<ul style="list-style-type: none"> * Completely liberalize lending and deposit rates
<ul style="list-style-type: none"> • Supervise credit guarantee companies (CGCs) 	<ul style="list-style-type: none"> * Establish a regulatory agency for CGCs * Monitor CGCs' performance * Investigate scope for collateral guarantees 	<ul style="list-style-type: none"> * Merge or close failed CGCs * Introduce reguarantee facility * With banks and CGCs, initiate pilot program for collateral guarantees and collateral information systems 	<ul style="list-style-type: none"> * Phase out credit guarantees * Depending on results of pilot program, establish collateral guarantees and collateral registration at CGCs nationwide
<ul style="list-style-type: none"> • Clarify property rights to expedite the recovery of collateral 	<ul style="list-style-type: none"> * With banks, CGCs, and legal authorities, develop expedited system for recovery of collateral in events of default * Clarify rights to use land, including where relevant ownership rights, and develop functioning land use markets so that real property can serve more effectively as collateral for loans 	<ul style="list-style-type: none"> * Introduce in a pilot program (selected provinces, one bank, court or arbitration system) to handle collateral recovery quickly 	<ul style="list-style-type: none"> * If successful, extend program to all banks and countrywide
<ul style="list-style-type: none"> • Improve accounting and audit practices 	<ul style="list-style-type: none"> * Through SETC, Tax Departments, and SAIC, reiterate the need for appropriate standards for bookkeeping * Convene a panel to affirm standards for SMEs 	<ul style="list-style-type: none"> * Enforce penalties for inadequate financial reporting 	
<ul style="list-style-type: none"> • Continue general banking sector reforms 	<ul style="list-style-type: none"> * Continue to improve banks' portfolios by assignment of nonperforming loans to asset management companies, by freeing banks to make all loan decisions on the basis of sound commercial practices, by improving bank supervision and regulation, and by recapitalizing the state commercial banks and establishing realistic provisioning policies (and practices) * Introduce competition (both foreign and domestic) in accordance with WTO provisions * Improve the quality of audit and disclosure by enterprises and banks * Implement the revised commercial law, especially as it relates to enforcement of contracts * Encourage the PBC to investigate ways to introduce a credit information system to apprise banks and enterprises of the credit standing and loan servicing records of prospective clients 		
<ul style="list-style-type: none"> • Continue to develop capital markets 	<ul style="list-style-type: none"> * Continue to improve the quality of regulation and supervision of capital markets, including in particular higher standards for disclosure * Complete integration of A and B markets * Promote development of active trading of government securities to establish a yield curve * Encourage corporations with satisfactory performance and financial reporting standards to issue corporate bonds * Develop a municipal bond market * Introduce several over-the-counter markets and markets specializing in high-tech companies 		

Priorities	Short Term (within a year)	Medium Term (1 to 3 years)	Long Term (beyond 3 years)
2. Enhancing Management and Technical Skills			
<ul style="list-style-type: none"> • Facilitate the provision of training 	<ul style="list-style-type: none"> * Appoint a professional body/bodies to accredit training programs from commercial suppliers 	<ul style="list-style-type: none"> * Certify courses offered by licensed training institutions * Encourage CGCC, IAs, and similar organizations to establish rosters of reliable trainers for clients and to seek feedback on the quality of training programs from participants 	
<ul style="list-style-type: none"> • Improve labor mobility 	<ul style="list-style-type: none"> * Develop plans to increase the mobility of senior managers and technical personnel, in particular, by enabling them to dispose of housing and take pension and other benefits to new positions * Continue measures to permit greater mobility of labor (especially rural-urban migration) nationwide 	<ul style="list-style-type: none"> * Develop pilots that allow all workers to increase the portability of pensions, housing, health insurance, etc. 	<ul style="list-style-type: none"> * Mainstream portable benefits countrywide
<ul style="list-style-type: none"> • Empower managers to make independent personnel decisions 	<ul style="list-style-type: none"> * Promulgate the principle that all hiring by private firms are independent of governments and the Party 	<ul style="list-style-type: none"> * Extend principles to all SMEs and collectives * Allow salaries/benefit decisions to be made by managers/boards of firms 	<ul style="list-style-type: none"> * Free all firms, including large SOEs, to appoint personnel on the basis of merit * Delink all enterprise remuneration from official salaries and official influence
3. Improving Quality and Quantity of Information			
<ul style="list-style-type: none"> • Coordinate responsibilities of different agencies to collect and distribute information 	<ul style="list-style-type: none"> * Clearly designate various agencies' responsibilities to collect and disseminate information 	<ul style="list-style-type: none"> * Reduce inconsistencies/ambiguities in the information provided by different agencies 	
<ul style="list-style-type: none"> • Improve the dissemination of information on policies and regulations; internal and external markets; access to technology; availability of training services, finance, personnel, etc; and so on 	<ul style="list-style-type: none"> * Effectively use the Internet as a medium for dissemination * Upon registration, SAIC to provide all new firms with a pamphlet documenting the classes of information they should use and where to find that information 	<ul style="list-style-type: none"> * All relevant agencies (SAIC, SETC, IAs, CGCC, CCPIT, Tax Departments, SSB) to establish and publicize web sites that contain comprehensive information of value to private firms * For CGCC, in particular, recruit library and data management skills, and establish a training program for staffs of CGCC and the LCs in collecting and disseminating information to the membership 	

Priorities	Short Term (within a year)	Medium Term (one to three years)	Long Term (beyond three years)
4. Implementing Policies/Laws/Regulations More Effectively			
<ul style="list-style-type: none"> • Remove special privileges and level the playing field for all 	<ul style="list-style-type: none"> * Extend the benefits promised to foreign firms under the PRC's WTO accession protocol to all domestic private enterprises * Continue the process of extending equal treatment to all firms irrespective of ownership or origin 		
<ul style="list-style-type: none"> • Ensure consistent interpretation of regulations 	<ul style="list-style-type: none"> * Using the model of the current training program preparing government officials at all levels for the requirements of the WTO, extend that training to improve those officials' knowledge of domestic policies, regulations, and the like, and how they apply to domestic private firms * Build and maintain a comprehensive database on all policies, laws, and regulations that affect private firms, and disseminate the information as in 3 above 		
<ul style="list-style-type: none"> • Simplify administrative procedures to make government services more easily accessible and reduce the scope for bureaucratic discretion 	<ul style="list-style-type: none"> * Review licensing requirements for enterprises with the view to eliminating unnecessary ones * Establish timetables for routine inspections (health, safety, environment, etc.) of enterprises and announce them publicly * Eliminate all ad hoc fees and levies on enterprises and replace them by legitimate, transparent tax schedules 	<ul style="list-style-type: none"> * Establish a single point at which new firms can satisfy all their registration requirements (a domestic "one-stop shop") 	<ul style="list-style-type: none"> * Monitor officials' performance and dismiss officials who abuse their office
<ul style="list-style-type: none"> • Elicit comments on policies/laws/regulations 	<ul style="list-style-type: none"> * Encourage the CGCC and IAs to establish regular exchanges with local officials on behalf of their memberships to provide feedback on how their clients are affected by the implementation of existing statutes, and to recommend changes that would facilitate the activities of private enterprises 		
5. Improving Market Organization			
<ul style="list-style-type: none"> • Secure property rights (especially intellectual property rights) of private firms 	<ul style="list-style-type: none"> * Review penalties for infringement of proprietary assets of firms and recommend changes to make protection of domestic firms consistent with that required for the property of foreign firms 	<ul style="list-style-type: none"> * Enforce the laws protecting the proprietary assets of individual firms and penalize those who infringe them 	
<ul style="list-style-type: none"> • Define and safeguard quality and standards 	<ul style="list-style-type: none"> * Governments and private bodies to develop a framework for establishing and conforming to quality and standards 	<ul style="list-style-type: none"> * Implement the framework and improve the enforcement of standards 	

Priorities	Short Term (within a year)	Medium Term (1 to 3 years)	Long Term (beyond 3 years)
<ul style="list-style-type: none"> • Minimize local protectionism 	<ul style="list-style-type: none"> * As emphasized by Prime Minister Zhu Rongji in his speech to the NPC in March 2002, take steps to ensure free access of local firms to all parts of the domestic PRC market * As needed, promulgate new laws to prohibit disruption of inter-provincial commerce, and introduce penalties for local officials who impede the legitimate activities of non-local firms 	<ul style="list-style-type: none"> * Enforce laws that prohibit the protection of local markets, and monitor local legislative initiatives to ensure that they do not act as a restraint on inter-provincial commerce 	

In Table 3.2 a proposed agenda of actions is shown for each of the five broad areas that the survey identifies as being of most concern to entrepreneurs, and for the time periods over which those actions feasibly could be implemented. Probably nothing is more important than clearly establishing rights to property and then ensuring that the legal system is able to enforce contracts in a timely manner. Both are needed if firms are to borrow against assets, be they land and buildings, marketable equipment and other goods, or receivables. Governments need to pay particular attention to the issue of how creditors and guarantors can recover collateral in the event of default, even if this means establishing special courts or arbitration arrangements that can act decisively and quickly to settle claims in days or weeks rather than months or years. Even then, banks will need much greater discretion over the fees and interest rates they can charge for loans if small private borrowers are to become attractive commercial clients. The dramatic growth in consumer lending in recent years demonstrates clearly the enormous commercial potential for banks in lending to small businesses if conditions are right.

Summary

The survey conducted for this study finds an improved climate for private enterprise in the PRC since the earlier IFC study was completed, but confirms that the major impediments to the growth of private firms identified by the IFC study continue to constrain those firms. The areas that most need attention are: improving the access of private firms to finance, skilled personnel, and information; and improving policies and regulations, and the consistency and transparency with which they are implemented. Governments at all levels have initiated many actions to improve the situation, although some of them seem ill-designed for the purpose (e.g., guarantees for bank lending to SMEs), and progress in other cases seems unduly slow. An area that needs urgent attention is the discretion residing with local officials to interpret policies inconsistently, as well as to pester entrepreneurs for non-transparent payments. Better training of officials and more widely disseminated information about policies could help, as would more reliably enforced penalties for officials who abuse their office. The CGCC and similar organizations can help to improve matters by representing members' interests more effectively with governments, and by providing better information in many areas.

Section 4: The Role of the China General Chamber of Commerce

The preceding discussion raises the important question for this study: how best can the CGCC and its LCs ease the constraints on private enterprise and contribute to faster growth of the PRC's private economy? Elements of the answer would include decisions on how a refocused CGCC would better (i) represent its members' interests in discussing with governments members' concerns about the design and implementation of policies, laws, regulations, and rules; (ii) facilitate the interaction of individual firms with official agencies, including, for example, in acquiring licenses or registering with the tax authorities; (iii) inform its members about conditions in domestic and foreign markets, the policies that apply to them, important upcoming events, etc.; and (iv) coordinate social and mutual support activities for members. This section reviews the current organization, structure and functions of the CGCC, and considers what changes might allow it to serve its members better.