

## PRIVATE SECTOR ASSESSMENT (SUMMARY)<sup>1</sup>

### A. Sector Performance, Problems, and Opportunities

1. The economy of the People's Republic of China (PRC) has undergone fundamental change as it transformed from a heavy reliance on state-owned and collective enterprises to a mixed economy. It has now evolved toward greater private economic activity, with a sharp decline in the overall role of state-owned enterprises (SOEs). The private sector has expanded rapidly and is one of the key drivers of economic growth. By 2012, the share of industrial output of SOEs was down to 24%. The share of urban employment by SOEs was down to 18% in 2012, from 99% in 1978. Private enterprises have accounted for most of the growth in urban employment since 1978, and rural employment was virtually all private. SOEs accounted for only 11% of exports in 2013, compared with 47% by foreign-owned private firms and 39% by domestic private firms. In addition, profits have been significantly higher on average in private enterprises than in SOEs— 13.2% in 2012 versus 4.9%.<sup>2</sup> The private sector now plays a pivotal role in spurring innovation and raising productivity and competitiveness.

2. While the private sector has experienced rapid growth, there are still many barriers restricting greater private sector participation in the economy. The major constraints on private sector participation in the sectors and areas that the Asian Development Bank (ADB) operates in are

- (i) an uneven playing field in some industries and/or sectors, e.g., dominance of SOEs that receive favorable treatment; regulations restricting entry;
- (ii) a weak legal and regulatory framework;
- (iii) lack of transparency in the approval process;
- (iv) lack of or limited access to financing;
- (v) rising costs and high tax burden;
- (vi) inadequate infrastructure;
- (vii) lack of access to factors of production;
- (viii) tariffs for some services are below cost-recovery levels;
- (ix) weak contract enforceability;
- (x) weak policy coordination among government agencies; and
- (xi) poor policy execution.

3. Opportunities for improving the enabling environment for private sector participation lie within the reach of government policy, such as removing unnecessary bars on the participation of the private sector; reforming SOEs, particularly those providing finance and delivering infrastructure, so as to provide the private sector a level playing field; strengthening the policy and regulatory framework; deepening the finance sector; using market mechanisms in environmental management; reforming the *hukou* (household registration) system and social security instruments, so as to facilitate labor mobility and investment in human capital; reforming public finance to improve the tax system and the role of the private sector in infrastructure; and streamlining public sector administration.

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<sup>1</sup> This summary is based on sector reviews and Asian Development Bank (ADB) technical assistance reports.

<sup>2</sup> Lardy, N. R. 2014. *Markets Over Mao. The Rise of Private Business in China*. Washington, DC: Peterson Institute for International Economics.

## B. Government's Sector Strategy

4. The Third Plenary Session of the 18th Central Committee of the Communist Party of China, held on 9–12 November 2013, announced a far-reaching and comprehensive set of reforms to tackle the development challenges facing the PRC.<sup>3</sup> In particular, it called for the market to play a decisive role in resource allocation. It recognized that the private sector will be an important engine of growth and innovation. It also recognized that it is important the required reforms—such as ensuring open and fair market competition; SOE reform; improving the enabling policy, legal and regulatory, and institutional framework; implementing price reforms in various sectors, e.g., water, oil and natural gas, electricity, transport, and telecommunications; and introducing market mechanisms to help resolve environmental and climate change issues—increase private sector participation in the economy. Moreover, foreign direct investment will closely align with national development priorities so as to boost scientific innovation, industrial upgrading, and balanced development.

## C. ADB Sector Experience and Assistance Program

5. **Private sector development.** Sovereign loans and technical assistance projects in infrastructure, the finance and agriculture sectors, education and vocational training, and finance have been integral to Asian Development Bank's (ADB) efforts to improve the enabling environment for the private sector. Sovereign loans and technical assistance have provided an opportunity to promote new approaches to market-led development, including a market approach to resource protection, energy conservation by energy supply companies, and the promotion of energy trading and trade facilitation under the Central Asia Regional Economic Cooperation and Greater Mekong Subregion programs. ADB lending made through the government to small and medium-sized private agro-enterprises, farmer cooperatives, and individual farmers has allowed these entities to enhance production and develop agricultural value chains. Project-based support has been complemented by a long-standing engagement in policy and institutional reforms. Past areas of support have included the legal framework on competition, SOE and finance sector reforms, agricultural policies, infrastructure pricing, procurement, and trade reform.

6. During the country partnership strategy (CPS) period (2016–2020), ADB sovereign operations will focus on the following areas:

- (i) **Agriculture, natural resources, and environment.** ADB will promote private sector development through (a) investment in agricultural and food safety infrastructure to create an enabling environment for private investment; and (b) assistance to the private sector in the areas of agricultural value chains, climate-smart agriculture, and rural financing. ADB will also promote the development and implementation of ecocompensation or payment for ecological services arrangements, and sustainable ecotourism.
- (ii) **Energy.** ADB will promote private sector development by (a) engaging in policy dialogue on incentives (e.g., feed-in-tariffs) to promote emerging renewable energy technologies; (b) supporting reforms to enable private sector participation in power distribution; (c) supporting public–private partnerships (PPPs) to meet urban energy demand; (d) engaging provincial and city governments in structuring and financing such PPP transactions; and (e) working with central and provincial governments to expand access to credit for energy efficiency investments.

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<sup>3</sup> Chinese Communist Party Central Committee. 2013. *Decisions on Important Issues Concerning Comprehensive and Far-reaching Reform*. Beijing. Third Plenum of the 18th Central Committee of the Communist Party of China.

- (iii) **Transport.** ADB will promote private sector development in the following areas: multimodal passenger hubs and freight logistics parks, SOE reform, urban transport services, integrated urban development, and intercity rail services.
- (iv) **Urban infrastructure and services.** ADB will promote private sector development by (a) advocating the adoption of overarching legislation and regulations for PPPs, (b) improving operational performance and efficiency of water utilities, (c) supporting tariff reforms, (d) promoting new technologies and advanced urban development concepts and approaches, (e) supporting urban infrastructure improvements, and (f) supporting a more consistent legal and regulatory framework for privatization of utilities.
- (v) **Education.** ADB will promote private sector development by (a) involving private industry and employers in governance boards of universities and technical and vocational education and training institutions to open up course and syllabus offerings relevant to employers, and (b) supporting expanded partnerships between industry and universities to promote incubation centers and stimulate innovation.
- (vi) **Health.** ADB will promote private sector development in the areas of elderly care by analyzing constraints and recommend viable solutions to promote private sector investment.
- (vii) **Finance sector.** ADB will continue to help support a private sector enabling environment through enhancement of the financial infrastructure (including reform of company law, bankruptcy law, and credit market law) that will further support private sector development in finance.
- (viii) **State-owned enterprise reform.** ADB will support (a) policy and institutional reforms on SOEs such as budgeting for SOEs, taxation of SOEs, corporate governance of SOEs, and economic regulation; and (b) learning from successful SOE reforms in other countries, and aligning with the government's reform program.

7. **Nonsovereign operations.** Financing nonsovereign projects are delivered by ADB's Private Sector Operations Department. Debt and equity financing is provided on commercial terms for projects with high development and demonstration impacts. ADB will respond to market demand that maximizes the development impact, and play a catalytic role in mobilizing financial resources, cofinancing, and providing technical assistance to support green growth.

8. In infrastructure, ADB will help the private sector to address environmental problems, underlining the need to review unsustainable practices. Private sector operators can effectively address the existing challenges of public utilities, such as obsolete technologies, lack of pollution abatement equipment, low energy and other resource efficiency, limited environmental management capabilities, and financial constraints. ADB will implement its environmental mandate by financing projects in environmental infrastructure, and by applying environmental, social, and corporate governance requirements to all projects. During 2011–2015, ADB approved 12 private sector infrastructure projects totaling \$2.9 billion and mobilized cofinancing from more than 40 banks. ADB also implemented technical assistance totaling \$2.1 million to support the environment, such as promoting fuel switching from coal to natural gas, cash-flow-based energy efficiency finance for local banks, and reusing treated wastewater.

9. More specifically, ADB will (i) finance private sector infrastructure transactions that offer innovative solutions to environmental problems, with particular focus on cross-sector, cross-jurisdiction private sector participation; new opportunities to address the water, energy, and food security nexus; and demonstration of advanced technologies; (ii) support agribusiness projects that enhance productivity, inclusion of smallholder farmers in value chains, and food safety; (iii) explore opportunities to support commercially viable business models in areas such as climate

change finance, environmental protection, and social development, including health and education; and (iii) pursue opportunities to further catalyze commercial cofinancing into its transactions through parallel loans, guarantees and risk transfers.

10. In the finance sector, ADB has helped commercial banks and nonbank financial institutions to mobilize resources and manage risks, and worked with them to support inclusive economic growth, environmental protection, and climate change. During 2011–2015, ADB provided two loans totaling \$350 million to support leasing of clean buses and health care. In addition, ADB provided \$2.3 million in technical assistance to help improve clean bus operations and management. Over the forthcoming CPS period, ADB will focus its finance sector operations on (i) expanding access to finance and strengthening finance sector development by supporting financial institutions to provide services to underserved segments, (ii) supporting growth of nonbank financial institutions that are new or in the early stage of development, and (iii) supporting climate change finance and environmental protection. ADB will also explore new initiatives and opportunities for working with financial intermediaries to support health and education development.

11. In trade finance, ADB will support financial intermediaries and explore new financial products and mechanisms to increase the flexibility and availability of financing for trade and supply chains. During 2011–2015, ADB supported 1,194 PRC export transactions (over 1,054 small and medium-sized enterprises) valued at \$858 million through its Trade Finance Program (TFP). Most of the PRC exports under the TFP transactions were destined for Bangladesh, Pakistan, and Viet Nam. Over the forthcoming CPS period, the TFP will enhance trade facilitation by supporting yuan-denominated exports to other developing member countries. In addition, ADB will continue to implement activities under the Supply Chain Finance Program in the PRC, which had conducted over 70 transactions in 2015 valued at over \$80 million, and supported more than 40 small and medium-sized businesses.

12. ADB supports private equity funds by providing much-needed equity finance to support the strategic, corporate, and development objectives of small and medium-sized enterprises. During 2011–2015, ADB invested \$230 million in four regional funds with a PRC focus, with aggregate commitments of \$2.3 billion. These funds are expected to invest in a portfolio of more than 25 companies engaged in climate change mitigation and adaptation, financial services, agribusiness and food security, health care, and infrastructure development. Over the forthcoming CPS period, ADB will invest in regional private equity funds that align with ADB's operational sectors. As part of its growth strategy within this asset class, ADB will leverage its capital, institutional strength, and knowledge in private equity fund investing to explore opportunities in managing third-party capital for (direct) deployment.