

CHINA'S SMALL ENTERPRISES IN ECONOMIC TRANSITION: SUCCESSSES AND PROBLEMS¹

FUXIN JIANG

School of Business, Nanjing Normal University

and

CHUNPING ZHOU

School of Economics, Yangzhou University

China's small enterprises have been the backbone of China's economic transition to a market-oriented, industrialized, urbanization and open economy, and have promoted a transformation in the role of the government in the economy. The main problems China's small enterprises face are closely tied in with the economic transition period and the imperfection of current institutions. Small enterprises have pushed China's economic transition forward, but China's small enterprises are also still in transition themselves. With the continuation of China's economic institutional reform, the sustained development of the economy and support from China's government, small enterprises are expected to benefit from the existing opportunities.

I. INTRODUCTION

Modern economics faces a great challenge to explain China's institutional change and economic transition from a state-planned system to a market-oriented system over the last 20 years. The new institutional economics presents a framework that posits economic transition as institutional change, stressing the interaction between organizations and institutions over time (Yang 1998; Huang 1999).² The existing studies of the components of institutional change have been carried out primarily by North (L. Davis and D. North).³ This work emphasizes analysis of the operations of different groups involved in institutional change, but does not focus on enterprises of different ownership or scale.

Existing studies of China's small enterprises focus on their role in increasing employment (Mo 2001)⁴, the process of transformation to a market-oriented economy (Wu 1995)⁵ and the role of the small-scale sector in industrialization (Chen 1995).⁶ These studies do not address the role of small enterprises in China's economic transition. This article fills this gap by studying the functions of China's small enterprises in the economic transition, and the problems they face as a result of their key role in this process.

The important theme developed here is that China's small enterprises have successfully promoted the economic transition to be market-oriented, industrialized,

urbanized, and open to the world economy, and have played a role in the transformation of government's functions since the realization of the reform and opening policy. The second section of the article utilizes empirical data to support this theme. Owing to the lack of concrete data on China's small enterprises overall, data on township and village enterprises will be analyzed.⁷ The third part analyzes the main problems facing the development and the transformation of China's small enterprise. The last part discusses some forecasts for the future of China's small enterprises.

II. FUNCTIONS OF CHINA'S SMALL ENTERPRISES IN ECONOMIC TRANSITION

1. Small Enterprises and China's marketization

The process of China's marketization and privatization has not been synchronized. The goal of China's economic institutional reform to set up a market-oriented economic system was put in place in 1992, but the market-oriented economy began to develop commerce since the initial stage of the reform at the end of the 1970's. Privatization began when state-owned enterprises (SOEs) began changing as a result of outside pressures. The course of China's market-oriented economy has been realized not by privatizing SOEs within the planned economy, but rather by changes from outside the planned economy. By allowing township and village enterprises⁸, private enterprises⁹, individual industrialists and businessmen¹⁰ and other non-SOEs to become market-oriented decision makers, pressure was created that led to acceleration of reform of SOEs. Therefore, the mode of China's reform can be understood as gradual, incremental or marginal reform, which is quite different from the shock approach that would have occurred if SOEs had been privatized quickly and directly. This gradual approach to reform has been largely successful in creating steady and sustained increases in the economy.

As one important part of the small enterprise sector, township and village enterprises accelerated China's market-oriented course in the 1980's. The formation and development of township and village enterprise was closely related to the separation of powers within township government and the reform of the local finance and tax systems. The state-owned sector captured monopoly rent from the government's protective policies in the planned economy system. After economic reform began, and with the flexibility of rationing and the separation of powers in the economy, local governments participated in the market, sharing monopoly rent with state-owned enterprises. Local governments helped township and village enterprises to acquire factors of production such as capital, land and labor, and thus helped them compete with the state sector. Therefore it can be argued that local governments played an important role in China's market-oriented course (Zhang and Su, 1998).¹¹ Despite the local government role in promoting the development of these small firms, an important point is that township and village enterprises made their decisions about what and how to produce and sell independent from any government directives. This situation was in sharp contrast to SOEs, which were controlled by state plans. A further implication was that township and village enterprises were not required to take on heavy burdens like SOEs who were required to provide education, health care, retirement and housing for their employees. As a result, township and village enterprises had more autonomy in management and a chance to be more competitive and produce higher economic efficiency than SOEs. The investigation of Weitzman and Xu (1994) indicated that the increasing ratios of SOEs and township

and village enterprises' total factor productivity (TFP) were 4.0% and 12.0% respectively between 1979 and 1991.¹² Xie Qianli's conclusion indicated that the increasing ratio of SOEs' TFP was 2.5% while collective industry, including township and village enterprises, was 7.2% between 1980 and 1992.¹³ The rise of township and village enterprises created a competitive market within the planned economic system, bringing great pressure to state-owned sectors and lowering substantially the industrial average profit ratio. Taking garments as an example, the capital tax ratio of textiles was 69% in 1980 and only 7% in 1991. Therefore township and village enterprises accelerated management institutional reform of SOEs in the mid 1980's.¹⁴

The rapid rise of small private enterprises since the 1990's is another important factor that helped push China towards its market-oriented course. Because of clearly defined property rights and a flexible managerial mechanism, small private enterprises expanded in the market step by step. At the same time, the profit margin of SOEs declined continuously and most small SOEs made losses. In 1994, 24,000 industrial enterprises with independent accounting systems were making losses, including 19,700 small enterprises representing 82% of the total number. Under the pressure of economic competition from the private sector, small SOEs had to reform to adapt to the market. In August of 1998, 47,631 industrial enterprises with independent accounting systems in China had reformed. In some places 90 percent of the local small SOEs had reformed. What's more, not only small SOEs but also large SOEs underwent institutional and property rights' reform to establish modern corporate systems under the pressure of market competition. The structure of SOEs' property rights has become diversified with a great deal of state capital leaving competitive industries and even some monopolistic industries have opened to private capital.

The rapid growth of small private enterprises accelerated SOE reform and provided the foundation of SOEs' property rights reform. For example, growth in private firms created the chance for unemployed workers from the former SOEs to find new jobs, which helped SOEs' reform proceed smoothly. For example, there were about 4,600,000 unemployed workers absorbed by small private enterprises in 1998.

Table 1
Gross Output Value of Industry by Ownership (1978—1995) (100 million yuan: %)

year	State-Owned		¹⁵ Collective-Owned		Individual-Owned		Other Ownership	
	Output	%	Output	%	Output	%	Output	%
1978	3289	77.6	948	22.4	-	-	-	-
1980	3916	76.0	1213	23.5	1	0.0	24	0.5
1985	6302	64.9	3117	32.1	180	1.9	117	1.2
1986	6971	62.2	3752	33.5	309	2.8	163	1.5
1987	8250	59.7	4782	34.6	502	3.6	279	2.0
1988	10351	56.8	6587	36.1	791	4.3	495	2.7
1989	12343	56.1	7858	35.7	1058	4.8	758	3.4
1990	13064	54.6	8523	35.6	1290	5.4	1047	4.4
1991	14955	56.1	8783	33.0	1287	4.8	1600	6.0
1992	17824	51.5	12135	35.1	2006	5.8	2634	7.6
1993	22725	47.0	16464	34.0	3861	8.0	5352	11.1
1994	26201	37.3	26472	37.7	7082	10.1	10421	14.8
1995	31220	34.0	33623	36.6	11821	12.9	15231	16.6

Source: China Statistical Yearbook (1996), China Statistic Press.

China's market-oriented course has been a process whereby the share of the non-state sector has risen continuously while the range of planned resource allocation has shrunk as the government exited economic activities. Township and village enterprises and small private enterprises changed the single ownership structure of the traditional system and created the current situation with all kinds of ownership types. In view of China's industrial production structure's evolution, the proportion of non-state industrial production including township and village enterprises, private enterprises and individuals continuously increased, while state industrial production decreased. The proportion of non-SOEs' industrial production was only 22.4% in 1978 and 66.0% in 1995. Conversely, the proportion of SOEs' industrial production decreased to only 34.0% by 1995 (Table 1).

The formation and development of small enterprises not only directly accelerated China's market-oriented course, but also pushed the transformation of government's functions and administration reform to some degree. Government's means to manage the economy changed from direct to indirect management and from administrating management to economic and legal management, which further brought the market mechanism into play in resource allocation. In the future, reform of the political system and the further transformation of government's functions will ensure the base for China's small enterprise development.

2. Small Enterprises and China's Industrialization

Before the reform and opening policy, China's government monopolized industrial investment rights and preferred investing in heavy industry. In this environment it was difficult for small enterprises to develop, and therefore China's industrialization and urbanization proceeded slowly. Due to this mode of China's traditional industrialization, government accumulated some 510 billion yuan for industrial development via the "scissors" gap between the price of agricultural and industrial products. Thus peasants' income increased very slowly. The peasants' net annual income increased from 64 yuan to 134 yuan between 1954 and 1978, with an average annual increase of less than 3 yuan. Simultaneously, most labor stayed in the countryside. Although the proportion of agricultural labor decreased from 88% to 76%, the number increased from 180 million to 310 million—an increase of 1.2 times between 1952 and 1978. After reform began, the situation where industrial investment was monopolized by the government started to change. The rise of small enterprises, especially township and village enterprises, let China's industrialization mode enter into a new stage.

The township and village enterprise was a successful part of China's small enterprise sector. If the contract responsibility system with remuneration linked to output was one of China's peasants' creations, the rise of township and village enterprises was another one. The township and village enterprise became a strong wing of China's industrialization and changed China's dual economy structure. It also broke the natural economy, which was a trinity of rural, agriculture and peasants. The township and village enterprise radically influenced China's industrializing structure.

Table 2
The Structure of Gross Output Value of Rural Society¹⁶ (1980-1992) (%)

<i>Year</i>	<i>Farming, Forestry, Animal Husbandry, Fishery</i>	<i>Industry</i>	<i>Construction</i>	<i>Transportation</i>	<i>Wholesale, Retail Sale Food Services and Storage</i>
1980	68.9	19.5	6.5	1.7	3.5
1985	57.1	27.6	8.1	3.0	4.3
1986	53.1	31.5	7.8	3.3	4.3
1987	49.6	34.8	7.7	3.6	4.4
1988	46.8	38.1	7.1	3.5	4.5
1989	45.1	40.7	6.4	3.6	4.3
1990	46.1	40.4	5.9	3.5	4.1
1991	42.9	43.5	6.0	3.5	4.1
1992	35.8	50.1	6.2	3.6	4.4

Source: China Statistical Yearbook (1993), China Statistic Press.

As a result of growth in township and village enterprises, the proportion of gross output value of the rural economy decreased from 68.9% to 35.8% between 1980 and 1992, which caused agriculture to be secondary in the rural economic structure. Employment in township and village enterprises accounted for over 9% of total rural employment and rural non-agricultural output accounted for 31% in 1980. In 1987, the proportion of employment in township and village enterprises was 23%, and non-agricultural production exceeded agricultural output for the first time. In 1992, rural industrial output accounted for over 50% of rural gross output value, reflecting a great improvement in China's rural industrialization (Table 2).

Table 3
Survey of China's Township and Village Enterprises (1978-1995)

<i>YEAR</i>	<i>Number of Enterprises (10 thousand)</i>	<i>Persons Employed by township and village enterprises</i>		<i>Gross Output Value of Industry</i>	
		<i>(10 thousand)</i>	<i>%</i>	<i>(10 thousand)</i>	<i>%</i>
1978	152.4	2826.6	9.2	385.3	9.1
1980	142.5	2999.7	9.4	509.4	9.9
1985	1222.5	6979.0	18.8	1827.2	18.8
1986	1515.3	7937.1	20.9	2413.4	21.6
1987	1750.2	8805.2	22.6	3243.9	23.5
1988	1888.2	9545.5	23.8	4529.4	24.9
1989	1868.6	9366.8	22.9	5244.1	23.8
1990	1850.4	9264.8	19.6	6050.3	25.3
1991	1908.9	9609.1	20.1	8708.6	32.7
1992	2079.2	10581.1	21.9	13635.4	39.4
1993	2452.9	12345.3	25.3	23446.6	48.4
1994	2494.5	12018.2	24.6	32336.1	46.1
1995	2202.7	12862.1	26.3	51259.2	55.8

Source: China Statistical Yearbook (1996), China Statistic Press.

In another way, township and village enterprises played an important role in China's industrialization. In 1978, the industrial output of township and village enterprises was 38,530 million yuan, which accounted for only 9% of the total. In 1995, it had reached 5,126 billion yuan, accounting for 56%, nearly half of rural industrial output (Table 3). Township and village enterprises also changed the proportion of non-state and rural industry substantially, which created a type of industrial structure unique to China.

3. Small Enterprise and China's Urbanization

Township and village enterprises pushed not only rural industrialization but also urbanization. Small towns and small enterprises promoted one another. Lots of people concentrated in small towns, increasing the demand for agriculture products. This promoted agricultural industrialization and the transition to a market economy from a self-sufficient, household based economy.

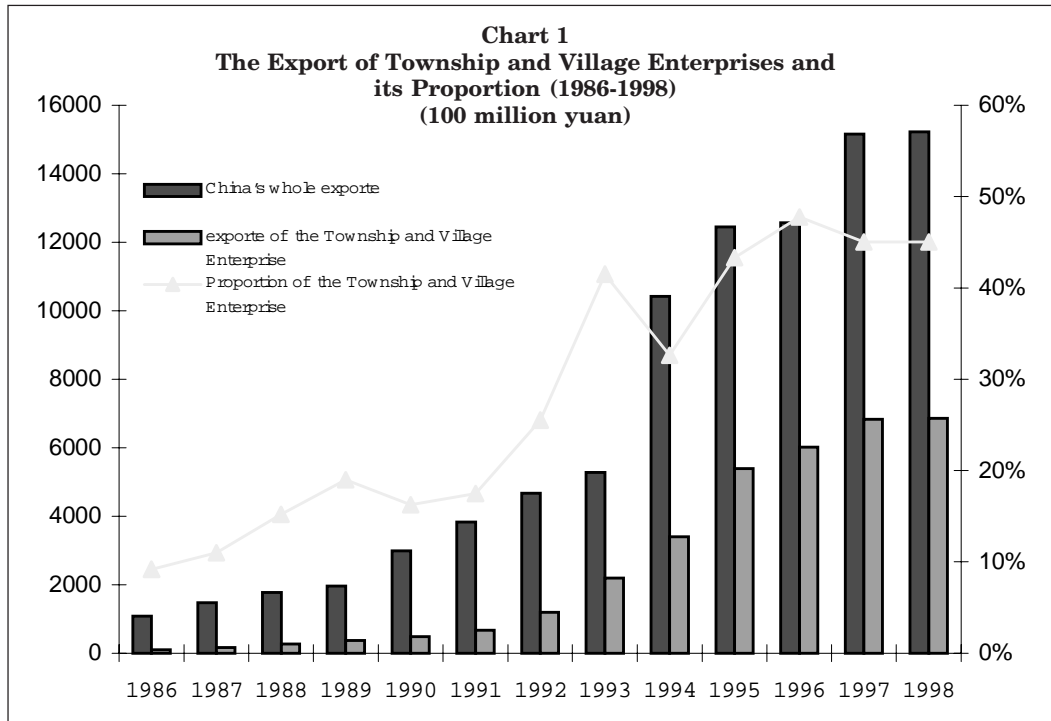
Before reform, the majority of rural labor stayed in the country side because of the rigid population household registration system—the *hukou* system. It was very difficult to move into cities causing urbanization to proceed quite slowly. Between 1952 and 1978, the level of urbanization rose from 12.5% to 17.9%. There was only 5.4 percentage points added in 26 years, or 0.2 percent annually.

After reforms began, the pace of urbanization picked up. Between 1978 and 2003, the level of urbanization rose from 17.9% to 40.5%. At the end of 2003, the urbanization level of Jiangsu Province, where township and village enterprises were relatively well developed, was 46.8% and the level in southern Jiangsu was more than 64%. By then the average GDP in southern Jiangsu exceeded \$3000 and traditional agriculture had disappeared.

With the boom in township and village enterprises, small towns grew up. At the end of 2003, there were 20,600 towns in China's administration system, with a non-farming population of 150,000,000. Township and village enterprises became the main channel of absorbing rural labor. In 1978, the number of rural laborers employed by these enterprises was 28,266,000, accounting for 9.2% of the rural labor force. In 1990, the number was 92,648,000 and 19.6%, respectively, and in 2000, the number was 128,200,000 and 25.7% respectively. The development of township and village enterprises accelerated the transfer of rural labor to urban areas and to non-agricultural employment.

4. Small Enterprises and China's Economic Opening to the World

Since the beginning of the reform period great changes have taken place in China's domestic market. Small enterprises had difficulty making profits when China's former shortage economy transformed to a surplus economy. China's opening policy provided the condition for small enterprises to enter the international market. As the degree of China's opening advanced, the status and function of small enterprises in foreign trade stood out more and more, and they became an important part of the development of China's export oriented economy as they took part in the international division of labor via low cost production. In 2003, the proportion of small enterprises accounted for 62.3% of China's exports. The labor-intensive products that have been the staple of China's exports such as textiles, clothes, toys, hardware and so on, come primarily from small enterprises (Chart 1).



Source: China Statistical Yearbook (1999), China Statistic Press; China Township and Village Enterprise Yearbook (1999), China Agriculture Press.

Township and village enterprises were the largest part of China's small enterprises and contributed the most to China's small enterprise exports as well. They participated in the international division of labor from the beginning of the 1980's. Before 1980, there were less than 1,500 small enterprises involved in exporting. In 1990, the number reached 58,000 with an export value of 48,500 million yuan accounting for 16% of China's total exports. From then on, the number of firms involved in exports and the value of their exports continued to rise. Between 1990 and 1998, the number of small enterprises with exports increased to 124,000 from 58,000 with employment increasing to 9,535,000 from 5,300,000; their export value increased to 685,370 million yuan from 48,560 million; and their export proportion increased to 45% from 16% (Chart 1). This impressive export growth from township and village enterprises became an important factor in China's economic development by altering the country's economic structure and increasing rural residents' income, in addition to greatly contributing to the growth of China's foreign exchange earnings.

III. PROBLEMS OF CHINA'S SMALL ENTERPRISES IN THE CONTEXT OF ECONOMIC TRANSITION

The problems of China's small enterprise development are closely connected with China's transition to a market economy, which has been quite different from other countries' experiences. Small enterprises have pushed China's economic transition but are still in

transition themselves. In the early days of reform, China's economy was a shortage economy. Small enterprises gained the chance to develop, but their institutional shortcomings (such as weak property rights of township and village enterprises)¹⁷ and extensive management abuses had not yet appeared. Since the mid 1990's, China has transformed from a shortage economy to a surplus economy and from an extensive economic mode into an intensive one. Owing to pressure to be profitable, small enterprises must improve their factor endowments structure, industrial structure and level of specialization to suit China's transition.

1. Problems in the Development of China's Small Enterprises

(a) Constraints Due to the Behavior of Government

First, low administrative efficiency constrains the development of China's small enterprises. China's political system reform is clearly slow compared with economic system reform, and the functions of government have still not transformed sufficiently. The administrative examination and approval process has many trivial details, so small enterprises have very high operation costs. The many departments administering small enterprises, and the many steps with long lead times to set up, lead to very high registration costs. These conditions and the resulting unfair competition have stifled the entrance of private capital in some areas. In addition, infrastructure in some localities is not adequate and the environment for the development of the private economy is not good. For example, rapid increases in economic development usually depend on favorable policies of land-use and taxation.

Second, the opportunistic behavior of government officials constrains China's small enterprise development. There are many taxes and charges imposed on small enterprises' operations. Due to overstuffed government, local governments rely on adding various fees to solve their financial difficulties to balance their budgets. This creates major problems for small enterprises' development. Further, to help relations with government departments, small enterprises have to pay for public relations, which adds to their operational costs. Research found that China's private enterprises spent 18% of their entertainment expenses, 15% of their net profit after tax and 44% of their dividends for their investors in 2003 for these types of costs (research group 2005).¹⁸

Another issue is that although protecting private property rights has been written into the constitution in China, private property rights are not yet well protected in practice, allowing local governments too much discretion, especially with respect to land use. This situation works against the long-term development of China's small enterprises. According to the economic freedom indices of 155 countries or areas in the world in 2005 issued by the Heritage Foundation and the Wall Street Journal, the score of China's property rights is above 4. That is to say that China's protection of private property rights is still repressed and cannot offer an expectation of long-run returns.

Third, the inertia of the planned economic system continues to restrict China's small enterprise development. There has been more than 20 years since China's reform and opening policies began, but the vestiges of the planned economy still influence the government's opinion and behavior to some degree. This is also reinforced by the extension of a feudalistic autarchy culture rooted for more than 2000 years in China.

Incomplete transition of the government's functions, too much economic intervention by the government, even to the extent of intervening in small private enterprises' internal affairs, and the bureaucratic nature of the government, all add to small enterprises' operating costs. Therefore, it is very hard for small enterprises' to function independently in practice.

(b) Financial Problems

The shortage of capital is one of the main problems facing China's small enterprises' development (Ling Hanchuan, 2003).¹⁹ Financial problems exist for nearly all of China's small enterprises. Ling reported that about 67% of small enterprises identify problems with access to capital as the most important obstacle to enterprises' development. These finance problems are revealed in low loan ratios and high financing costs. Small enterprises spend 5 times more to gain a loan than big enterprises. The time it takes for a small enterprise loan to be examined and approved is long and the procedure is complicated, and in the end, the amount of loans small enterprises win is only about 5% of big enterprises.

The reason for small enterprises' finance problems is, first of all, the weakness of the indirect financing system. China's finance institutions are state-owned banks that mainly serve SOEs and big enterprises. Small private enterprises find it very difficult to gain loans from banks. There are few middle or small finance institutions serving small enterprises. Although there are many rural credit cooperatives, 12 stock commercial banks and 88 city commercial banks across China, compared with developed countries, the amount is small and cannot meet the financing demands of small enterprises.

The second reason for finance problems in the small enterprise sector is economic in that the scale of small enterprises is limited and its credit standing is low. As in other countries, banks face higher risk and higher cost when loaning to small enterprises than when they loan to big enterprises. With reforms cracking down on banks' loaning behavior, banks have cut their loans to higher risk projects, which are mostly the small enterprises. China's small enterprises' finance systems are unhealthy and the lack of information transparency results in low credit standings. Many small enterprises do not have financial statements required for audits and they are not adept at record management. More than 60% of China's small enterprises' have credit ratings of 3B or below. To avoid risks, 80% of recent loans provided by banks concentrate on enterprises with credit ratings of 3A and 2A.

The third reason is that China's capital market was designed to serve SOEs. Private enterprises account for less than 6% of all listed companies. Due to the high threshold of financing required plus a limit based on an allocated target for listings by the administration, small private enterprises find it very difficult to obtain capital from the securities market.

The last reason for financing problems is that the venture capital market has developed slowly. The amount of capital invested in the science and technology of small enterprises is insufficient. By the end of 2004, there were 217 venture capital institutions and about 50 billion yuan of venture capital in China. But China's venture capital

enterprises are few in number and mostly small scale, with more investment coming from government than private sources. In addition, the mechanism for exiting projects is not developed, corporate law limits venture capital and persons with ability in venture capital are scarce. All of the above restrict the development of China's venture capital.

(c) Credit Shortages

The credit shortage in China's economic activities is causing disruption in the market economy and increasing transaction costs. There are many imitated commodities and pirated intellectual property rights. The problems of breach of faith, producing and selling imitated products with low quality, disclosing false information, cheating on quality and so on, are ubiquitous. Research has shown that 47% of small enterprises think credit conditions are medium, 35% think they are poor, and only 18% think they are good.²⁰ The economic loss caused by credit shortages including cheating on contracts, defaulting on debt, imitation of products with low quality, etc. in China is 586 billion yuan every year, equaling one fourteenth of China's GDP. Because of the infestation of low quality imitated products, in effect intellectual property rights cannot be protected since the private cost is not consistent with the social cost of the economic activity. Accordingly, entrepreneurs are discouraged from innovating, transaction costs increase in the market, and effective organizations are difficult to form. The main reasons for the credit shortage in China's market economy lie in poor protection of intellectual property rights, local protectionism, loose execution of the law and an unhealthy credit system.

(d) Shortage of Innovation Capital

The technology level of small enterprises is quite low in China. Equipment and production technology in most small enterprises are at the level of the 1970's-80's. Enterprises using pre-1970s technology account for approximately 20% and those who are using more recent, 1990s technology account for only 4.2%. The technology level of joint-venture small enterprises is usually higher than even these exclusive small enterprises whose technology levels are of the 1990's.

One of the issues is the shortage of innovation capital, which is mostly limited by China's science and technology system. In China, the development and investment system of science and technology depends on the state. Outlays for R&D are in the institutions of pure technology research. Most outlays for R&D in enterprises depend on self-financing and bank loans except for a few high priority items of large enterprises that can get partial investment from the state. Small enterprises and research institutions lack cooperation. Research institutions do not compete in the market and their relations with enterprises are loose. The proportion of innovations created in these types of research institutions that end up being produced beyond very small runs or prototypes is estimated to be only 10-15%.

Many of China's small enterprises do not spend resources on R&D and even those that do spend less than 1% of their sales revenue. According to survey research, though they represent the advanced level of non state-owned small enterprises, overall small

enterprise outlays for R&D are quite deficient. In 2002, their expenditures on R&D was only 0.31% of their sales revenue, far from the developed countries' level of 2-3%.²¹ Since small enterprises do not invest in innovation or technical personnel, not surprisingly their innovations are rarely significant.

(e) Pollution Problems

Partly because most of China's small enterprises lag behind in production techniques and have low efficiency, they tend to be serious polluters of the environment. It is estimated that over 80% of industrial production carries with it major pollution. Owing to the shortage of investment in pollution treatment, pollution resulting from small enterprises accounts for 60% of the total. Until the end of 2003, there had been nearly 1,000,000 small enterprises shut down for pollution reasons. Because of pollution, China's small enterprises create negative externalities and add social costs, both of which influence their sustainable development.

The reason for serious pollution by China's small enterprises is first the high cost of pollution control for small enterprises. Because the technological equipment used by small enterprises tends to be older generation, the utilization rate of resources is low and released pollutants per production unit are high. The second reason is that small enterprises' polluting activity is often beyond government's ability to supervise. Local governments' interests collide with social welfare. Sometimes local government may even collude with enterprises letting them ignore their pollution issues. The last reason is limited financing with low credit standing, making it very difficult for small enterprises to finance pollution control equipment.

2. Transition of China's Small Enterprise Development Mode

(a) Revamping the Structure of Factor Endowments

Comparative advantage is created from the structure of factor endowments. China's structure of factor endowment is that capital is relatively scarce and labor is relatively abundant. Therefore to be viable the favorable factor investment structure for China's comparative advantage is labour intensive industry (Lin YifuyLi Yongjuny2001).²² The international competitiveness of China's small enterprises is therefore also rooted in the cost advantage of labour intensive production. In addition, developing labour intensive enterprises also can relieve some of the pressure of China's surplus labor. In the course of China's economic transformation, SOEs have released lots of labor and the labor surplus in rural areas also needs to be transferred to productive activity, so demand and supply in the labor market is in grave imbalance. For a long time to come, the emphases of small enterprises will continue to be labour intensive production. The way for China's small enterprises to develop is not high-level science and technology based on capital intensive processes, but instead is the adaptation, innovation and transfer of labor intensive technology.

From a macroeconomic policy perspective, there is unbalanced policy for enterprises' development. For the purposes of expanding employment and utilizing appropriate comparative advantage, China should move away from policies that give non-market advantages to technology and capital intensive industries (Xia Xunge, 2000).²³

At the same time, possessing comparative advantage is not the same as possessing competitive advantage. If China's small enterprises lack competitive advantage, they cannot be viable. The competitive advantage of small enterprises' factor endowment may be a losing position with declining viability with their technological inferior conditions. With increasing global competition and the growing importance of knowledge-based activities in the new economy, the advantage of low cost and low price of labor intensive products is facing growing competitive pressure. China's small enterprises, especially those with export markets, must transform their product structures and improve their products' value added so they can be internationally competitive. Therefore it is not enough to pay attention to the comparative advantage based on abundant labor resources; China also needs to cultivate small enterprises' competitive advantage by supporting science and technology with capital, technology and tax support.

(b) Upgrading the Level of Industrial Structure

In the 1960s, in order to solve the grave shortages quickly, the government encouraged and supported five types of small enterprises: coal, oil refining, cement, glass and thermal power. Since reforms began in the late 1970s, the five types of small enterprises developed fast and basically changed China's long time situation of shortages in energy and raw materials, relaxing bottle-necks that had limited development of the whole industrial sector. From the 1990s on, China's shortage economy ended and the economy has been transforming from an extensive economic mode to an intensive one. Under these new conditions, the five types of small enterprises have not been able to adjust to the demands of China's rationalization and upgrading of the economic structure. Their production techniques are lagging, the quality of products is poor and they pollute the environment. In accordance with the typology of industrial distribution, the five types of enterprises belong to the capital intensive category of the secondary industry. In accordance with the character of industrial production technology in these sectors, it is not a rational niche for small enterprises to enter (Jiang Fuxin, 2004).²⁴

In order to help push the strategic adjustment of China's economic structure, China's government has taken measures to gradually shut down these five types of enterprises. Taking cement as an example, by the end of 2000, 3200 small cement kilns producing 80 million tons of poor quality cement had been closed. With the closing of the five types of small enterprises, the industrial structure of China's small enterprises will upgrade step by step and small enterprises will be able to pay more attention to sustainable development.

(c) Upgrading the Level of Specialization

The organizing structure of China's enterprises and industries is not reasonable. On the one hand, all enterprises, large and small, strive to be vertically integrated. The degree of social division of labor and specialization are low. For example, there are various products in the machine tools industry, making it most fit for specialized and cooperative production. But most of China's enterprises in the machine tools industry are vertically integrated with very low degrees of specialization. In addition, as a result of the planned system, this structure was replicated in both large and small enterprises. As the production and management of these enterprises are identical, vicious competition

has become one of the significant problems China's small enterprises face in the new market economy.

Hence, one important way for China's small enterprises to build their competitiveness is to choose a strategy of specialization. The success of Wenzhou's small enterprises is one example of where specialization of China's small enterprises has been successful. In Wenzhou there are 143 towns in which every town has its own product, and more than 30 towns' output has been over 1,000 million yuan. There were about 5000 enterprises making shoes whose output in 1999 was 25,000 million yuan, and whose relevant industrial output in total reached 15,000 million yuan, and whose market share was over 20% of the national output. There are about 260 enterprises making lighters whose output has accounted for 70% of the world market. In Liushi Town of Wenzhou, there are about 1000 enterprises making low voltage equipment whose market share is one-third.

In China's 10th Five Year Plan, the government urged small enterprises to focus on high quality, specialty products that fit the supply chain needs of larger enterprises. The plan emphasized that China's small enterprises should increase their degree of specialization in order to increase productivity.

(d) Increasing Utilization of the Cluster Effect

Clustering, or agglomeration, is a significant trend of China's small enterprises, especially with township and village enterprises. In 2000, 89% of township and village enterprises sold their products in villages, 9% in towns and only 2% in counties or cities. This dispersed development reduces the benefits of clusters and restricts the development of tertiary industries, adding to the external transaction costs of small enterprises.

In some cases, small enterprises' success in areas such as Wenzhou in Zhejiang Province, the Zhujiang River delta and the Changjiang River delta have shown the positive spillovers of small enterprises' cluster effects. First, small enterprises that group together promote cooperation, which helps them understand the needs of big enterprises, and reduces purchasing, transportation and storage costs. Secondly, small enterprises that locate together can make full use of public goods like infrastructure and take advantage of scale economies. Thirdly, clustering can help small enterprises find opportunities to develop in the tertiary sector, and can also help them make use of market and social services provided by the service industry to overcome difficulties of capital, technology, management, information and marketing. Finally, as a result of the effect of learning and competition, enterprise clusters may allow a switch in competitive advantage based on factor endowment to one based on innovation, which may facilitate technology absorption and the process of technology innovation.

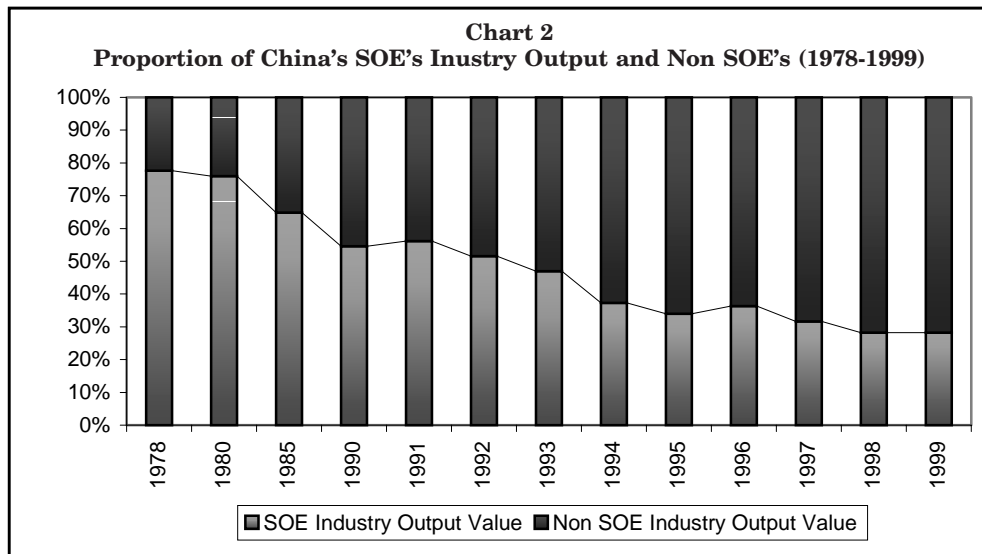
IV. FUTURE DEVELOPMENT OF CHINA'S SMALL ENTERPRISES

1. Further Adjustment in the Structure of the SOE Sector and China's Small Enterprise Development

In view of the changing trend of China's SOEs, and with the improvement of China's economic transition to be market-oriented, the ownership structure has changed substantially. The contribution of SOEs to the economy has fallen while non SOE

economic activity has increasing gradually. Between 1978 and 1999, the proportion of SOE industrial output value fell from 78% to 28% while the non SOE economy increased accordingly (Chart 2). The target of China's economic system reform is to establish a complete market-oriented economic system. China will continue to implement reforms and opening as part of WTO. With further reductions in the proportion of the SOE economy, state-owned capital will exit not only from general competitive industries, but also from monopolistic industries and public utilities.

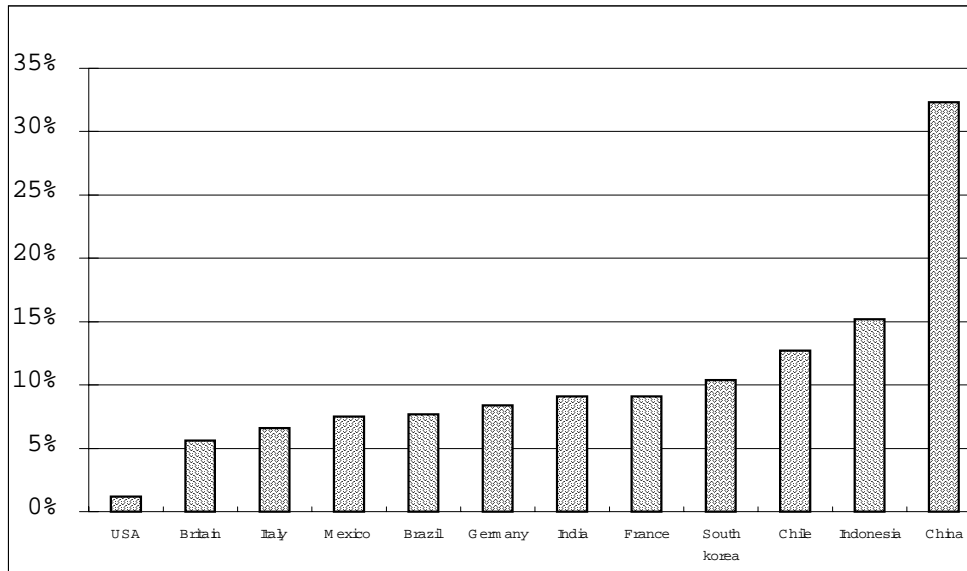
This process will provide small private enterprises development opportunities. China's government has changed the former regulations so that private capital is permitted to enter formerly monopolistic industries, such as public utilities, infrastructure, finance services, science and technology industries serving national defense and so on. In addition, private capital is encouraged to participate in the structural adjustment and reorganization of the SOE economy, and the new rules state that private enterprises enjoy equal treatment in investment, finance services, finance and tax policies, land use and foreign trade. These changes mean that there is every reason to believe that the gradual improvement of China's market-oriented economic system will allow more room for small enterprises to develop.



Resource: China Statistic Yearbook (2000), China Statistic Press.

According to the trends of market economy countries around the world, the proportion of state-owned economic activity in GDP is low, falling between 1%-15% (Chart 3). The state sector of developed market economy countries exists only in partial monopolistic or strong externality and welfare areas, and its proportion is very low. For example, in 1980, the proportion in the United States was 1.2% and in 1979 it was 5.6% in Britain. The proportion in Chile and Indonesia was a little higher, at 12.7% and 15.2% respectively in 1979. On the whole, the proportion of the state economy in GDP for developed countries was only 4.5% in 1995, while for developing countries it was 9.5%. In 2003, the state

proportion in China was reduced to 32.3%, but this is still very high compared with developed market economy countries, indicating there is still a lot of room for development of the non-state sector.



Note: The data for USA, India and South Korea are for 1980; the data for Italy is for 1978; the data for China is for 2003.

Sources: World Bank, *Bureaucrats in Business: The Economics and Politics of Government Ownership* (1995); National Bureau of Statistics of China (2003).

2. Small Enterprise's Development as China's Economy Continues to Grow

The continuous steady increase of China's economy offers small enterprises a large domestic market. China's economy has grown fast since reforms began. Between 1978 and 2003, China's GDP rose from 362,410 million yuan to 1,1725 billion yuan. As a result, the average annual per capita income of urban and rural households increased substantially from 134 yuan to 2622 yuan, and the annual per capita disposable income of urban households increased from 343 yuan to 8472 yuan (Table 4). By the end of 2004, China's saving deposits of urban and rural households exceeded 11,000 billion yuan. These trends have created a very large domestic consumer market that represents market potential for small enterprises.

Table 4
China's GDP and Per Capita Income (1978-2003)

Year	1978	1980	1985	1990	1995	2000	2001	2002	2003
GDP (%)	11.7	7.8	13.5	3.8	10.5	8.0	7.5	8.3	9.3
Per capita net income of rural residents (yuan)	133.6	191.3	397.6	686.3	1577.7	2253.4	2366.4	2475.6	2622.2
Per capita disposable income of urban residents (yuan)	343.4	477.6	739.1	1510.2	4283.0	6280.0	6859.6	7702.8	8472.0

Source: China Statistic Yearbook (2004), China Statistic Press.

In this growth process, however, the household income gap between urban and rural areas has grown rather large. In 2003, the income of urban residents was 3.2 times that of rural residents. Nonetheless, peasant's income has also risen, and since China has more than 900 million people living in rural counties, there is a large potential consumption market. When the government begins to pay more attention to the problems of peasants, agriculture and rural counties, this market will grow even larger.

3. Government's Support of China's Small Enterprise Development

Before the middle of the 1990's, small enterprises successfully pushed China's transition from a traditional economy to a market economy. At the same time, the institutional advantages brought by the economic transition, combined with the shortage character of China's economy, provided an opportunity for China's small enterprises to develop. Since the mid 1990's, China's government has instituted some favorable policies for non SOE enterprises with respect to market entrance, legal protection, technology innovation and so on, which provided institutional foundations for China's small enterprises' future development.

The first is legal protection. The law of "Provisional Regulations of the Peoples Republic of China on Private Enterprise" passed in 1988 established the legal status for private enterprise for the first time. In 1988, there were 90,600 private enterprises with 1,640,000 employees. By 2002, private enterprises numbered 24,350,000 with as many as 34,093,000 employees. Since the 1990's, China's government has put forward that the target of economic system reform is to establish a market economic system and has admitted that the private economy is the main component of the market economy by protecting private property in the law. These developments support the expectation that China's private enterprises will develop over the long term.

On the other hand, the government has supported the development of small enterprises in inferior positions in the market. Influence by the traditional, planned system, China's government still tends to prefer state ownership and large scale enterprises. In an effort to overcome these preferences, in 2003 China issued and carried into execution the "Law of Promotion of Small Enterprises," which established the legal status of small enterprises in the national economy and declared that supporting small enterprises' development was the government's responsibility. This law includes offering capital, technology innovation, market exploration, social services, business set-up assistance and so on.

In another measure, in 1998 the National Committee of Economy and Trade set up a small enterprise department to carry through macro management and harmonization with respect to the development of China's small enterprises and non SOE economy. Local governments established special institutions to manage small enterprises too, in which nine provinces or cities set up small enterprise bureaus, creating a national organization system to support small enterprises' development.

A third measure has been the support of service. A healthy service system is a key aspect for small enterprises' healthy development. By constructing a social service system for small enterprises, fair competition can be maintained and legal rights and interests can be protected. So far 31 small enterprises service centers have been set up with

provincial arrangements, with over 200 special service institutions throughout the country. The small enterprise social service system is successfully offering services such as credit backing, financing, business set-up help, technology support, information consultation, market exploration, human resource training, operation and management assistance, links to international cooperation and so on.

A fourth aspect is technology support. In this area service organizations offer help with technology development, examination, popularization, product design and process to lower the technology innovation costs of small enterprises. Since 1997, in accordance with a broader science and technology system reform, China's government chose Qindao, Hefei, Liuzhou, Mianyang and other cities to establish and perfect all kinds of technology innovation service organizations by honoring some local, special technology centers mainly serving small enterprises' technology innovation. At present, there are 40 technology innovation service centers, over 500 productivity promoting centers and over 100 science and technology incubators in China to support small enterprises' technology innovation.

V. CONCLUSION

Small enterprises have become the micro body and significant force of China's economic transition. Now, in the current stage of China's economic transition, some unhealthy restrictions on China's small enterprises' development have emerged. China's government should continue perfecting the market economic system by reducing market entrance limitations, transferring the government's functions and promoting administration system reform to provide the external circumstances of fair competition for all the main players. With China's transition to a modern market and open economy, China's small enterprises are also experiencing their own transition. China's small enterprises have shown many new development trends in terms of factor endowment structure, industry structure and specialized cooperation. The government should continue to enhance small enterprises' competitive edge in the market with policies and measures to promote China's small enterprises' transition.

NOTES

1. This study was funded by the program of comparative research of the Yangtze River Delta and Zhu River Delta sponsored by the Center for the Yangtze River Delta's Socioeconomic Development of Nanjing University, No.05JJD790011.
2. Ruilong Yang (1988): "the Three Stages of Institution Transitional Way in China", *Economic Research*, No.1,3-10.; Shaoan Huang (1999): "the Part's Transfer Hypothesis in Institution Transition and its explanation of China's institutional Reform", *Economic Research*, No.1,66-72/79.
3. Davis, I and North, D (1971), *Institutional Change and America Economic Growth*, Cambridge University Press.
4. Rong Mo (2001), "Developing Small Enterprises to Promote China's Employment", *Management World*, No. 5,58-63
5. Xiang Wu (1995), "The Township and Village Enterprises: the Impetus of Market Economy Development", *Reform*, No.4, 105-108.
6. Naixing Chen (1995), "The Small Enterprises' Development and China's Industrial Construction", *China's Small Enterprises*, No.1,10-13.

7. In China, the small enterprise is defined to have less than 2000 employees in industry, less than 500 employees in retailing industry. At the end of 2003, China has 3,600,000 small enterprises, 27,900,000 individual industrialists and businessman and the proportion of small enterprises accounts for 99.6%. The township and village enterprise is the main body of China's small enterprise, accounting for 80%.
8. Township and village enterprises were established by rural collective economic organizations and peasants, undertaking all kinds of agricultural obligations. In view of their property character, these enterprises include the township and village collective-ownership enterprise (presented by the mode of Southern Jiangsu), and the township and village private enterprise (presented by the Mode of Wenzhou). In view of the scale, these enterprises generally are small. (At the end of 2002, China had 21,330,000 of these enterprises, employing 132,880,000 persons, with an average of 6 employees per firm). In view of their business activity and geographical scope, these enterprises mainly function in village markets and focus on activities related to agriculture and the lives of peasants. They are the extension of peasant's investment and employment.
9. Private enterprises include sole proprietorships, partnerships and corporations. Under the planned economic system, China's enterprises are divided by ownership categories and function under different policies. They are SOE, collective-ownership enterprises (including rural collective-ownership enterprise and urban collective-ownership enterprise) and private enterprise. SOE and collective-ownership enterprises are defined as "public-owned enterprises" and private enterprises are defined as "nonpublic-owned enterprises".
10. The individual industrialists and businessman category is defined to be the individual who takes personal property or family property as operating capital, enrolls legally and deals in nonagricultural activities in permitted areas. In China, because sole proprietorship enterprises have a double tax, many individuals are not willing to apply to establish a sole proprietorship enterprise. Therefore individual industrialists and businessmen are not considered legal enterprises and are not counted in the number of small enterprises. Most of individual industrialists and businessman have floating activities with no fixed operation location. Now the number of employees in the individual industrialists and businessman is 2, and some even employ other workers besides family members. In fact, they behave like an enterprise. At the end of 2003, China had 23,531,900 individual industrialists and businessman, employing 46,365,400 persons. Therefore, in our opinion, the individual business should be brought into the scope of small enterprises and enjoy the same policies.
11. Weiyang Zhang and Shuhe Su (1998), "The Competition Between Regions and the Privatness of China's SOEs," *Economic Research*, No.12.
12. Martin Weitzman and Chenggang Xu (1994), "Chinese township-village enterprises as vaguely defined cooperatives", *Journal of Comparative Economics*, No.18,121-145.
13. Qianli Xie (1995), "The Evaluation and Dependability Analyses of China's Industry Productivity Change Since the Reform," *Economic Research*, No. 12,10-22.
14. This approach was different from property rights reform of SOEs in the mid of 90's, where the contract responsibility system reform was the main approach.
15. The Collective-Owned category includes both rural and urban collective-ownership units.
16. Rural gross output value includes the gross output of agriculture as well as output of rural collectives, individual industry, construction, transportation and business.
17. The property shortcoming of township and village enterprises originates from the ambiguous property rights of the village collective-ownership unit (represented by the mode of southern Jiangsu). This resulted in institutional reform beginning in the 1990's. The target of the reform was to establish clearly defined property rights. Now, the property rights of township and village enterprises are mostly held by individuals.
18. The Research Group (2005), "China Private Enterprises' Investigation Report of 2005", *China Business Times* No.2mon-3day.

19. Hanchuan Ling (2003), "The Problems in the Development of the Small Enterprises", *China Social Science*, No. 2, 84-94.
20. Hanchuan Ling (2003), "The Problems in the Development of the Small Enterprises", *China Social Science*, No. 2, 84-94.
21. Dongsheng Jiang (2004), "The Management and Technology Innovation of China's Non State-Owned Growing Small Enterprises", *Management World*, No.2, 148-153.
22. Yifu Lin and Yongjun Li (2001), "The Development of Small Finance institutions and the Finance of Small Enterprises", *Economic Research*, No.1.
23. Xunge Xia (2000), "A Few of Policy Questions of the Small Enterprises' Development", *Reform*, No. 4, 31-35.
24. Fuxin Jiang (2004), *The Industry Location and Development of Small Enterprises*, Nanjing Normal University Press.