The Private Sector: Challenges and Opportunities During Xi’s Second Term

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The ongoing trade feud with the United States, combined with an internal economic slowdown and the party’s tightening grip on the economy, presented China’s private sector with unprecedented challenges as President Xi began his second term in 2018. Beijing has responded to the frustrated private sector with promises of substantial tax cuts and an expansion of credit, together with a pledge to further deepen structural reforms and to double down on spurring indigenous innovation. What will Xi’s second term mean for the private sector? Some worry that he will further roll back the market-oriented reforms; a more hopeful scenario is that the hostile international environment and the mounting domestic pressures will counteract any anti-market trends and provide the party’s reform-leaning politicians with a rare opportunity to push forward market reforms and to create a true level playing field for the private sector.

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The year 2018 marked the fortieth anniversary of China’s reform and opening up. In 1978, visionary leader Deng Xiaoping launched the country’s market-oriented reforms: the private sector started from scratch but quickly began to flourish. In 2018, the private sector contributed more than 50 percent of total tax revenue, over 60 percent of gross domestic product (GDP), more than 70 percent of the achievements in “technological innovation,” and more than 80 percent of the country’s employment.1

Nevertheless, 2018 was also profoundly difficult for the country’s private sector. Economic deceleration continued and the magnitude of the U.S.–China trade battle was not anticipated. An annual growth rate of 6.6 percent was the slowest since 1990. Mounting uncertainties caused by the U.S.–China trade dispute, combined with the aftermath of the decade-long debt crisis, produced pervasive pessimism and a loss of confidence among private entrepreneurs.2 Rising production costs and tax burdens became increasingly unbearable during the economic downturn.3 The stock market experienced a 20 percent tumble, further pressuring publicly-traded firms. The private sector is arguably now confronting “the most challenging environment since the early 1990s,” argues MIT political scientist Yasheng Huang, who has begun to wonder whether the Chinese economy is losing steam 4 The second-richest man in China, Alibaba’s Jack Ma, commented uncharacteristically (he is usually blithe and spirited) that “2018 was indeed a difficult year” and, what is worse, the next few years “could be even more difficult.”5

In his 2019 New Year’s speech, President Xi devoted two lines to the private sector: “Policies to cut taxes and fees must take root to ease the burden on enterprises. We must show our sincere appreciation to talent of all kind and stimulate their creative energy.”6 This commitment clearly reflects the concerns of the Chinese Communist Party (CCP) about the serious challenges facing the private sector and the economy more generally.
Current challenges confronting the private sector

The most serious external challenge facing the Chinese economy is the escalation of U.S.-China trade tensions. Negotiations are ongoing as the United States has delayed (until March 1, 2019) a rise in tariffs from 10 percent to 25 percent on $200 billions of Chinese exports. The Asian Development Bank has predicted a 6.3 percent drop in Chinese growth rate in 2019 under the existing sanctions, and a 5.3 percent drop if all bilateral trade is taxed at a higher tariff rate. The trade dispute affects state and non-state firms disproportionately, as the private sector contributes 45 percent of all Chinese exports, and state-owned enterprises (SOE) contribute only about 10 percent. Although Chinese consumers have started to take sides (e.g., buying domestic Huawei smartphones and boycotting iPhones), continuation of the trade conflict will hurt the Chinese economy much more than it will hurt the U.S. economy, and private Chinese firms will confront a more dire situation.

Domestically, the private sector faces several significant challenges, many of which are long-existing problems. First, take “over-leveraging” (i.e., carrying too much debt). In 2015, leveraging rose to an alarming level of 2.1, measured by the ratio of outstanding debt (excluding central government debt) relative to GDP. A substantial part of the leveraging came from a booming shadow banking sector. According to Yi Gang, head of the People’s Bank of China (PBOC) (China’s central bank), China’s leverage ratio has been “stabilizing instead of quickly accelerating” during the past year or two. But deleveraging the economy has been achieved at a high price. The nationwide campaign to deleverage the economy seriously affects shadow banking, which is one of the main sources of borrowing for the private sector. During the credit crunch, some struggling private entrepreneurs had no choice but to sell to the state or to SOEs. According to Shanghai Securities News, in 2018 more than twenty-three private firms agreed to sell controlling stakes in their businesses to state-controlled firms. Xi Jinping, in his November address, acknowledged that some financial institutions “dare not issue loans to private firms, and some withdraw their loans, resulting in a liquidity problem”

Many argue that the deleveraging campaign has targeted the wrong sectors. For instance, according to Gao Shanwen, chief economist of China’s Essence Securities, Co., Ltd., SOEs have been much more leveraged than private firms, but the deleveraging campaign wrongfully targeted the private sector, thus having a damaging effect on its liquidity. Peking University economist Huang Yiping argues that deleveraging should target the zombie firms (i.e., those firms that are unable to cover debt-servicing costs from their current profits), which are usually big firms rather than small or micro enterprises (SMEs), many of which are also private firms. According to one estimate, the closing down of all zombie firms would result in a 4 to 5 percentage point reduction in the overall leveraging rate.

The private sector has long suffered from a high tax burden. Almost all private entrepreneurs whom I interviewed during my fieldwork from 2013 to 2017 mentioned the “overwhelmingly high tax rate” as a major obstacle in running their business. The new reform of the value-added tax (VAT), beginning in 2016, has affected the different types of firms in different ways. The new tax code has benefited SOEs and other big firms due to a tax cut in the new tax code,
whereas many smaller and micro enterprises now face an increase in their effective tax rate.\textsuperscript{16} According to one estimate, following the VAT reform the total amount of taxes paid by SOEs dropped by 6.5 percent, whereas the tax rate for the private sector increased by 16.8 percent.\textsuperscript{17}

The private sector also faces a substantial political challenge due to tighter party control. During the Nineteenth CCP Congress, President Xi stressed the importance of “ensuring party leadership over all work.”\textsuperscript{18} In fact, the requirement that all entities with more than three party members set up a party unit has been written into the party constitution since 1925.\textsuperscript{19} But Xi’s assertion that state firms are “the most reliable force for the party and the state” and “the material and political foundation for socialism with Chinese characteristics”\textsuperscript{20} have understandably worried private business owners. This is not mere rhetoric: the government has already pressured some big private-tech companies to assign the state a direct role in corporate management.\textsuperscript{21}

Another way to instill state and party control in private firms is to send state-appointed officials to the labor unions in private companies. For instance, the city of Qingdao in Shandong province recently sent 92 government-appointed “first chairmen of labor unions” to various local private firms and non-state organizations. These cadres are required to spend at least eight days per month at the respective firm to set up and run the state-controlled labor unions for a duration of two years. This policy has caused many private business owners to worry about a future increase in state intervention in their operations.\textsuperscript{22}

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Beijing has closely monitored economic activities and public opinion and has noted the pervasive pessimism within the private sector. In early November 2018, President Xi convened an unprecedented special session of private business leaders. He listened to their concerns, reaffirmed their status in the Chinese economy, and reassured them that a series of measures would become available to help them overcome their current difficulties.\textsuperscript{23} Below, I take a closer look at some of the policies that Xi mentioned in his November speech, and other policies or measures that have been issued by other government agencies, some of which were issued before the November meeting.

In short, the current leadership is not dismantling “every one of the reforms that made China’s spectacular growth possible,” as the new editor-in-chief of \emph{Foreign Policy} Jonathan Tepperman ignominiously overstated,\textsuperscript{24} although it should be acknowledged that some of the policies have been (or will be) less effective than others in helping the private sector.

\textit{New policies and reactions from the private sector}

The first measure Xi mentioned in his November speech is tax and fee reductions—a reference to a major tax-cut plan that was issued by the Ministry of Finance the previous month.\textsuperscript{25} The announcement was widely circulated among private entrepreneurs and was seen as a welcome signal from the government. Some expect that the overall corporate income tax rate will drop from 25 percent to 20 percent, with the size of the tax reduction at about 5 trillion yuan during the next five years, but specific details have yet to be revealed. Experts worry that such a large tax cut, although it may appear to be promising on paper, will be difficult to implement. Hu Yifan, chief China economist at UBS Wealth Management, argues that it will be difficult to roll
out this big tax cut unless “there is a structural overhaul of fiscal expenditures, such as providing some infrastructure projects to private enterprises or reducing the number of civil servants.”

Xi also pledged to help private firms gain better access to credit. The central bank responded immediately. Guo Shuqing, party secretary of the PBOC and chairman of the China Banking and Insurance Regulatory Commission, stipulated that bank lending to private companies must meet what he calls the “125 Target”: big banks should issue no less than one-third of new corporate loans to private firms (1), medium and small banks should issue no less than two-thirds of new loans to private firms (2), and the goal for the next three years is for all banks to lend no less than one-half of their corporate loans to private firms (5). Premier Li Keqiang reiterated in 2019 these targets, followed by the central bank reduction of the reserve-requirement ratio by 1 percentage point, to free up a net 800 billion yuan for lending. But the new quota policy for credit has been criticized. Political scientist Victor Shih, for instance, argues that it might introduce “greater distortions” that ultimately will harm the private sector. Shih suggests that the new initiative has already caused a sell-off of bank shares as bankers realize that they will have to lend to risky firms that are more likely to default, and private firms will face higher interest payments, which eventually affect hurt their bottom lines.

It is commonly acknowledged that the playing field between SOEs and private firms has not been leveled. In a seminal paper, *Growing like China*, Song et al. conclude that “state-owned firms have low productivity but survive because of better access to credit markets.” Vice Premier Liu He, one of China’s principal economic policy makers, forcefully denounced the recent revival of the catchphrase “the state advances, the private sector retreats” (*guojin, mintui* 国进民退) on social media for being “partial and mistaken.”

For the private sector to truly enjoy the benefits of these new policies, the government must demonstrate a serious effort to create a level playing field for the private sector. In October 2018, Governor Yi Gang of the PBOC mentioned the concept of “competitive neutrality,” a principle first coined by the Australian government and further developed by the OECD. Competitive neutrality is a highly technical concept. Xu Zhong, director general of the research bureau of the PBOC, explains that the push for “competitive neutrality” of SOEs seeks to create a fair and competitive environment for both the state and non-state sectors, and to reduce government intervention in the market. According to PBOC Governor Yi Gang, opening up traditionally closed industries is also part of the “competitive neutrality” initiative, referring to the ongoing opening of the financial sector as an example. World Bank expert Zhang Chunlin further explains that the essence of this principle is that “all actions taken by the government have a neutral effect on competition between private and state-owned enterprises.” More specifically, SOEs and private firms should enjoy equal treatment in areas such as “taxation, supervision, and government procurements.” Nevertheless, Zhang admits that implementation is key, and carrying out reforms to achieve competitive neutrality will be “extremely difficult.”

How would “competitive neutrality” look when implemented? Shortly thereafter, *Caixin*, China’s leading financial and business news outlet, published an editorial calling for measures that “truly abolish the administrative ranks at SOEs that practically make executives equal to government officials,” “harden the budget constraints” of SOEs, and “raise requirements for returns on investments.” Only when these measures are implemented will SOEs become truly
independent market players that are “independently operated, financially autonomous, self-disciplined, and self-developing.” Beijing will need to follow up with these concrete measures to convince the private sector (as well as foreign firms) that it is doing more than merely paying lip service.

New hopes
Yet there is some hope amidst the gloom. One area to watch is new technology and innovation: Beijing’s commitment to indigenous innovation will continue, and the private sector has already made enormous progress in upgrading China’s technological sophistication and competitiveness.

The OECD and the World Bank estimate that China invests a total of $410.2 billion in R&D, gradually catching up with the annual average of R&D spending of $464.3 billion in the United States. A large amount of this investment comes from the government: government funding for R&D grew thirtyfold between 1991 and 2016, and this number continues to grow. Among business players, private firms dedicate higher shares of their revenue to R&D as compared to some of their SOE and even international competitors. For instance, Alibaba surpassed PetroChina (an SOE) to become the country’s top publicly listed spender on R&D in 2016; and Huawei invested more money than Apple in R&D in 2016.

Government support for innovation and R&D is consistent with an important component of Xi’s “supply-side” structural reforms that involve technology and industrial upgrading. In his 2018 speech to the National People’s Congress, Xi pledged to “move Chinese industries up to the medium-high end of the global value chain and to foster a number of world-class advanced manufacturing clusters.”

“Made in China 2025,” another important and relevant policy initiative, was announced by Premier Li Keqiang in 2015. The guiding principles of this policy—“to have manufacturing be innovation-driven, to emphasize quality over quantity, to achieve green development, to optimize the structure of Chinese industry, and to nurture human talent”—resemble Xi’s characterization of the supply-side structural reforms. These speeches and policy initiatives do not single out the private sector, but the priority industries—including new advanced information technology, automated machine tools and robotics, and new energy vehicles and equipment—are primarily led by the private firms.

Although China is still fighting the long-standing reputation of what U.S. Vice President Mike Pence has called China’s “wholesale theft” of Western technology, the country has experienced a “science and technological renaissance.” It has achieved significant progress in areas such as artificial intelligence (AI), robotics, aerospace, 5G technology, self-driving vehicles, quantum computing, electric vehicles, and mobile payments. The vast majority of companies behind these exciting developments are private firms. In fact, China now has nine of the world’s twenty largest tech companies—namely, Alibaba, Tencent, Ant Financial, Bytedance, Baidu, Didi Chuxing, Xiaomi, Meituan Dianping, and JD.com—all of which are private firms. These companies, driven by intense competition, are working relentlessly to create new products and to develop new business models, and their investments in R&D are unprecedented.
Although many structural problems are constraining private-sector development, the Chinese economy and its political arrangements provide unique structural advantages for the adoption of certain technologies. Take Artificial Intelligence (AI) as an example. According to industry expert and venture capitalist Kai-Fu Lee, cutting-edge AI research is still taking place primarily in North America, but AI implementation and applications have mushroomed in China due to its unique strengths, such as abundant data, its fast-paced business landscape, and a “government that adapts public infrastructure with A.I. in mind.” Lee observes that China’s AI development model is not based on top-down planning; instead, Beijing initiates a concept and then encourages local officials to enact specific policies so that other actors (e.g., private companies) can innovate. Many local-level initiatives, such as AI industrial parks, are taking shape. An article in *Nature* marvels that “[a] new ‘innovation hub’ seems to be launched in China each week” and it estimates that the nation had more than 1,600 business incubators as of 2016.

First, local experimentation, then Beijing decides whether it should be scaled up. Such an approach exemplifies Deng Xiaoping’s philosophy of “crossing the river by feeling for the stones.” This has been tried and tested throughout China’s reform era.

Nevertheless, we should acknowledge that government investment in big data and AI is more than merely an economic strategy; it is also highly political. These technologies are useful to strengthen authoritarian control, since enlisted, private companies have to collaborate with the government to control the spread of information (e.g., censorship) and to monitor its citizens (e.g., facial recognition). Author Shoshana Zuboff asks whether we are entering “the age of surveillance capitalism.” In this area, there is certainly a strong and visible footprint of the Chinese government.

Although social science scholars have long recognized the role of the state to promote innovation. The relations of Chinese companies with the government potentially have huge economic consequences that affect both private business and innovation. The Chinese telecommunications equipment giant Huawei is a case in point. Even though Huawei is not a state-owned company, and its CEO Ren Zhengfei has recently publicly declared that he never has and he would “definitely refuse” if Beijing were to ask for data about customers, countries in the West still worry about the company’s ties to the government, Ren’s ties to the military, and, more generally, its compliance with Chinese law. The United States has already blocked the sale of Huawei smartphones and is working to ban Huawei (as well as ZTE, another Chinese telecommunications company) from selling equipment due to national security concerns. Germany has indicated that it will ban Huawei equipment from being used in the 5G rollout and the United States is also putting pressure on its allies to ban Huawei products. Such blowbacks from the global market have already hurt not only Huawei but other companies as well. In January 2019 Ren Zhengfei reportedly circulated an e-mail to his staff warning that “the overall situation will probably not be bright” and employees will have to “prepare for times of hardship.” The United States is now considering imposing tighter controls on exports of AI and other technologies from China, a worrying trend that will certainly affect many private companies and stifle innovation in China. In addition, Nobel award-winning economist Michael Spence has advised the Chinese government to make a more credible commitment to insulate private firms from national security agendas.
The more optimistic hope is that the profound difficulties in the Chinese economy might spur real and deep structural reforms that otherwise would be difficult to promote. Realizing this “new hope” requires courage and political will at the top levels. Economist Hanming Fang compares today’s China to that in the late 1990s when China was applying to join the World Trade Organization (WTO). Premier Zhu Rongji, a committed reformer, launched SOE reforms in the late 1990s. How difficult was it to reform the SOE sector at that time? In 1998, Zhu famously pledged that “no matter what is waiting in front of me, whether land mines or an abyss, I will blaze my trail and will have no hesitation or misgivings” (不管前面是地雷阵还是万丈深渊，我将勇往直前，义无反顾).52

It is probably not an overstatement to state that today the Chinese economy today is facing another “abyss” and there are a number of minefields threatening the private sector. However, the current external pressures also provide an opportunity for the Chinese government to accelerate the much-needed reforms in the financial sector, to create a conducive environment for the private sector to compete with the state sector, to enforce intellectual property rights, and so forth.53 This view is shared by a number of China experts in the United States. For instance, Daniel Rosen and Scott Kennedy insightfully point out that “China needs to embrace a structural reform agenda as much as the United States and other advanced economies need to insist on it” and China will benefit immensely from “restored internal structural adjustment and external stability in its relationship with the United States and its other trading partners.” Simply put, both Washington and Beijing have an incentive to escape the current “win-lose trap.”54

In this article, I have reviewed the major challenges facing the Chinese private sector in the current climate and some of the new measures the Chinese government is or will soon be implementing, including tax cuts, an easing of credit, and the principle of “competitive neutrality,” all of which primarily target the private sector. In addition, external pressures have strengthened Beijing’s commitment to indigenous innovation. Many private firms are now global leaders in high-tech industries and will continue to benefit from strong government support.

How will these phenomena affect the Chinese economy? Will the private sector maintain its growth momentum? Economist Nicholas Lardy worries that the current CCP leadership will step away from the market-oriented development path that has served the country so well during the past four decades,55 but that is not necessarily the only option. There is hope that reform-leaning politicians will seize the opportunities from the current external challenges, combined with the domestic economic hardships, to defend their policy positions and to promote market reforms. These reforms, if successful, will create a level playing field for the private sector.

About the Contributor
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Notes


10 Ibid.


12 See fn. 1.


19 “党章历次修订概览,” CCP Members Website, at http://www.12371.cn/special/dzxd/


23 See fn. 1.


26 See Xu Zhong’s article in ft16.


30 Ibid.


33 See Xu Zhong’s article in ft16.


“Ibid.


See fn. 19.


49 Kathrin Hille, “Huawei Chief Warns of Job Losses amid 5G Security Concerns,” Financial Times, January 20, 2019, at https://www.ft.com/content/2b0c6a22-1cbe-11e9-b126-46fc3ad87c65

50 Ibid.


52 Premier Zhu made this pledge in response to the general difficulties in carrying out the economic reforms in the 1990s, including the SOE reforms. See “朱镕基经典语录,” Zhongguo gongchandang xinwen wang, September 19, 2009, at http://dangshi.people.com.cn/GB/85040/10081875.html


55 Nicholas Lardy, “Xi Jinping’s Turn Away from the Market puts Chinese Growth at Risk,” Financial Times, January 15, 2019, at https://www.ft.com/content/3e37af94-17f8-11e9-b191-175523b59d1d