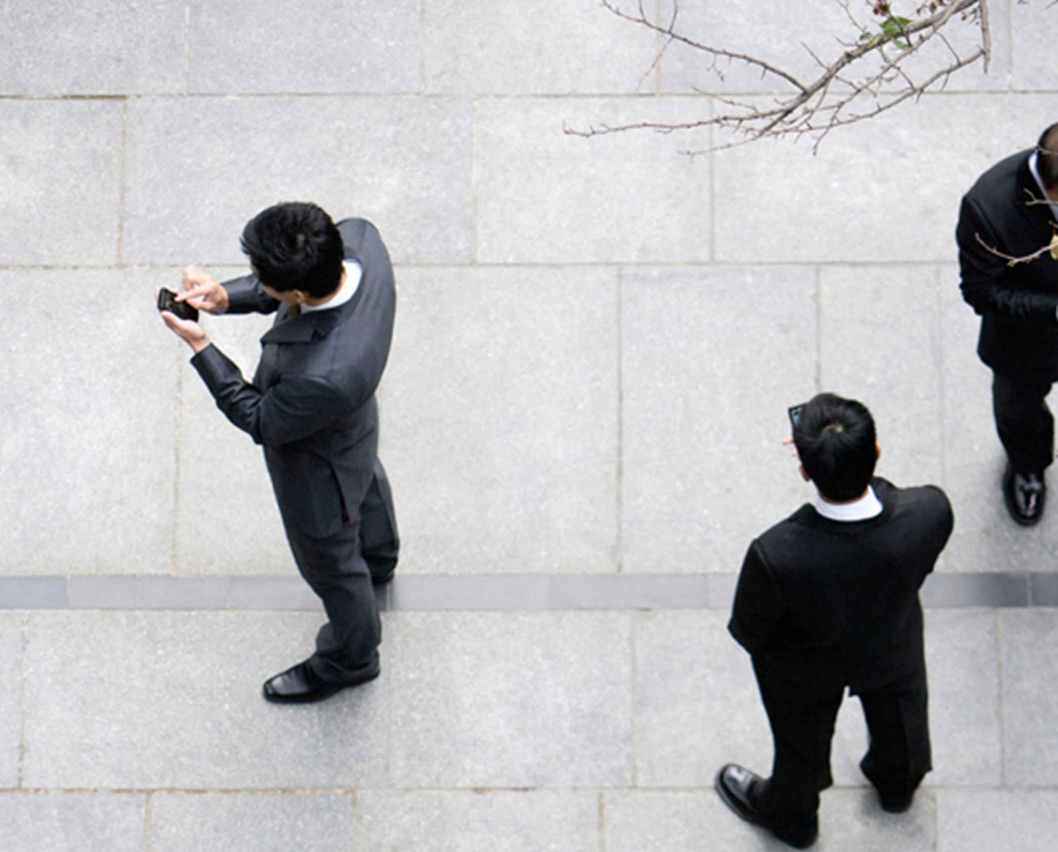

DEVELOPMENTS IN CHINESE ENTREPRENEURSHIP

Key Issues and Challenges

Edited by Douglas Cumming, Michael Firth, Wenxuan Hou, and Edward Lee

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Introduction

Douglas Cumming, Michael Firth, Wenxuan Hou, and Edward Lee

China's economic reforms have been ongoing for more than 30 years and the fruits of this move toward a free market system are becoming increasingly apparent. Initially, the reforms concentrated on improving the efficiency of state owned enterprises (SOEs), and the SOEs were reorganized with corporate structures and mandates to be profit making. At the same time, markets developed and competition became keener. Later, reforms focused on developing new industries. It was soon apparent, however, that the corporatized SOEs were not well-suited to developing completely new technologies and new forms of doing business. China's government therefore began encouraging individuals to start up new business ventures. The government decided to tap the innate entrepreurial spirit that lies within people, a spirit that had been long suppressed under the centralized state planning system in place since the 1950s.

The government sees the development of a vibrant private sector as a vital necessity to achieve their objectives of modernizing the economy, increasing Gross National Product (GNP) and employment, and delivering innovative and high technology products and services. To help foster the development of the private sector, the government opened up the banking sector and formal and informal financial markets were developed to help finance the business plans of entrepreneurs. China's growth as an economic power, where it is set to overtake the United States in terms of GNP in the next few years, is largely down to the performance of the private sector.

China's new entrepreneurs operate in traditional industries, where they have overhauled the way these businesses operate, as well as in new industries. These "new to China" industries include property, building, and construction, which cater to people's desire to own their homes, and footwear, clothing, retailing, and electronic goods, which supply both the domestic and export markets. Perhaps the most visible entrepreneurs are those in the telecommunications, Internet, and e-commerce sectors. Jack Ma is one of the best known of China's new entrepreneurs and he built his fortune in e-commerce. His company, Alibaba, was the largest initial public offering (IPO) in history when it listed on the NYSE in September 2014, and this event brought great exposure to China's entrepreneur-led businesses.

Scholars have recently turned their attention to documenting and analyzing the rise of entrepreneurs and private sector business in China. However, this research has thus far been published in a wide array of specialist journals and magazines that are not easily accessible to an international audience. With this in mind, we have put together this book, which has contributions written by leading experts on entrepreneurial activity in China. We believe our book will be thought-provoking and highly informative for all those with an interest in detailed accounts of entrepreneurial development in China.

Chapter one "Entrepreneurship in China: Progress and Challenges" by David Ahlstrom and Zhujun Ding provides an overview of entrepreneurship in China. It reviews the historical development of the entrepreneurial class and traces the important political decisions that allowed and encouraged private sector businesses. The roles of institutional and social factors in entrepreneurship is carefully laid out. The chapter also provides an excellent review of historical and current research into entrepreneurship research in China, which runs the gamut from theory, to experimental, to archival approaches and draws on the disciplines of economics, finance, management, and sociology. The chapter provides an excellent coverage of where we are in terms of research and is essential reading for those who want to work in this area.

Chapter two "Overcoming the Innovation Challenge: Examining the Determinants of New Product Innovation in Chinese SMEs by Alex Newman, Yanyan Gao, and Jinghuai Zheng examines the financing of research and development (R&D) in small and medium-sized firms. Based on a comprehensive questionnaire survey of

1439 Shanghai-based industrial firms, the authors found that internally conducted R&D is more efficient than externally conducted R&D. Efficiency is measured by turning R&D into new product sales. One reason for this finding is that really promising R&D is kept in-house to avoid information leakage to competitors. R&D that is farmed out to other firms is less likely to lead to saleable products. Another important finding from the research is that internal funding and tax credits are more directly linked to successful product innovation than are external financing sources and government subsidies. Raising external finance through bank loans is often a short-term solution and this is not conducive to financing long-term R&D. Moreover, the detailed disclosures needed to borrow money and sell new shares will lead to a leakage of information on research ideas, which will lead to fewer successes.

Our understanding of the financing of entrepreneurial businesses in China is further enhanced in chapter three where Mingzhi Liu, Yulin Shi, and Zhenyu Wu investigate the activities and performance of angel investors. In their chapter "Angel Investors' Affiliations and Investment Returns in China," the authors examine the financial returns to angel investors in China. Angel investors are private individuals who invest in startup firms as opposed to venture capital firms, which raise funds from clients and invest in later stage entrepreneurial firms. Not surprisingly, the authors find that the returns to angel investors are extremely variable. However, on average, the returns are positive, which is to be expected if angel investors are to survive in the longer term. Some of the angel investors are affiliated with venture capital funds but the benefits from doing so are unclear. The authors show that the returns to angel investors from investing in a firm are reduced when a venture capital fund also invests in the firm although this negative effect is reduced (and can become positive) if the venture capitalist investment is high (above RMB 70 million). This complex relationship between angel investors and venture capitalists has not been documented before and highlights the importance of investor-type in the outside financing of entrepreneurial businesses.

In chapter four, "Corporate Governance and Corporate Social Responsibility Disclosure: Evidence from China," Naqiong Tong explores the association between corporate governance and corporate social responsibility (CSR) disclosures. CSR has garnered more interest in recent years because of widely reported environmental and workplace disasters associated with firms. Firms have attempted to reduce the direct or inferred reputational damage from these scandals by increasing information on CSR. Using recent data from listed firms in China, the author finds that the quality of CSR disclosures is better in firms with a larger board size and a higher proportion of independent directors. Other noticeable associations are that firms with greater management shareholdings, a dominant controlling shareholder, and a more diversified set of large stockholders have greater CSR disclosures. Overall, firms with more elaborate systems of checks and balances, as manifested in their corporate governance structures, are more likely to have detailed CSR disclosures. This may indicate that these firms care more about the environment, customers, and their employees although the authors do not claim they have proved such a causal link.

Chapter five by Hongyan Yang, Ting Ren, and Massimiliano Sassone, "Foreign Direct Investment, Institutional Environment and the Establishment of Private Economy in China," examines the effects of foreign direct investment (FDI) on the growth of the private sector using provincial level data. Prior research has identified at least two possible outcomes of FDI on the domestic private sector. One possible outcome is that FDI generates positive spillover effects for the domestic private sector economy. This is based on knowledge transfer from foreign firms to local firms. Knowledge transfer includes technology as well as labor skills. The transfers are made to the domestic private sector as a whole as well as to domestic firms in the supply chain. In contrast, FDI could have negative spillovers including crowding out effects where local firms are forced out of business. Here, the potential beneficial effects of knowledge spillovers do not materialize as the knowledge/technology gap between foreign firms and local firms is so great that knowledge transfer becomes well-nigh impossible. With this as a background, the authors use government statistics to show that FDI has generally had positive effects on the domestic private sector in terms of the number of establishments and the number of employees in the private sector. This evidence suggests a very positive role for FDI.

In chapter six, Chenglong Zhang examines the importance of networks in explaining the success of small high technology firms. His chapter "How China's Technological Small and Microtechnology enterprises' Network Embeddedness Impacts Performance: The Mediated Effect of Entrepreneurial Opportunity" reports the results from a survey of small high technology firms that asked questions about their use of networks. Dividing entrepreneurial opportunity into three types, discovery, creating, and imagining, the author shows that these factors play an influential role in the relation between embeddedness and performance.

In chapter seven, Shasha Wu, Ting Ren, and Hongyan Yang examine the venture capital industry in China. "Fund Ownership, Investment Preference, and Performance: The Venture Capital Industry in China" details the rise of the venture capital industry from its beginnings in the 1990s through to the present time. While many of the early venture capital (VC) firms were financed by foreigners, China-funded VC firms quickly arrived on the scene and a natural question is whether there are differences in the investments made by the foreign VC firms and domestic VC firms. While foreign VC firms have a long history of investment, Chinese VC firms should have more local knowledge and may have better political connections. Thus, there could be differences in investment styles and financial performance between the two types of VC firms. The authors address these issues in fine detail. They find that foreign VC firms are more adventurous in terms of financing nontraditional industries (including IT) and startup entrepreneurial ventures. Foreign VC firms have earned better returns than domestic VC firms and they are more likely to exit their investments through merging with, or being acquired by, other firms and by making IPOs in overseas markets. While these differences have been quite pronounced, there is some evidence that the strategies used by foreign and domestic VC firms are becoming closer.

The detailed and insightful contributions herein highlight the high quality of research on entrepreneurship in China. As the editors of this Palgrave MacMillan book on Developments in Chinese Entrepreneurship, we not only learned a great deal from reading all of these chapters, but we also immensely enjoyed corresponding with each of the authors. We are extremely grateful for their timely and excellent contributions.

Chapter One

Entrepreneurship in China: Progress and Challenges

David Ahlstrom and Zhujun Ding

1.1 Introduction

The People's Republic of China (PRC) enjoys a growth rate that has averaged around 8% annually for over three decades. Recently founded private enterprises are increasingly an important part of that steady economic development as there are estimated to be about ten million such enterprises in China supplying a majority of the country's employment (China News, 2013; Huang, 2008). Moreover, there is evidence that private small and medium-sized enterprises (SMEs) played an important role in China's economic growth earlier on the twentieth century as well (Huang, 2011; Rawski, 1989).

Yet in spite of that exemplary growth, entrepreneurship has not typically been a focus of researchers as much attention has been paid to the reforming state sector or to China's economic upheavals during the past century (Ahlstrom & Wang, 2010; Huang, 2010; Steinfeld, 1998). Although the Chinese diaspora had a long history of entrepreneurship around Southeast Asia, or the "South Seas" as it is often rendered in Chinese writings (Ahlstrom, Young, Ng, & Chan, 2004; Huang, 2005; Pan, 1990), the same cannot be said of Mainland China (Seagrave, 2010; Tung & Chung, 2010). The old examination system, a lack of institutional protection for property rights, limited availability of artisanal technologies that form the basis for many new products (Mokyr, 2002), a strict licensing regime and other cultural factors (Greif & Tabellini, 2010) that limited rewards to entrepreneurs likely hindered entrepreneurship in imperial China, much the way certain institutional factors such as the power of the guilds and the overemphasis on classical education was thought to have checked European growth before 1820 Europe (Balazs, 1964; Greenblatt, 2011; Landes, 1998; Ogilvie, 2011).[1] In particular, the many years of war and upheaval in the twentieth century, and the ascension of the Chinese Communist Party (CCP) in 1949 (and subsequent introduction of the Soviet economic model) stifled entrepreneurship and small business in China while other countries were experiencing much postwar growth (Harding, 1987). In the decade of the 1950s, the People's Republic of China (PRC) collectivized agriculture and nationalized industry; small business and entrepreneurial activities were shut down. Many business and property owners were punished or imprisoned. Major industrial sectors such as film and garments were able to pull up stakes and move out of Mainland China to Hong Kong and Southeast Asia. By the end of the 1950s, the SME sector that had developed smartly in Republican China virtually ceased to exist (Barone, 2004; Harding, 1987; Rawski, 1989).

The trend in 1960s China (as in many countries) was not only the collectivization of farms and small businesses but also the expansion of heavy industry using many elements of the Soviet central planning model, which further served to stifle entrepreneurship (Barone, 2004; Harding, 1987; Naughton, 1995). Economic and industrial development were thought to be largely based on scale and scope economies and capital accumulation (Galbraith, 1967; Naim, 2013; van Zanden, 2009). In China, this model of centralized agriculture and scale production was aggressively pursued as nearly all firms had their assets assigned to the government; scale and cost minimization were the order of the day (Harding, 1987).[2] Penalties for "profiteering" were quite strict; people were jailed for minor commercial infractions such as selling a few stalks of sugar cane on the street (Ahlstrom, Bruton, & Lui, 2000).

Correspondingly, research in economics and generally the social sciences was not particularly concerned with entrepreneurship and its kindred, small business, particularly in the decades after the Second World War in spite of its apparent importance in earlier economic growth (e.g., Leff, 1979; McCloskey, 2013; Nasar, 2012;

Schumpeter, 1934).[3] For example, in the development economics field, Kaldor (1966) argued that the failure of firms in achieving scale economies and specialization was key to hindering firm development and national industrialization. In a subsequent influential review in the *Journal of Economic Literature*, Nathanial Leff (1979) added that the level of entrepreneurship was often not a constraint on the pace of development in countries.

In spite of the increasing attention directed at entrepreneurs in the popular culture in recent years, entrepreneurship still rates only a few mentions in development economics studies (e.g., Perkins, Radelet, Lindauer, & Block, 2013; Rodrik & Rosenzweig, 2010), though more recently several economists (Baumol & Strom, 2007; Baumol, Litan, & Schramm, 2009; Lerner, 2009, 2012; McCloskey, 2010), management scholars (Bruton, Ahlstrom, & Obloj, 2008; Du, Guariglia, & Newman, 2013; Ireland, Hitt, & Sirmon, 2003; Peng, 2001; Zahra, Sapienza, & Davidsson, 2006), historians (Landes, 1998; Pomeranz, 2001), and finance scholars (e.g., Cumming, Fleming, & Schwienbacher, 2009; Cumming & Suret, 2011; Levine, 2005) among others have started to draw more attention to the significance of entrepreneurship, new ventures, and the supporting institutions in general that contribute to economic growth and development (Aghion & Durlauf, 2005; Ahlstrom, 2010). Economics is recently emphasizing the importance of entrepreneurship as it is thought to drive growth and development (e.g., Audretsch, Keilbach, & Lehmann, 2006; Autio & Fu, 2014; Baumol et al., 2009; Haltiwanger, Jarmin, & Miranda, 2010; Wong, Ho, & Autio, 2005), and alleviate poverty (Bhagwati & Panagariya, 2013; Bruton, Ahlstrom, & Si, 2015; Bruton, Ketchen, & Ireland, 2013). Both management and finance scholars attest to entrepreneurship's importance in driving economic growth, social development, and prosperity (Ahlstrom, 2010; Allen, Qian, & Qian, 2005; Butler, Ko, & Chamornmarn, 2004; Bruton et al., 2008; Levine, 2005; Phelps, 2013). *The Economist* magazine (2009a: supplement p. 6) concurs in describing entrepreneurship as "an idea whose time has come."

The growth opportunities provided by China's entrepreneurs and the particular challenges they face has led to important questions about how to encourage productive entrepreneurship, as opposed to its less productive forms (Baumol, 1990; Baumol et al., 2009; Young, Ahlstrom, Bruton, & Rubanik, 2011). Research in management and sociology to economics and finance generally agree that the institutions and incentives in the society matter a great deal in encouraging entrepreneurship. How firms navigate China's challenging environment, given the unpredictable nature of its transition economy, is a very important question particularly in terms of the institutional regime there (Ahlstrom et al., 2000; Kazanjian, Drazin, & Glynn, 2002; Peng, 2006). Financing, venture capital, and other factors such as shadow banking are also important to entrepreneurs in China, and particularly impact the opportunities and incentives provided by the environment that help (or hinder) the entrepreneur's ability to create and grow new firms (Li, 2006; Zhang, 2013). Yet to date, the entrepreneurship literature has only recently started paying attention to these issues in China (e.g., Li, 2006; Wang, Ahlstrom, Nair, & Hang, 2008; Yang & Li, 2008). This chapter provides some background on key topics with respect to entrepreneurship in China and suggests several topics for future research.[4]

1.2 Background

Entrepreneurship is generally regarded as a creative process whereby an entrepreneur causes changes in a market or economic system through provision of an innovative product or business model often in response to a valuable, enacted economic opportunity (Alvarez & Barney, 2013; Kirzner, 1973; Sarasvathy, 2008). As noted earlier, entrepreneurship was once a backwater area of study for academic researchers and consultants (Ahlstrom & Ding, 2014). Attention was typically directed toward the traditional factors of production labor and capital and on the price mechanism (Ahlstrom, 2014). German economist Werner Sombart (1913) and Austrian economist Joseph Schumpeter (1934, 1942) were among the few who argued that the key to development and growth was often not lower prices or more scale in production or added capital but the creation of credit, innovation, and new ventures. This required creative destruction, that is, innovations and new ventures that may render the old system, or part of it, obsolete, but will provide more in terms of welfare gain to the society in terms of new products and ventures, as well as jobs, productivity, and growth (McCloskey, 2013; Phelps, 2013).

Such creative destruction of an older order has almost become Schumpeter's trademark, though the first use of the term "creative destruction" in economics probably should be attributed to Sombart (1913). Both maintained that the simple accumulation of capital is not the heart of economic growth. In discussing the importance of innovation, as opposed to mere capital accumulation, Schumpeter noted: "Add successively as many mail coaches as you please, you will never get a railway thereby" (Schumpeter, 1934, p. 64).

More recently, researchers and policymakers have rediscovered Schumpeter's thesis regarding the important role entrepreneurs and their technologies play in creating new ventures, product markets, and growth (Acemoglu, 2009; Baumol et al., 2009; Haltiwanger et al., 2010; McCloskey, 2010). Empirical research extended the foundation laid by Schumpeter and further clarified the importance of entrepreneurship to an economy through innovation and new ventures thus leading to job creation (Aghion, Akcigit, & Howitt, 2005; Ahlstrom, 2010; McCloskey, 2013; Phelps, 2013; von Tunzelmann & Wang, 2007). Though it had long been thought that big companies created the most jobs (Galbraith, 1967), in the late 1970s, MIT researcher David Birch (1979) discovered that in an eight-year period ending in 1976, firms with fewer than 20 workers created four times as many new jobs as did companies with over 500 employees. His report, titled *The Job Generation Process*, demonstrated the need to study job creation at the firm level, thereby opening up a whole new field of research in employment and entrepreneurship (Abzug, Simonoff, & Ahlstrom, 2000; Birch, 1979; Shane, 2008).[5] Later research (Medoff & Birch, 1994) confirmed that not all small firms created jobs, rather often it was young firms (sometimes small, but certainly growing) that did much of job creation. They called these firms "gazelles"—companies that with at least $100,000 in revenue were able to grow 20% or more per year for four years. In one period studied in the early 1990s, gazelle firms accounted for nearly two-thirds of the net new jobs in the economy (Medoff & Birch, 1994). Recent data from John Haltiwanger and colleagues (2010) also show how (usually) young growth firms account for significant net job creation, which in turn is important for national income and economic growth (McCloskey, 2013).

1.3 Entrepreneurship in China

In much of the preindustrial world, sovereigns or local rulers held claim to all property in their lands, including new inventions (Rosenberg & Birdzell, 1986). As a result, subjects' property could be confiscated on the order of the sovereign. This could include innovations, which were regularly appropriated and utilized (or simply held) by local nobles or the monarch, often with limited compensation (Finley, 1965). A similar institutional structure existed in Imperial China (Balazs, 1964). As a result, it was common for people in China with assets to avoid acquiring conspicuous capital or concentrating resources in investments that might attract attention (Balazs, 1964; Rosenberg & Birdzell, 1986). This made it challenging for Chinese proprietors to significantly develop and grow their workshops and businesses, and also made it difficult to concentrate wealth to create funding for major investments required by industry.

In addition to the dearth of property rights, which worked to limit entrepreneurship, preindustrial Imperial China also reserved its biggest rewards for those who did well in the imperial examinations, much as classical education and examinations in Europe (Greenblatt, 2011). These exams were devoted primarily to the Confucian texts, other classics, and calligraphy (Ho, 1962). Successful candidates often entered the government hierarchy and high society, which gave them access to rents associated with many government positions. Others outside of the government, though they may have gained success in commerce, had much less access to government favoritism and were often unable to achieve high social standing (Balazs, 1964). Institutional rules favored the scholar-official who could devote much time to exam preparation and were weighted against the creation of new firms and products by entrepreneurs.

Entrepreneurship was to experience a small flowering in Republican China in the first decades of the twentieth century (Rawski, 1989). However with the CCP's accession to power in 1949, China's nascent market economy was transformed into a socialist one governed by a system of central planning with large state-owned enterprises(SOEs) and collective agricultural units. The state determined the allocation of most economic inputs and outputs, and maintained a monopoly over production and distribution (Reynolds, 1982). At that time, enterprises had to seek approval for doing virtually everything from the higher departments, which were separated from frontline production. In many factories, managers had to obtain authorization from their superiors before they could make expenditures greater than 50 Yuan—about ten dollars at that time (Liu & Wang, 1984).

Under the planned economy, management systems emphasized production, cost control, and filling needed quotas (Naughton, 1995). With the *danwei* system implemented at that time, enterprises provided housing and benefits to employees, such as child care, schools, clinics, shops, services, post offices, and so on. The *danwei* acted as the first step in a multitiered hierarchy linking each individual with the central Communist Party infrastructure. The "Iron Rice Bowl" of lifetime employment also restricted the ability of individuals to operate outside of the system. Entrepreneurship was suppressed both legally and by the de facto restrictions of the *danwei* system. Although some artisans continued to quietly work outside of the system, they often did so at the risk of arrest and punishment (Ahlstrom et al., 2000). What entrepreneurship did exist was on a small scale in the form of the black market and underground economy, often unproductive rent-seeking activity to take advantage of the perennial inefficiencies and shortages in the economy (Harding, 1987).

As China stabilized after the end of the Cultural Revolution, the new leader Deng Xiaoping launched China's Four Modernizations reform program in 1978 to improve the moribund economy and stimulate much needed economic growth. The first step was to decollectivize agriculture so farmers, after producing their annual grain quotas, could raise other crops, fish, or livestock to sell outside of the country's formal economic plan (Harding, 1987). Deng's popular agricultural reforms were soon extended beyond farms to households so small businesses could be set up to supply much needed local goods such as bricks and other building materials. The rural reforms created the impetus for the rapid development of township