Cambridge University Press
978-0-521-89810-2 - Capitalism with Chinese Characteristics: Entrepreneurship and the State
Yasheng Huang
Excerpt
More information

ONE

Just How Capitalist Is China?

In 2004, Lenovo, a computer maker based in China, acquired the manufacturing division of IBM. This event, coming off the heels of the news that China had contributed more than the United States to global GDP growth, took the world by storm. Richard McGregor (2004), a reporter for the *Financial Times*, captured a widespread sentiment when he wrote that the purchase was "a symbol of a new economic era, of how a fast-rising China had suddenly grown powerful enough to subsume an iconic American brand." Princeton economist and *New York Times* columnist Paul Krugman (2005) had not been alarmed with Japanese acquisitions in the 1990s but he was about Chinese investments. He believed that the Chinese corporate acquisitions posed a great threat to the United States. There are even those who hailed the Lenovo acquisition as heralding a new world order with China at its center (Shenkar 2006).

Business-school academics are particularly enamored with Lenovo. For them, Lenovo is proof positive of China's fertile entrepreneurial environment and rising competitiveness. In his book, *The Chinese Century*, Oded Shenkar, a professor at Ohio State University, rejects the notion that China lacks its own homegrown corporate giants. Lenovo, he argues, is just as homegrown as the best of the Indian corporations, such as Wipro or Infosys (Shenkar 2005). Lenovo is also featured prominently in *Made in China: What Western Managers Can Learn from Trailblazing Chinese Entrepreneurs*, a book by Donald Sull, a business professor at INSEAD (Sull 2005).

There is one problem with these otherwise perceptive books – Lenovo is not a Chinese company. There is no question Lenovo is a huge success story but it succeeded precisely because it was able to operate outside of the Chinese business environment. The Chinese face of the firm is Lenovo China headquartered in Beijing. This is the original firm founded in 1984 under the Chinese Academy of Sciences (CAS). But the real corporate control and equity holdings of the production and technology development of Lenovo actually reside elsewhere – in Hong Kong. Consider Lenovo (Beijing) and Lenovo (Shanghai), the business units of the firm that run manufacturing, R&D, software development, and customer services. Both of these business units are not only foreign-invested enterprises (FIEs); they are, in fact, wholly owned FIEs – that is, they are 100 percent owned by a legal foreign entity, which is Hong Kong Lenovo. They have no direct equity relationship with Lenovo China. As wholly owned FIEs, the Beijing and Shanghai divisions of Lenovo are more foreign than GM's operation in Shanghai, which is a 50–50 equity joint venture. The foreign operations of Lenovo are so substantial that in 2003, seven of Lenovo's Hong Kong subsidiaries were included on a list compiled by the Chinese government as among China's 500 largest FIEs.

This is a book about this and many other phenomena of the Chinese economy. In the first part of this chapter, I provide a detailed account of Lenovo in order to make a larger point – the Chinese economy is so complicated that what appears to be straightforward and obvious on the surface is not at all so once we dig into the details. To get into these details requires going far beyond the normal empirical basis of much of the economic analysis on China (e.g., data on GDP and foreign exchange reserves). In this book, I have examined numerous government documents, including memoranda and instructions issued by officials of the central bank and by senior bank managers and a large quantity of survey data on households and Chinese firms. The conventional economic data, such as GDP, exports, and FDI, serve as motivations for further research rather than as statements about settled conclusions. (I provide more details on the empirical sources of the book later in this chapter.)

The Lenovo example is not just about getting the facts right about the Chinese economy; it is also about drawing the right analytical and policy implications from China's growth experience. This is another theme running throughout the book. Much of the received wisdom in the academic literature states that entrepreneurship, financial liberalization, and private property rights security are not significant components of Chinese economic growth. (Or, at the very least, to the extent that these components are important, they have very different manifestations from those prevailing elsewhere.) The success of the Chinese economy has inspired the idea that economic growth follows from an adept tailoring of economic policies and institutions to their local contexts rather than from an application of universal economic principles. Let me apply this idea to the experience of Lenovo.

A critical detail of the Lenovo story is its foreign registration status. A reader may wonder, "So what?" What is so significant about the fact that Lenovo is registered as a foreign-owned company in China? Furthermore, isn't it the case that Hong Kong is now a part of China so the designation of Hong Kong Lenovo as a foreign firm is a frivolous legal fiction? The answers to these questions show precisely how important it is to get the details of the Lenovo story right.

Understanding the Hong Kong roots of Lenovo entails significant implications about constructing the right causal attributions. Hong Kong is a laissez-faire economy based on a market-oriented financial system, rule of law, and property rights security. Hong Kong, many would argue, is the closest living case to the textbook version of neoclassical economics in the world. This is why it matters so much to accurately attribute the success of Lenovo. If we believe Lenovo to be a product of China's business environment, then many of those who argue that China has created a unique, country-specific formula for cautious deregulation, state ownership, and selective government intervention in the economy have a point. If we believe Lenovo to be a product of Hong Kong and Hong Kong institutions, the success of Lenovo then becomes a story of rule of law and market-based finance. It is thus worth going into some details about this matter.

Apart from the initial financing from CAS in 1984, it is the market-oriented and conventionally Western Hong Kong capital market that supplied Lenovo with almost all of its subsequent capital during the critical growth period of the firm.[1] In 1988, Lenovo received HK$900,000 from China Technology, a Hong Kong–based firm, to invest in a joint venture in Hong Kong. This investment thereby established Lenovo's legal domicile in Hong Kong. (Originally, the firm was known as Legend.) Here, luck and fortuity played a role. The father of Liu Chuanzhi, the main founder of Lenovo, ran China Patent Agent based in Hong Kong. China Patent Agent was a major shareholder of China Technology. Computer manufacturing is capital-intensive and requires substantial investments. It was the capital market in Hong Kong that met this high level of capital requirements of Lenovo. In 1993, Hong Kong Lenovo went public on the Hong Kong Stock Exchange. The initial public offering (IPO) raised US$12 million, which the firm plowed back into its investments in China. Lenovo is a success story of the market-based finance of Hong Kong, not of China's state-controlled financial system.

Although it is true that the founders of Lenovo all came from CAS, that the firm became a business subsidiary of CAS is a historical artifact. The founding capital was 200,000 yuan, an enormous sum in China in

1984. The money was actually a loan from CAS, not an equity investment. In fact, the arrangement was exceedingly convoluted. According to one account, the 11 founders of Lenovo had secured the money as a bank loan, which they lent to CAS. CAS then turned around and loaned the money back to Lenovo. Under Western law, Lenovo would have been a straightforward private firm with CAS as its creditor, not the equity holder. But the reason why Lenovo incorporated itself this way has nothing to do with the actual share of capital contributions. The reason is that in 1984, there was really no legal vehicle to register an independent private-sector firm of the size of Lenovo and operating in a modern industry such as computer manufacturing. In the 1980s, although private-sector liberalization in rural China went far and deep (a topic I revisit in the next chapter), the urban economy remained almost completely state-controlled. Many of the large-scale otherwise private businesses were incorporated in this way in the 1980s.

Understanding Lenovo's Hong Kong connections also helps us gain the right perspective on the Chinese business environment. The legal status of Lenovo as foreign-owned mattered to Lenovo in a most fundamental way – this was its entry ticket into computer manufacturing in the first place. After its founding, Lenovo was denied a production license in computer manufacturing in China. Instead, the Ministry of Electronics granted a production license to the Great Wall Group, a traditional SOE. Lenovo only began to produce computers in China not as a Chinese company but as an FIE originating in Hong Kong. Every single manufacturing, service, and R&D operation launched by Lenovo in China has followed exactly the same route. They are either wholly owned by Hong Kong Lenovo or they are foreign joint ventures with other Chinese firms. In 1997, Hong Kong Lenovo absorbed the last remaining Chinese operation, its Beijing operation.[2]

As an FIE, Lenovo came under the jurisdiction of the Foreign Equity Joint Venture Law or the Wholly Foreign Equity Law. Chinese laws and regulations provide a more liberal operating space for foreign-registered firms than they do for domestic private firms. In the 1990s, China pursued a highly biased liberalization strategy that conferred substantial tax and policy incentives on FDI while restricting the growth potentials of the indigenous private sector.[3] Until 2005, many of the high-tech and so-called strategic industries were declared off-limits to domestic private entry. Indigenous private entrepreneurs, many highly capable, could grow their businesses only via foreign registration. This is why Lenovo acquired a foreign legal status. As an FIE, Lenovo was able to operate in greater regulatory space and with more autonomy. As an illustration, the

Cambridge University Press
978-0-521-89810-2 - Capitalism with Chinese Characteristics: Entrepreneurship and the State
Yasheng Huang
Excerpt
More information

firm that bypassed Lenovo and was given the production license in computer manufacturing – the Great Wall Group – operated completely within China's domestic business environment. The firm floundered badly.

Professor Sull chronicles seven other firms in his book: Sina, UTStarcom, AsiaInfo, Haier, Galanz, Wahaha, and Ting Hsin. Every single case Professor Sull discusses is a Lenovo-like story. The firms are all registered as foreign firms in China, or some of their main operations are so registered. Sina, UTStarcom, Ting Hsin, and AsiaInfo are wholly owned FIEs, 100 percent owned by foreign investors, identical to Lenovo (Beijing) and Lenovo (Shanghai). Galanz and Wahaha are joint ventures. (In 2007, Wahaha's founder was involved in a bitter dispute with its foreign business partner, Danone.) Haier itself is not an FIE but its main business and production units are FIEs, including its core areas in refrigerator and washer and dryer production. All of these firms are legally classified as FIEs and they fall under the relatively more liberal purview of China's foreign investment laws and regulations.

It is quite understandable that Sull assumed that all of these firms are Chinese. They are Chinese to the extent that their managers and owners are ethnically Chinese, but their legal status is *foreign*. That corporate success in China requires a combination of Chinese management and foreign legal status is probably the cleanest illustration of the massive distortions in China's business environment – that this is a system that has imposed a straitjacket on the domestic private sector. It is thus not a coincidence that corporate success stories in China all share an underlying commonality with Lenovo and Sina. In 2002, *Forbes* compiled a list of the most dynamic small firms in the world. On that list, four are run by Chinese entrepreneurs and derive most of their revenue from their China operations, but each one of them is actually headquartered in Hong Kong.

The rise of Lenovo has so impressed some foreign analysts that a McKinsey consultant goes so far as to claim that China has the "best of all possible models" (Woetzel 2004). This reasoning holds up the particular policy and institutional path that China has followed as a model for other developing countries. China has inspired Western researchers to argue that microeconomic and macroeconomic successes do not depend on adoption of Western-style financial and legal institutions. This is the argument in an influential finance paper that claims that informal finance is nearly as good as market-based financial institutions in channeling capital to the private sector (Allen, Qian, and Qian 2005).

The story of Lenovo casts doubt on all these postulations. Yes, China lacks efficient legal and financial institutions, *but it has access to them – in*

Hong Kong. Take the view that formal finance does not matter. The management of Lenovo certainly would not agree with this. The firm raised more than US$12 million from its Hong Kong IPO. Formal finance – and the institutions supplying it – is absolutely essential to the success of Lenovo. Informal finance might be sufficient to start small kiosk businesses or simple production, but it is not adequate for firms to acquire modern production facilities and to move up on the technological ladder.

Lenovo is the most prominent product of what is known as "round-trip" FDI – "foreign" capital that is first exported from China and then imported back into China. The key function of Lenovo's Hong Kong operation has nothing to do with technology. In fact, according to one of the best and most-detailed accounts of Lenovo, the managers and scientists at Lenovo had far superior technical expertise than the Hong Kong firm with which it teamed (Lu 2000). The true contribution of China's open-door policy is not just about allowing foreign entry but also about allowing Chinese exit. It enabled some of China's own indigenous entrepreneurs to find an escape valve from a very bad system. To put it another way, China's success has less to do with creating efficient institutions and more to do with permitting access to efficient institutions outside of China.

This – largely unintended and under-appreciated – effect of China's open-door policy should be explicitly recognized, but recognizing this effect is qualitatively different from stating that China does not need efficient market-based institutions. The story of Lenovo is precisely about the importance of efficient market-based institutions. Lenovo was able to tap into these institutions because China is fortunate enough to have the most laissez-faire economic system at its doorstep. Hong Kong is a safe harbor for some of the talented Chinese entrepreneurs and an alternative to China's poorly functioning financial and legal systems. It is only a slight exaggeration to say that Lenovo benefited as much from the British legacy as from the growth opportunities within China itself.

China is unique in that some of its capable entrepreneurs have the option of accessing one of the most efficient financial markets and legal institutions in the world. But here is an important policy implication. It would be futile for other developing countries to emulate China's domestic financial and legal institutions and practices as a way to achieve economic growth. As successful as Lenovo is, the special circumstance of Hong Kong limits the general applicability of this model. In this connection, McKinsey's exhortation that China has "the best possible" business model is equivalent to urging other poor countries to acquire their own Hong Kong, a piece of advice of dubious utility.

Finally, there is the issue of whether or not getting the story right about Lenovo and about China really matters for China. Maybe the lessons of China cannot be readily extended to other countries, but as long as the China model works for China, this is fine. Isn't it the case that many firms like Lenovo are able to tap into Hong Kong's financial market and legal institutions and are able to emerge as competitive giants on the world stage? As long as there are substitute mechanisms, China's growth can continue.

This is a flawed inference from the success of Lenovo and other Chinese companies. Recall the fact that Lenovo was able to tap into the financial market of Hong Kong surreptitiously – Liu Chuanzhi's father was an executive in Hong Kong. Familial connections enabled Lenovo to escape from the clutches of China's poor institutions, but for each Lenova-type success story, there are untold cases of failure of indigenous entrepreneurs for whom access to Hong Kong is not an option. This is true especially of those would-be entrepreneurs located in China's vast rural and interior regions. One can go even a step farther. China's need for an efficient financial system is greater in the interior regions than it is in the coastal provinces precisely because the interior is so short of other conditions for growth.

Bad institutions are especially detrimental to rural entrepreneurship, the type of entrepreneurship that matters far more to the welfare of the vast majority of the Chinese, as compared with urban, high-tech entrepreneurship. Two chapters of this book delve extensively into this issue. Unlike many countries, the most dynamic, risk-taking, and talented entrepreneurs in China reside in the countryside. These rural entrepreneurs created China's true miracle growth in the 1980s, first by dramatically improving agricultural yields and then by starting many small-scale businesses in food processing and construction materials. The open-door policies alone can do very little – and they did very little – to help these entrepreneurs in the interior regions.

To a large extent, the story of Lenovo mirrors the story of China. What appears to be abundantly obvious on the surface is, in fact, not obvious at all. To get the facts right requires a deep digging into many details. A substantial portion of this book illustrates this point. In part, this is a history book – marshaling facts and data about the evolution of the Chinese economic system over the last three decades. But, as my account of Lenovo shows, getting the China story right is also about constructing the correct explanations about China. The explanation I put forward in this book is simple and even bordering on the mundane: China succeeded where and when bottom-up, private entrepreneurship flourished and it stagnated where and when entrepreneurship was suppressed.

In this chapter, I begin with a basic question, "Just how capitalist is the Chinese economy?" This is a legitimate question, considering the following. First, the year 2008 marks the 30th anniversary of China's economic reforms (1978–2008). By 2008, it will have taken China one year longer to reform its socialist economic system than the duration of the pre-reform central planning system itself (1949–1978). (Indeed, by the account of economic historians, a full-fledged central planning system was not established until the mid-1950s.[4]) The question of the pace at which China is transitioning to capitalism is worth considering. Second, some of the most prominent and authoritative China economists have already declared that China's transition to a market economy is now complete.[5] The remaining challenge, they argue, is economic development. It is legitimate to subject this judgment to an empirical test.

One of the most important – if not the most important – hallmarks of a market economy is the role and magnitude of the private sector. However, as in so many other areas of the Chinese economy, there is no straightforward answer to this seemingly direct question about the size of the Chinese private sector. The reason is that the Chinese style of reforms has spawned a large number of firms that have fundamentally confusing and often deliberately vague ownership structures. After sorting through some definitional complications, I show that the size of the Chinese private economy, especially its indigenous component, is quite small. Using fixed-asset investment as a measure of policy, I show that the policy treatment of the indigenous private sector deteriorated substantially in the 1990s as compared with the 1980s. This policy reversal is the most important reason why China's transition to capitalism remains incomplete 30 years after the reforms began.

The second section of this chapter provides a preview of my account of the Chinese reforms during the last 30 years and concludes with a précis of the remaining four chapters of the book. Three issues are highlighted. First, a good account of the Chinese economy should be able to explain both its many well-known weaknesses – the weak financial system, the underdeveloped private sector, and the deterioration of social performance – as well as many of its considerable achievements, such as its rapid growth and its impressive reduction of poverty. The key factor identified in my account is a reversal of economic policies at the end of the 1980s. In the 1980s, the direction of economic policy was progressively liberal, primarily in the rural areas of the country. Access to finance by the private sector improved rapidly and rural entrepreneurship was vibrant. In the 1990s, the direction of economic policy was reversed, with an increasing emphasis on industrial policy and state-led investment drives. Although GDP growth was rapid during both eras, both the drivers and the effects of the growth differed substantially. In the 1980s, the rapid GDP growth was accompanied by fast personal income growth, an improving income distribution, and a steep decline in poverty. Since the early 1990s, and at an accelerating pace since the late 1990s, the welfare implications of the fast GDP growth turned adverse. In other words, many of the best-known achievements of the Chinese economy owe their origins to the policies of the 1980s and many of the deep-seated problems today are an outgrowth of the policies of the 1990s.

The second part of my account emphasizes the importance of the rural sector. The importance of the rural sector derives not just from its sheer weight in the Chinese economy and society – that China has a large rural population – but also from the institutional perspective. In China, the origins of market-based, entrepreneurial capitalism are heavily rural in character. This observation entails some significant auxiliary implications. One is that the fate of rural entrepreneurship has a disproportionate effect on the character of Chinese capitalism. When small-scale, market-oriented, broad-based, and politically independent rural entrepreneurship is accorded greater operating freedom and supported by policies, entrepreneurial capitalism thrives and produces many of its associated virtuous effects. When rural capitalism is restricted in favor of its urban counterpart, Chinese capitalism is less welfare-improving. In essence, this is the tale of the two decades. In the 1980s, the country was moving directionally toward the virtuous kind of capitalism, or what Baumol, Litan, and Shramm (2007) describe as entrepreneurial capitalism. In the 1990s, the country still moved toward capitalism but of a different and less virtuous kind – the state-led brand of capitalism.

The third part of my account has to do with how to interpret China's growth experience. My purpose here is to present the relevant factual details and to develop the right analytical perspective based on them. I argue that China's growth experience is actually very conventional. Private ownership, financial liberalization, property rights security, and even some degree of constraints on the political rulers are as essential to China's economic success as they are to economic successes elsewhere. The success of Lenovo, which "borrowed" the institutional benefits of Hong Kong, illustrates this point. On the other hand, many of China's failings are a direct result of the country's poor and underdeveloped economic and political institutions and, more important, a consequence of the fact that the country reversed its policies and practices from the directional liberalism of the 1980s to the directional illiberalism of the 1990s.

1 Just How Capitalist Is China?

A hallmark of a market economy is the size and the vitality of its private sector. There are two standard perspectives on this question as related to China. One is the view that growth happened in China despite the absence of sizable private ownership. Advocates of this view point to TVEs – the growth engines in the 1980s and the first half of the 1990s – as an illustration. The other standard perspective is that China's private sector was not substantial *ex ante* but became substantial *ex post*. This perspective is rooted in the gradualist framework on the Chinese economy. According to the gradualist perspective, China did not actively privatize its SOEs, but it successfully created a hospitable business environment for the entry and the organic growth of private entrepreneurship. Over time, the private sector grew to overshadow the state sector. Market economy developed by evolution rather than by revolution.

I provide an alternative perspective in this book. Later in this chapter and in Chapter 2, I delve extensively into the TVE phenomenon; the gist of the finding is that TVEs, upon a microscopic examination, were in fact a substantially private phenomenon. In this section, I look into the gradualist perspective on China's private sector. The issue here is not so much whether the gradualist perspective is directionally accurate about the growth of China's private sector. There is little question that the size of China's private sector today is much larger than that in 1978. (In 1978, it was zero.) The issue is just how successful is China's evolution toward a market economy. Scholars schooled in the gradualist perspective declared a huge success. The analysis I present in the following paragraphs reached a far more tempered judgment on this question.

As almost with any other aspects of the Chinese economy, the issue comes down to data as well as perspectives. Let me use the example of Huawei Technology Corporation, one of the largest private-sector firms in China, to illustrate the myriad complexities of the Chinese economy. By most accounts, Huawei, with sales revenue of about US$5.7 billion and operating in more than 90 countries, is China's most successful private-sector firm. But our knowledge of its actual ownership structure is almost non-existent. Huawei is a microcosm of China's private sector – we know that it is there but we do not know its actual size and its boundaries. The convoluted