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Subsidies, rent seeking and performance: Being young, small or private in China☆

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ABSTRACT

Entrepreneurs in emerging market economies operate in weak institutional contexts, which can imply different types of government. In some countries (e.g., Russia), the government is predatory, and the main risk faced by (successful) entrepreneurs relates to expropriation. In other countries (like China) this kind of risk is lower; nevertheless the government is intrusive, and the rules of the game remain fluid. The implication of the latter for entrepreneurs is that they are more likely to spend time and resources on influence (rent seeking) activities rather than on productive activities. We illustrate this type of government by focusing on the distribution of subsidies in China. We present a simple formal model that explores not only the direct effects of rent seeking for a company but also externalities under a situation of policy-generated uncertainty in the distribution of subsidies. We explore how these effects differ for the entrepreneurial sector (young, private and small companies) compared with other sectors. We posit that while the performance of private companies is more affected than the performance of state firms, the impact of government-induced uncertainty on young and small companies is actually less pronounced. Our empirical analysis, based on a unique large dataset of 2.4 million observations on Chinese companies, takes advantage of the regional and sectoral heterogeneity of China for empirical tests.

1. Executive summary

Institutions (rules and norms) shape the context in which entrepreneurs operate, and therefore affect both the opportunities and the risks that entrepreneurs face. Entrepreneurship research initially focused on the role of formal institutions ('rules') (North, 1990, 2005; Baumol, 1996), with more recent studies asserting the complementary roles of informal institutions ('norms'), in particular in emerging economies where formal institutions are weak (e.g., Estrin et al, 2013). However, it is of substantial importance for policy makers, practitioners and researchers to understand better the exact nature of these institutional forces, and the possible mechanism of their impact on entrepreneurs. This is an important gap in knowledge that we aim to address.

The inadequate conceptualization of the nature and mechanism of institutional forces in the current entrepreneurship literature is partly due to methodological limitations. Most of the existing work corresponds to the birds' eye view, where formal institutions are modelled by measuring the broad national rules of law and regulation, and the informal norms (such as corruption and trust). Such approaches rely on the assumption of individual firms and entrepreneurs receiving similar effects from very broad general

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institutional configurations. In contrast, our fundamental premise is that while a strong institutional environment implies the same treatment for all economic actors, a weak one does not. Consistent with this, in order to understand the impact of a weak institutional environment, one needs to analyse the institutional patterns at a sub-national level.

We focus on China, one of the two largest economies in the world, in which institutional heterogeneity is additionally amplified by regional decentralisation. We propose novel measures of institutional quality, based on regional patterns in the distribution of subsidies, to capture the uneven playing field across regions and sectors of China. We demonstrate that where the playing field is uneven, the average performance suffers; and this effect is concentrated on large private firms, as predicted from our conceptual modelling. All this is based on a unique, quality dataset of 2.4 million observations of Chinese firms, and the results are robust to alternative econometric specifications.

We make a number of contributions. At our starting point, this paper advances the literature by distinguishing predatory governments from intrusive and opaque governments, and by theorising a specific mechanism of weak institutions that is characteristic with non-transparent government intervention. We propose a new proxy for institutional weakness related to the uneven patterns of subsidies' distribution at a highly disaggregate level. We estimate the costs of weak institutions by considering the implications for performance. This approach not only gives more texture to the theory on the formal institutions' influence on entrepreneurial choices of actions, but also allows direct empirical testing of the performance consequences of these choices.

Furthermore, our empirical analysis sheds new light on one of the most fascinating cases of the emerging economies — China; where its future economic growth hinges on balancing the state's still powerful grip, its regional decentralisation and competition. China's development has its foundations in the ascent of “entrepreneurial capitalism” (Baumol et al., 2007) and we spell out what are some of the key institutional difficulties that the development of entrepreneurship faces.

The approach we propose is applicable to many other opaque emerging market economies that, over time, evolve towards the model of entrepreneurial capitalism. In the latter the critical role is played by new private, small, innovative firms. Motivated by this, our contribution is to disentangle how weak institutional contexts affect young, small and private firms. We provide evidence suggesting that, in an environment which is opaque but not predatory, young firms are not seriously affected by institutional weakness because they are able to rely on their own resources, capabilities and private networks. However, big private firms' performance is affected in those regions of China where the playing field is uneven.

A practical implication of our research for entrepreneurs is that we offer one clear cut proxy of what to expect in given locations when choosing to start a venture. Policy makers are in turn alerted to the costs of implementing alternative policy regimes which may not adversely affect young private businesses at their start-up, but which will affect them as soon as they grow and become larger.

2. Introduction

Under deficient formal institutions, political connections are important for entrepreneurs who invest in building these connections either to protect themselves from expropriation or to gain access to resources (Zhou, 2013; see also: Xu, 2011; Zhang, 2015). At the same time, the relative weight of these aspects differs across emerging market economies. In particular, Puffer et al. (2010) contrast the institutional model of Russia with that of China. In Russia, the government is predatory, and entrepreneurs are in constant risk of expropriation. As a result, entrepreneurship remains weak, and the only businesses that thrive are those that are protected from expropriation by linkages with power structures (*ibid.*; Aidis et al., 2008). In China, while expropriation can happen, it is an exception rather than the norm, because the government recognises the value of entrepreneurial initiative for development (Puffer et al., 2010). There, the critical way in which institutional weakness impacts entrepreneurs is not by the need for protection from expropriation, but by the time and effort they invest in seeking access to resources via cultivating relations with the government (Zhang, 2015).

Anecdotal evidence of this phenomenon abounds. Using Baidu (the popular search engine for the Chinese World Wide Web domains), we could identify a large number of commercial courses, case studies and tips for strategies and tactics offered to teach entrepreneurs how to “deal with” the government. Equally it is remarkable to see how many online businesses advertise their products related to government–public relations. Behind the prosperous markets for these services are the “consumers” — private entrepreneurs in particular; and one wonders how much effort they need to invest in their relationship with the government. Many stories in the Chinese media give clues. In one case, a famous entrepreneur (Feng Lun) complains “how exhausting and time-consuming it was to deal with government agents”. Mr Lun, the President of Wan Tong Group, had to take flights 180 times in a year to make sure a project application was signed off by the government.[1] Similarly, one of the most successful Chinese entrepreneurs, Liu Chuangzhi, the CEO of Lenovo, recalled that when his company was small, he had to spend more than 70% of his time and energy in maintaining relations with the “external environment”, “governments in particular”.[2] In another article about government subsidies, it becomes clear from many entrepreneurs' experience, that “getting subsidies is all about having a good relationship with the government, so you would get information in a timely manner and can access insiders to help with applications”.[3]

This reality makes China a fascinating example for study of how institutional framework affects entrepreneurship. Learning from the failures of the state-centred development model, China started to drift away from it in the late 1970s (Huang, 2008; Lu and Tao, 2010; Zhang, 2015). China's drift was followed – about ten years later – by India and many other emerging market economies. Over the last three decades, China experienced unprecedented economic growth, and became the second largest economy in the world. The

[1] Source: Phoenix Media TV interview; http://finance.ifeng.com/business/renwu/20130128/7610444.shtml, as accessed on the 16th of February, 2015.

[2] Source: http://management.yidaba.com/zhengfu/, as accessed on the 16th of February, 2015.

[3] Source: New Beijing News at http://epaper.bjnews.com.cn/html/2013-01/24/content_405802.htm?div=-1), access on the 16th of February 2015.