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Department of Economics
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How did the Chinese private de novo firm develop during market transition, when the formal institutional structure wasn't benevolent?

Author: Marine Arakelyan
Supervisor: Andreas Bergh

Abstract

This thesis will focus on one of the most external factors that drove the institutional change particularly in Chinese industry, which is the emergence of private de novo firms. The purpose of this thesis is to bring together the important role of emerging private firms in a marketizing economy and the impediments imposed by the government. Several institutional problems need to be addressed in order to understand their complex development. The most serious ones that we would focus are the lack of sufficient legal framework to protect private property rights, the importance of political capital for securing future business transactions and finally, poor developed financial institutions. We will further discuss the alternative methods these de novo firms entail which uphold additional institutional framework for China's economic success. The paper will present four hypotheses which will be based on earlier research and econometric analysis using World Bank Investment Climate Survey conducted in 2003.

Key words: China, private de novo firm, alternative mechanisms

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References

List of Abbreviations

CEO	Chief Executive Officer
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GEI	Governance Environment Index
NPC	National Peoples Congress
PCBC	The Peoples Bank of China
PRC	People Republic of China
SME	Small and Medium Enterprises
SOE	State Owned Enterprises
WTO	World Trade Organization

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1. Introduction

China has seen a remarkable growth in recent years due to opening up to the market towards globalization, WTO accession and the emergence of private firms. There are strong indicators that growing private firms is a dynamic force in China's economic development. There is a clear growth in China's overall GDP. According to the OECD report, China's average annual growth rate of 9.5% consistently held in the past 20 years is likely to continue strong, which translates China's growth as one of the fastest sustained economic transformations in the world in the past 5 decades.[1]

There is an increasing importance in China's economic transition into a more market-friendly environment to allow the private sector to take more precedence in the share of national GDP. According to the National Bureau of Statistics, China's GDP growth rate has grown tremendously, which can be correlated with the decreasing state-owned enterprises share of GDP and growing GDP in alternative income generating machines in the private sector, such as newly privatized firms and entrepreneurial de novo firms. It is observed in previous literature that eventually the growth and even the steadiness of an economy will depend upon the speed at which new firms come into existence, the rate at which they survive and develop into mature enterprises.[2] Certainly, in a transition from a socialist/communist economy, the government will pose resistance to dispersion of power.

Impediments for new private firms as opposed to state-owned enterprises include a weak legal infrastructure; as implied by the Helping-Hand model. Given China's Helping hand model, as described by Frey and Shleifer, in reforms towards a transitioning economy, the government is not completely above the law, but uses power to help businesses which are in its favour, whether it is due to ownership type, sector, size, or political connection. State officials enforce contracts and the government aggressively regulates to promote businesses which are in line with government incentives. The legal framework plays a limited role in this model, because bureaucrats arbitrate most disputes, which translates to organized corruption, yet relatively limited[3].

Hence, it is apparent that a core component in a transitional economy is its ownership structure, which in a planned to market transition requires a growing dominance of private ownership, compared with state-owned enterprises as under the old system. "This in turn

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[1] OECD (2005), "Economic Surveys: China", pp. 12-17

[2] Johnson, Simon, John McMillan and Christopher Woodruff (2000), "Firm Creation and Economic Transitions", Economics of Transition, 8(1):p. 428

[3] Frye, Timothy and Andrei Shleifer (1997), "The Invisible and Grabbing hand", American Economic Review. Papers and Proceedings, 87(2): pp. 354-358

means that no matter how big the state sector was at the start of transition, as long as the non-state sector can grow, the transition will eventually succeed".[4] Undoubtedly, there is a growing importance in the private sector, which is still met with government restraints.

"The dominant role played by the state is reflected not only in the bulky share of state ownership in the financial service industry, but also in the tight control of market entry in many aspects by the government".[5] Though China is following a market-oriented direction, the strong role of the government still shows a clear preference to use their discriminatory power in the financial sector to control funds. This "inside" market system fosters natural impediments politically, legally, and financially, which will be further discussed in the upcoming sections.

The thesis will be broken down in the following order. The introduction will be followed by the second section, which will highlight the role of institutions in shaping the private sector development pathway. The third section will entail a descriptive layout of background on emerging private firms, focusing on the in-place institutional framework, the importance of private firms in China's economy, and the distinction between de novo and privatized firms. In the fourth section, we will speak about the impediments placed by the government and group them into three main categories, which are legal, financial and political respectively. The latter will be followed by the discussion of the alternative methods, which come into sight as the direct lack of formal support from the government. This includes China's weak legal infrastructure, which promulgate conditions for biased financial treatment, creating the need for de novo firms to search for alternative methods, in addition to the lack of political connections, which can further limit their scope of activities. The section six presents an empirical model for testing the hypothesis generated from earlier sections using the World Bank Investment Climate survey. In conclusion, which is presented in section seven, drawing from our data analysis and theory, we show that there exists a need for alternative methods to act as a substitute for de novo private firms as a result of government-imposed impediments in comparison to State-Owned Enterprises (SOE's). Moreover, the analysis illustrate the linkage between the ownership type and the amount of credit obtained from formal financial institutions, particularly they confirmed a negative correlation between being a private firm and the amount of credit obtained from commercial banks.

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[4] www.worldbank.org, Progress in Ownership Changes and Hidden risks in China's Transition

[5] Liping, He (2005), "Evolution of Financial Institutions in Post -1978 China: Interaction Between State and the Market", China and World Economy, 1(6): p. 23

2. Institutional foundations of China's transition

The phenomenon for private firm development lies behind the structure of institutions. The role of institutions in supporting growth in developing and transition economies has inspired a renewed interest in recent years, however, the institutional framework for a modern enterprise economy in the China is not utterly in place.

The interesting question that arises, concerns how institutional framework has shaped the private sector development path where the formal institutional structure was not fully in place? To comprehend this requires the basic understanding of the nature of institutions. Hence, the objective of this section is to develop a basic theoretical framework for understanding the role of institutions which lie behind the private de novo firm development.

Even though recently it has been recognized that institutions do matter for analyzing different economic performances of transition economies, but the interesting questions which arises at the outset are: how do institutions change and particularly why have they been so successful in Chinese case with the underdeveloped legal system and poor developed financial system?

To begin with, it should be stated that the widespread definition of institutions are found in Douglas North's research works when he conceptualized the institutions as "rules of the game", which structure incentive systems and determine transaction costs. He further states that they consist of formal (rules, regulations, enforcement mechanisms) and informal constraints (habits, relational contracting, trust) as well as the enforcement attributes. Hence, if institutions are rules of the games, organizations and their entrepreneurs are the group of actors.[6]

In a transitional economy the role of institutional structure increases the importance in light of added dependence and confidence in the new institutional norms, whether informal or formal replacing the old ones. This naturally creates a conflict of interest to those in power that must delineate their scope of authority. Institutional reform is complex; it is always met with a great deal of resistance, in particular within the rules that govern the relationships between the government and the private sector.[7] We will discuss it further in the section four, which covers the impediments of private sector development. A core problem with institutional reforms therefore is that "Institutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the

[6] Douglass, North (1994), "Economic Performance Trough Time", American Economic Review, 84(3): pp. 359-361

[7] Johnson, Simon, John McMillan and Christopher Woodruff (2000), "Entrepreneurs and the Ordering of Institutional Reform", Economics of Transition, 8(1): p. 2

interests of those with the bargaining power to create new rules".[8] Hence, there is no pledge that the formal rules and institutions that progress through time will yield to economic growth. However, there have been forceful transformation in both political and economic institutions in numerous countries over the last 2 decades, and the China is one of them.

Several of these transitions followed by a big bang approach, particularly Eastern European countries and former Soviet Union, merged economic liberalization with immense forces of democratization and rapid privatization. On the contrary, China adopted the different path following the experimental and gradual approach to transition. The economic reform in the latter occurred without democratization, liberalization progressed slowly and privatization was deferred after the launch of reforms, which nonetheless resulted in high and stable growth rates since the reform process.[9] Hence, the consideration of informal norms is applicable to the growth of private sector, particularly when considering the absence or weakness of reliable and sustainable formal institutions to guide their development. Hence, this thesis, through a plethora of earlier research and econometric analysis, will try to motivate and answer the following question:

Question: *Has the informal institutional framework been the driving force behind the growth of Chinese private de novo firms?*

3. Role of private firms in Chinese context

The most vital institutional traits for a transition economy are the materialization and ratification of the market economy, the establishment of secure property rights, the development of financial sector, the liberalization of political institutions and more importantly the growth of a private sector. The latter is considered a significant outcome of the market-oriented reforms in China, which now accounts for about a third of GDP.

Private enterprises first appeared in rural areas and in the 1980s larger private enterprises began to emerge, although they were not officially recognized until 1988. Private enterprises developed rapidly, however only constitutional amendment in 1999 formally acknowledged this shift, thus allowing the private sector to emerge from the shadows.[10]

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[8] Douglass, North (1994), "Economic Performance Trough Time", American Economic Review, 84(3): p. 360
[9] Iftekhar, Hasan, Paul Wachtel and Mingming Zhou (2009), " Institutional Development, Financial Deepening and Economic Growth: Evidence from China", Journal of Banking and Finance, 33(1): pp. 157-158
[10] Hasan, Iftekhar, Paul Wachtel, Mingming Zhou (2009), "Institutional development, financial deepening and economic growth: Evidence from China", Journal of Banking and Finance, 33(1): p. 159

The below figure illustrates that the latter shift resulted in the rapid growth of private firms and the increase in the gross industrial output value. This supports our hypothesis which states:

Hypothesis 1*: The emerging private firms (de novo) are an important establishment for the growth of China's transition process toward the market economy.*

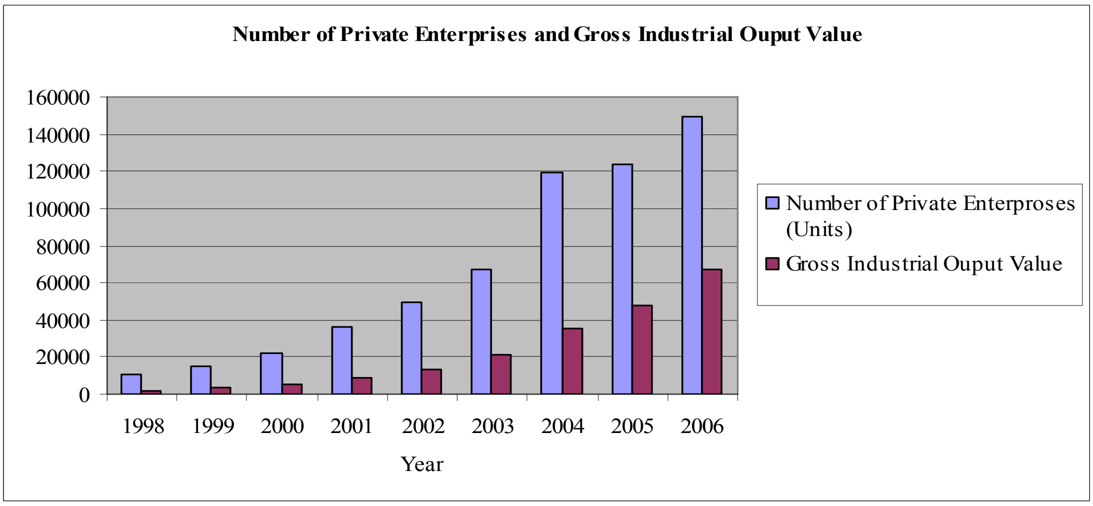

Figure 1
Source: China Statistical Yearbook 2007

We can see from the above figure that private business is the fastest-growing sector of China's economy. By the end of 2006 China had significant number of private enterprises and the gross industrial output value was increasing rapidly expanding at an annual rate of 20 percent, far above the 9.5 percent average growth of the national economy over the past decades. The private sector employs people laid off from failing state factories and contributes an increasing proportion of taxes to government revenue.[11]

The growth of the private sector has alleviated the social costs of SOE reforms, absorbing the unemployment and contributed to the increase of export shares in the world market. Despite the contributions of the private sector to the economy, it is poorly served by the formal financial markets, as only a very small portion of bank credit have gone to private firms. As a result, private firms are dependent heavily on informal financial channels and self-financing which will be further discussed in the fifth section of this thesis.[12]

In addition to this, economists argue that China lacks many of the conditions which are necessary for private-sector economic growth, particularly the growth occurred despite the lack of explicitly defined property rights. Nonetheless, private entrepreneurs and firms have

[11] www.internationalentrepreneurship.com, Entrepreneurship in China
[12] Iftekhar, Hasan, Paul Wachtel and Mingming Zhou (2009), " Institutional Development, Financial Deepening and Economic Growth: Evidence from China", Journal of Banking and Finance, 33(1): p. 158-159

emerged as the most dynamic forces contributing to China's economic development. Victor Nee's early analysis of China's transition to a market economy predicted that, "Despite barriers to entry and widespread discrimination, private entrepreneurs would eventually emerge as the leading edge of China's new market economy".[13] Moreover, the private sector has been the winner in terms of market share and efficiency.[14] The interesting fact is that "The difference does not seem to be between state-owned and private firms, but rather that de novo firms outgrew all other firms. Many studies find little difference between the performance of state-owned firms and privatized firms".[15] Hence, it is essential to distinguish between private de novo firms (start up entrepreneurs) and privatized ones, when comparing with SOE's. Otherwise, there will be a selection bias problem, which creates a distortionary effect, since a large number of newly privatized firms were former SOE's. Also, the well-performing with greater potential are privatized first leaving loss-making firms under the SOE epithet. This also partially accounts in the emergence of private sector resulting in the reconstruction of SOE's by letting go of the small and keeping the large "Zhuada fangxiao". In grasping the large, policy makers wanted to center their attention on the largest, centrally controlled firms, restructure them into even larger competitive enterprises, and finally refinance them while maintaining under state control.[16] Hence, they become the influential firms that are identified in Hellman's article. Hellman identified 2 main types of firms in transition economies. First, he identifies the concept of "influential firm", which tend to be classic incumbents, generally large, state owned firms inherited from the previous communist system with secure property rights. This type has influence on rules of the game typically without recourse to private payments to public officials. The second type is referred to a "captor firm", which are large de-novo private firms with less secure property rights, without a state-owned predecessor and weaker ties to the state. They typically make private payments to public officials to affect those rules. [17] It should be noted that there isn't a clear definition of private firms because previous literature is not consistent in their labeling criteria. In essence private firms can be misinterpreted as either de novo, privatized, or both. In making the clear distinction between privatized "influential firms" with new de novo "captor firm" and taking into consideration

[13] www.economyandsociety.org, The Entrepreneurial Spirit and the Birth of China's Free Enterprise Economies

[14] Chow, Clement and Erik Tsang (1994), "Distribution Reform in China: An Analysis of Private Sector Development", International Journal of Retail and Distribution Management 22(2): pp. 29-30

[15] McMillan, John and Christopher Woodruff (2002), "The Central Role of Entrepreneur in Transition Economies", Journal of Economic Perspectives 16(3): p. 166

[16] Naughton, Barry (2007), "The Chinese Economy. Transitions and Growth", The MIT Press Chapter 13, p. 297

[17] Hellman, Joel, Jones, Geraint, and Kaufmann Daniel (2003), "Seize the State, Seize the Day, State Capture and Influence in Transition Economies", Journal of Comparative Economics, 31(4): pp. 751-773.

that mass privatization occurred only 20 years after the reform, our analysis will be referred mainly to newly emerged private firms (de novo).

There is an increasing importance in China's economic transition into a more market-friendly environment to allow the private sector to take more precedence in the share of national GDP. According to the National Bureau of Statistics, China's GDP growth rate has grown tremendously, which can be correlated with the decreasing state-owned enterprises share of GDP. This indicates that the growing GDP can be positively correlated to alternative income generating machines in the private sector, such as newly privatized firms and entrepreneurial de novo firms. There is an increasing importance in China's economic transition into a more market-friendly environment to allow the private sector to take more precedence in the share of national GDP. This is in line with our hypothesis 1.

It is observed in the previous literature that eventually the growth and even the stability of an economy will be correlated with the rate at which new firms come into existence, the rate at which they endure and develop into full-grown enterprises.[18] The reasoning behind this is that these firms are generating welfare effects for the whole economy.

3.1 Advantages of Private de novo firms/Welfare Effects of Entrepreneurship

Competitive forces are the vital external factors that discipline a firm and force it to become more efficient. Hence, an important source of gain is the extra discipline resulting from the increased competition that these firms have created.

The huge set of economic literature points out that SOE's continue to command considerable influence and resources in China, however, the recent analysis have illustrated that over 6% of SOE's are losing money. Moreover, SOE's normally provide numerous benefits and face limitations in contrast with local private firms, so the latter firms have cost advantages and added flexibility.[19]

With respect to advantages to de novo firms compare to SOE's, there is strong power to accomplish structural change because during the start up process, private firms fill the niches, which are empty spaces of the production line. This contributes to their dynamic and flexible tendencies towards the market needs. Another key advantage that is worth mentioning is that the reform process in SOE's involve high cost of shifting the outdated production into a more modern and efficient system, meanwhile the structural process that is accomplished through

[18] Johnson, Simon, John McMillan and Christopher Woodruff (2000), "Firm Creation and Economic Transitions", Economics of Transition, 8(1):p. 428
[19] Ahlstrom, David and Garry Bruton (2001), "Learning from Successful Local Private Firms in China: Establishing Legitamacy",The academy of Management Executive 15(4): p. 73

the establishment of de novo firms is a natural change that occurs organically, with no need for internal reorganization. Therefore, if the country undergoes reform process, the quick and mass development of de novo firms strengthens the building process of market economy by establishing new employment opportunities, supplying consumer goods, mobilizing savings and more importantly ending the state firms' monopoly power. As much as the growth of de novo firms compete with SOE's they also a necessary commodity for the PRC government to keep healthy Chinese labor market, since the emergence of private firms, by increasing competitive pressure, poses the necessity for restructuring in many SOEs, thus enhancing the productivity. Moreover, it leads to the overall reduction of firms' price-cost margins.

Aside from all mentioned facts, the establishment of new employment opportunities has been arguably the most vital benefit of the new entrants.[20]

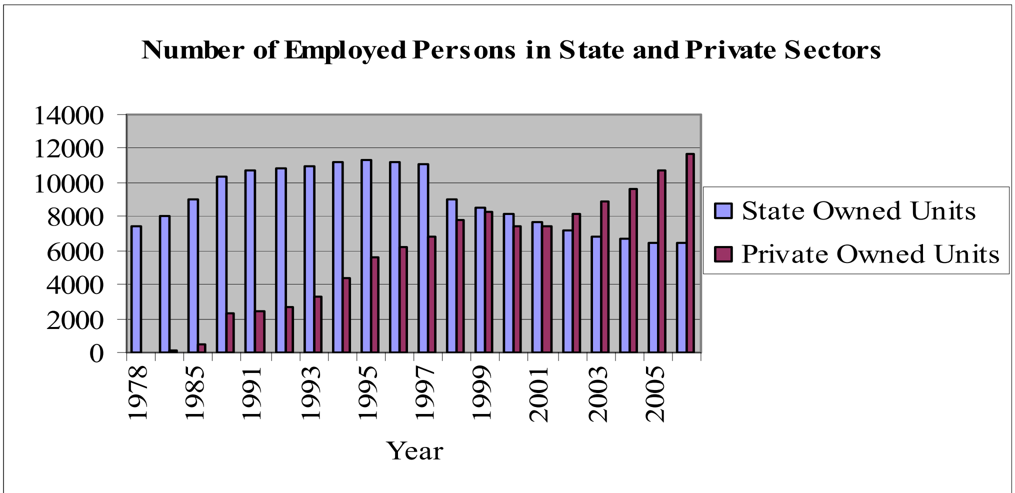

Figure 2
Source: China Statistical Yearbook 2007

We used the China statistical yearbook to obtain the following numbers, where private sector is referred to both self employed and private enterprises. From this figure we can observe that the private sector is becoming more important source for employment opportunities than the state. Over the period from 1978 to 2006, the number of employees working in the private sector grew; meanwhile there has been a decline in SOE's. These patterns are particularly important for the country like China with the vast population, which contains the potential risk of unemployment. The important observation is that the growth is not going independently of the state, but the private sector creates new employment

[20] McMillan, John and Christopher Woodruff (2002), "The Central Role of Entrepreneur in Transition Economies", Journal of Economic Perspectives 16(3): pp. 153-168

opportunities and absorbs unemployment from SOE's. Nonetheless, despite their economic and social benefits, several restrictions are present.

4. Impediments of private sector development

Due to the sluggish legacy of the centrally planned economy and the gradual development of market-supporting institutions leads to several obstacles for private firms in transition economies in their business administration process. This section will to develop and motivate the following hypothesis:

Hypothesis 2: *De novo firms have faced government imposed institutional constraints compare to SOEs.*

Hence, despite its growth in size and social and economic welfare effects, there exists a substantial hostility to private business in China. This can be explained in general terms from two broad sources, entailing both ideological and practical grounds. First, there is a resistance among many communist party bureaucrats who worry that the socialist system is being diluted, which will lead to the situation where "The private enterprises today could become the monopoly capitalist of tomorrow". Second, they are apprehensive that the emerging private enterprises lead to enlarged domestic competition for the largest employer in China – SOEs. Hence, the growing presence of the private firms was considered a great risk in terms of the economic power sharing for them. Thus, many regime administrators and party bureaucrats in China pose constraints on de novo firm development driven by both ideological and practical intentions.[21] Moreover, until the early 1980s, state or local governments maintained full control over the redistribution of capital and important raw materials. Private firms had to compete with state-owned firms for scarce resources. It is not surprising to find that private firms were often left out of business opportunities due to a lack of materials even if their products were popular in the market. They lacked legitimacy and political backing to secure access to capital, which forced them to turn to private resources and to pay much higher rates. The only factor resource that has been obtainable to the private firms in great quantity is labor, but still the firm is vulnerable to the enforcement of government regulation, which puts limits on the number of employees private firms are allowed to hire.[22] As we will discuss in the legal impediments section, it wasn't until 1988

[21] David Ahlstrom and Garry D. Bruton (2001), "Learning from Successful Local Private Firms in China: Establishing Legitamacy",The academy of Management Executive 15(4), pp. 72-73
[22] Nee, Victor (1992), " Organizational dynamics of Market Transition: Hybrid forms, Property rights, and Mixed Economy in China", Administrative Science Quarterly 37: pp. 12-13

that National Peoples Congress voted to allow private businessman to have more than seven non-family employees.

Certainly, in a transition from a socialist/communist economy, the government will pose resistance to dispersion of power. Consequently, next, we discuss government imposed impediments on private enterprises. There are a variety of constraints that are posed towards private de novo firms, broadly speaking, in legal, financial, and political avenues. The legal framework in China can be evidenced by weak formal infrastructure and partisan constitutional amendments, so it would be the starting point for introducing government imposed constraints.

4.1 Legal impediments

There is one common binding factor in transition economies; they have a dysfunctional legal system due to the inexistence of laws or the lack of enforcement mechanisms. In China legal norms were largely adopted from foreign models and were stimulated through a plethora of newly established institutions. However, the law in China largely remains dependent on the regime's policy goals, leading to the situation "rule through law" instead of "rule by law".[23]

Moreover, according to Johnson et al., it is a weak legal system and more importantly unpredictable action by government officials that holds back the private sector.[24]

The constitutional reforms did have some positive impact on private firm development, even though they didn't change the inferior status of that ownership. It should be noted that gradual, yet partial legitimization of private ownership was driven by growing labor market pressure and the government hunt for profits from private firms to secure their revenues. Consequently, the fourth constitution, which was passed in 1982, provided a legal basis for the broad changes in China's social and economic institutions and significantly revised government structure and procedures. Of central importance of private reform was the article 11, which holds "The individual economy of urban and rural working people, operated within the limits prescribed by law, is a complement to the socialist public economy." It was amended on April 12, 1988 and included a new paragraph: "The state permits the private sector of the economy to exist and develop within the limits prescribed by law. The private sector of the economy is a *supplement* to the socialist public economy. The state protects the lawful rights and interests of the private sector of the economy, and exercises guidance,

[23] Potter, Pitman B. (1999), " The Chinese legal System: Continuing Commitment ti the Primacy of State Power", China Quarterly, 159: pp. 682-683

[24] Johnson, Simon, John McMillan and Christopher Woodruff (2000), "Entrepreneurs and Ordering of Institutional Reform", Economics of Transition, 8(1): p.3

supervision and control over the private sector of the economy". It gave formal recognition to the country's emerging private sector and in addition to that in 1988 National Peoples Congress (NPC) voted to allow private businessman to have more than seven non-family employees, officially creating and recognizing the private firms. [25] However, only in 1999, almost 20 years later after the reform, the constitutional amendment has passed, which defined the position of the private economy from the previous "supplement to the state-owned economy" to "an important component" of the country's socialist market economy, nonetheless the issue of the protection of property rights was left out. And only in March 2004, the proper way to protect the property rights of private firms was reflected in the constitutional amendment. Apparently, this was the major step forward, yet not sufficient. The equal treatment in the taxation, bank-financing entry to state dominated sectors avenues still remains a major issue.[26]

Even though there is an increasing government incentive to provide a stronger legal framework for the private sector because of their value-add to the economic prosperity in China, but there is still high inclination to favor SOE's as seen through high barriers to entry and excessive red tapes.

Even though private enterprises have steadily begun to enter such sectors as aviation, ports, education, culture, and civil affairs, which were once dominated by SOEs, there still exist high entry barriers for them. Many industries are still not released to procure private ownership. In addition, it appears that the regulations themselves are not necessarily clear and transparent. Even in industries that they are permitted to step in, the threshold is still exists.[27]

Moreover, along with these high barriers to entry, a large impediment in the establishment of private firms is receiving approval from local authorities. Administrative approval dealings are generally onerous and excessive in paperwork and regulations. The local government officials had the stronger incentive to support the private entrepreneurs as long as they were registered as collective ones.[28] Hence, one of the easiest way to survive and grow successfully in China as a private firm was to take a "red hat". The term "red hat" means that the firm can obtain a collective or state license for production and operations by paying certain administrative fees to the state representative. Accordingly, some enterprises followed that path and registered themselves as collectives having the "red hat" on to get some help and

[25] www.china.org.cn, Constitution of the Peoples Republic of China, Amendments to the 1982 PRC Constitution
[26] Toshiki Kanamori and Zhijun Zhao (2004), "Private Sectors Development in the Peoples Republic of China", Asian Development Bank Institute, pp. 10-12
[27] Toshiki, Kanamori and Zhijun Zhao (2004), "Private Sectors Development in the Peoples Republic of China", Asian Development Bank Institute, p. 35
[28] www.repository.ust.hk, A Survey of the Economics Literature of China's non state enterprises

support from local government. Throughout the 1980s and 1990s, when the private sector was remerging in China, some private firms, under the name of collective, worked within the state or collective firms. Normally the fee is about 1-2 percent of the firm's output value or 5-10 percent of its turnover. After taking care of these payments, the private owner is able to some extent avoid government prohibitions on private firms and ideological pressures during the license period.[29]

There is no doubt that the prominent events in 2001 contributed to a momentous enhancement in climate for the private enterprises in China. It was long awaited WTO accession, which lead to the adjustments in numerous rules and regulations to abolish distinctions made on the basis of ownership. However, the process itself involves gradual shift and the actual benefits will be derived in a while.[30] Nonetheless, we strongly believe that the obvious benefit that WTO accession will entail with respect to the legal system is that the practice of "rule by law" will at least be weaken down, if not completely eliminated. The reason is that the latter contradicts to the "rule of law" provisions promoted by WTO.

4.2 Financial impediments

The second group of constraints is related to financial institutions. Given the importance of small and medium size enterprises (SME's), the strong presence of the government in the financial sector is a large impediment for private de novo firms, which are typically SME's. Although, China is the largest developing country with a fast growth economy, yet with weakly developed formal financial system. This creates biases for private de novo firm expansion.

Let us start our analysis with an interesting problem. Is it that banks are generally reluctant to provide with loans to newly emerged de novo firms due to the objective reasons, or do private firms get unequal treatment by the commercials banks compare to SOEs for the basis that they don't have party membership or they lack the secure relationship with an important person at the bank, who can informally influence the decision for authorization of a bank credit? All this factors need to be taken into careful consideration to get the full picture.
To begin with, it should be mentioned that most newly entrepreneurial private firms are small and medium-sized firms. *Size* of the firm is often correlated with the quantity of collateral and research has shown that the larger the firm is the easier it is to get bank credit. As much as

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[29] Liu Yingqiu (2007), "Development of Private Entrepreneurship in China: Process, Problems and Contra measures", p. 4
[30] Yuan Ding (2005), "Searching for the Accounting Features of Capitalism: An Illustration with the Economic Transition Process In China", SASE Conference Meeting, Budapest, p. 19

bias towards privatized firms and SOEs may be strong, there are other factors that may play a role in deterring financial capital for new de novo firms. Usually, small and medium sized companies have less access to finance through bank loans because of the limited publicly available information that banks can obtain about newly emerged firms. This in turn results in hard budget constraints as opposed to soft budget constrains faced by SOEs.[31]

This is in line with the findings provided by Marc Cowling and Paul Westhead, that lending decisions by banks, to some extent, are influenced by the size of the firm requesting a loan. Nonetheless, when these size effects are controlled, they found the presence of collateral had an extensive influence on banks loan distribution. Most notably, firms dealing with regional offices generally need to provide collateral. In the light of this evidence, it is logical that reliable information for small and medium enterprises in their accounting and auditing regulations is most important for banks to determine loan qualification.[32] So it may not necessarily mean that banking institutions are discriminating for SOE's, rather they may be using objective decisive measures due to the lack of formal information that comes with being a new, small, or medium sized enterprise. Also, this can lead to higher interest rates for these companies to compensate the higher risk premium of such interactions, which is an additional impediment in obtaining loans.

Nonetheless, a survey by the WTO in 2005 showed that one fifth of the respondents thought that *discrimination* was a large reason in not obtaining a bank loan.[33]

Hence, the most dynamic sector of the Chinese economy lacks access to formal sources of credit. Over 30 million private businesses have been established during the first two decades of reform; yet, as of year-end 2000, only one percent of the loans extended by state banks went to private enterprises. A supportive evidence for the above mentioned can serve the private entrepreneur's typical response to the survey conducted by Kellee Tsai; "A State Bank would not give me a credit if a Chairman Mao himself rose from the dead and told them to give me one!".[34] Also, with over 70% of deposits and loans accounted for by the 4 largest state-owned commercial banks and only 1% allocated to private sector enterprises, this shows a large stronghold in state preference in allocation of monetary funds.

A large controlling factor for the government is in their ability to steer financial funds to meet their incentives. Moreover, China has a large administrative hierarchy, which provides

[31] Timo, Baas and Mechthild Schrooten (2005), "Relationship Banking and SMEs: A theoretical Analysis", DIW Berlin Discussion Papers 469, pp. 5-6

[32] Westhead, Paul and Cowling Marc (1996), "Bank lending decision and small firms: does size matter", International Journal of Entrepreneurial Behavior and Research, 2(2): pp. 52-68

[33] OECD (2005), "OECD Economic Surveys: China", p. 142

[34] Tsai, Kellee (2002), "Back-Alley Banking: Private Entrepreneurs in China", Cornell University Press, p. 2

the framework for selective corruption from the government to arise. "The banking sector has been one of China's most protected industries, over-regulated, dominated by state-ownership, and protected from international competition."[35] Although in recent years, China has made attempts at diversifying their power in the banking sector. In 1979 China transitioned from a mono-bank system into a separation of commercial banks. However the structural changes didn't have much impact on the overall concentration of assets, deposits and loans. The four largest banks of China are the state-owned commercial banks, which have taken up the majority of total assets, deposits, and loans and there was only a slight decline in concentration ratios decreasing from 93.04% to 90.14% in 1994. Moreover, the previous studies which calculated the concentration indexes for the deposit and loans market provide evidence, that those 2 markets are dominated by state-owned commercial banks. The interest rates in those two markets are controlled by PBOC. Hence this leads to a situation which contradicts to the main provision of market economy, when the banks tend to compete for borrowers who are creditworthy.[36] In Chinese case, the majority of bank loans have gone to SOE's as stated above. Given the vital role that SME's play in the economy, the rigid presence of the government in the financial sector is a large impediment private de novo firm, which are typically SME's.

The interesting fact is that only in 1995 the first Commercial Bank Law was initiated. This increased economic responsibility of banks, but still permitted certain bias by the government. According to Article 34 of the Commercial Bank Law under basic rules for loans and business operations the "Commercial banks shall conduct their business of lending in accordance with the needs of the national economic and social development and under the guidance of the industrial policies of the state" Moreover, there is certain selective treatment in the determining loan distribution as implied in Article 36 in examining the repayment guaranty. "To obtain a loan from a commercial bank, a borrower shall provide a guaranty. The commercial bank shall strictly examine the surety's ability to repay the loan, the *ownership* and value of the mortgage or the collateral and the feasibility of realizing the right of mortgage or right of pledge."[37] An interesting inclusion of the guaranty of the customer's credibility in obtaining a loan is the matter of ownership type. The inclusion of ownership as a basic criteria indicates a clear sign that firm ownership types of SOE's, hybrid, privatized, and de novo firms is an important determining factor.

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[35] Naughton, Barry. 2007. "The Chinese Economy. Transitions and Growth" Chapter 19, pp. 449-481
[36] Wong, Richard and Sonia Wong (2001), "Competition In China's Domestic Banking Industry", Cato Journal, 21(1):pp. 19-41
[37] www.china.org, Law of the People's Republic of China on Commercial Banks

Hard budget constraints, wide income disparities, no bailout options are also financial impediments faced by private de novo firms. In terms to de novo firm's presence in the global market, financial constraints add to government imposed high barriers to entry for new firms and taxation bias for imports towards government owned- industries. Barriers for these small firms to enter the global market pose a limitation to their market size and a less stabilized credibility in world market. In addition, restrictions to access to credit and a smaller market to operate business, impedes de novo firms from becoming a publicly-shared firm. By softer budget constraints[38], which eases the 3 years profit requirement, SOE's and hybrids enjoy the benefits of opening up shares of the company to the global stock exchange, whereas private de novo firms are then limited to access innovation and investment capital from abroad. This prejudice and company immobility is conveyed from the experience of a Chinese business-owner as stated, "As entrepreneurs we are condemned either to being the concubines of the state enterprises or the mistresses of multinationals". [39]

In December 2001, when China entered the World Trade Organization, adopted standard global forms of regulations lasting up to five years. The liberalization of the interest rate lets foreign banks lend out foreign currency to Chinese domestic firms. Through the WTO policies, China can stimulate foreign entry and increase competition between domestic banks and foreign banks, which provides incentive for the domestic banks to broaden their lending to new private de novo firms and create a continuing upward growth trend in the national economy. Despite these efforts to assist privatization, de novo firms still experience resistance by the central government. These obstacles include a range of barriers to operation and expansion, lack of access to finance, difficulties in entry and exit, and major impediments to the proper functioning of labor markets.[40]

4.3 Political impediments

Political capital is very important for every genre of economy, whether it is state-controlled, transitioning, or a highly developed market economy. China is a relation-based country in terms of the five dimensions of Governance Environment Index (GEI) developed by Li and Filer, which consists of political rights, rule of law, free flow of information, public trust, and corruption, that are indicative of the governance settings. According to them GEI

[38] The term soft budget constrained is said to exit, whenever a loss-making company continues to receive financing.

[39] Huang, Yasheng (2007), "Ownership Biases and FDI in China: Evidence from Two Provinces", Business and Politics, 9(1), Article 1

[40] OECD (2005), "OECD Economic Surveys: China", p. 142

could be used to measure the degree to which the country is primarily rule-based or relations-based.[41] However, the degree of weight of political capital for each firm depends on the type of firm as well as the institutional framework surrounding it. As delineated by Li et al, the weaker the institutional framework governing the economy, from the legal, financial, and market aspects, the more political connections are deemed necessary to quail any distortions that may be present, especially in a transitioning economy. Transitioning economies assume rising amounts of inefficiencies from several in-place institutions that my pose a huge cost on private firms and ultimately damage their performance. Hence, "Political connections or status help to reduce this cost, and thus improve firm performance".[42] Therefore, in China's transitioning economy, the lack of political capital can present impediments to Chinese de novo firms.

Also, different degrees of political connections, including being a party member, appointments by the party, prior experience in the government, etc., in conjunction with the different industries and size in China's expanding and experimental transitioning market-friendly environment pose different importance on political capital. It can be assumed that political capital is always a positive leverage in negotiations and expansions of businesses and firms in the areas of legal contractual obligations, property rights, allocation of credit, controlled or barriers to entry for competitors.

Political connection is a relatively widespread phenomenon. According to Faccio political connections are particularly common in countries that are perceived as being highly corrupt, in countries that impose restrictions on foreign direct investments (FDI) by their citizens, and in more transparent systems. Also, she indicates that the value of political connections can take shape in various forms including preferential treatment by state-owned constituents such as banks as specified prior, lighter taxation, preferential treatment in competition for government contracts, relaxed regulatory oversight and so forth. [43]

[41] Shamin, Li (2005), "Why a Poor Governance Environment Does Not Deter Foreign Direct Investment: The Case of China and its Implications for Investment Protection", 48(4): p. 299
[42] Li, Hongbin, et. al. (2008), "Political Connections, financing and firm performance: Evidence from Chinese private firms." Journal of Development Economics 87(2):pp. 283-287
[43] Faccio, Mara (2004), " Politically Connected Firms", .Journal of Financial and Quantitative Analysis, pp. 1-2

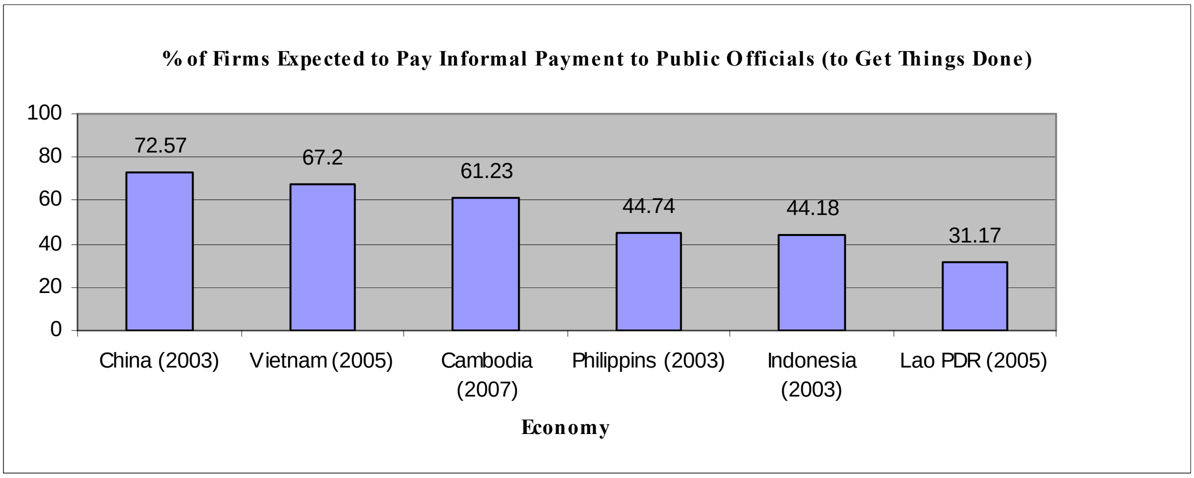

Figure 3
Source: World Bank investment climate surveys

The figure above, which is based on the World Bank investment climate surveys conducted in East Asian and Pacific countries, demonstrates the importance of political connections for private de novo firms due to the government's large influence over the allocation of resources. [44] The figure above can serve as an illustration that in Chinese context, where the percentage of informal payments to public officials (to protect property and contractual rights, to obtain bank loans, to obtain land allocation to expand on business, etc.) is relatively high, the lack of political capital can easily turn into a core constraint for the private de novo firms. Hence, these connections provide protection against expropriation formal bias by the government, a range of barriers to operation and expansion, better access to finance, assistance in entry and exit, and other major impediments to the proper functioning of labor markets.

Hence, the fall of bureaucratic shares in the face of market reform does not signify a reduction of elite opportunity. As nearly all assets, real estate, and natural resources are primarily under public ownership, and because incumbent elites exercise control over these assets at the begining of a market transition, this provide them with major advantage over other groups.[45] Therefore, the incentive for businessmen to establish political connections in transition countries ultimately arises from the state control of key resources. Due to the lingering legacy of the command economy and the slow development of market-supporting institutions, private entrepreneurs in transitional economies face many obstacles in running their businesses as we have already discussed in previous sections. They are often denied

[44] www.enterprisesurveys.org, Enterprise Surveys
[45] Walder, Andrew (2003),"Elite Opportunity in Transitional Economies", American Sociological Review 68(6):pp. 900-901

access to bank loans, which are largely reserved for state-owned firms, or are subject to heavy government regulations (red tape) or "extralegal" fees.[46] It is interesting to note, that competitive advantages stemming from political capital are highest in regulated and state dominated markets, while positive payoff of such connections can not be detected in competitive markets.[47] Hence, it can be concluded that economic actors put a little value for political connections in competitive markets, meanwhile a greater value is put in restricted markets, where there is a competition for government controlled rents. Thus the political connections function as a substitute for formal norms in underdeveloped and unsteady institutional environments. Executives spend substantial time interacting with others outside their organizations to seek out connections and cultivate close personal relationships to obtain resources or protection not otherwise available.[48] Hence, the lack of political connection in Chinese context can be the real impediment for future growth and expansion opportunities for private de novo firms

These findings are consistent with China's reform process paths, which shows that political capital provide economic payoffs in state controlled markets, meanwhile they have a little value in competitive market structures. Due to being mostly inexperienced in modern administrative procedures and steeped in revolutionary tradition, party and government members operated through their personal connections and patriarchal stands.[49] China is still commonly represented in the Western news media as a totalitarian state, and its economic success as economic reform without political attributes. Nonetheless, the communist economic system necessarily entails political change, and consequently, it would be more accurate to describe the Chinese experience since 1978 as a "great economic reform with lesser political reform", when political connections seem to play a significant role.[50]

5. Alternative Mechanisms for De Novo Firms

With the apparent constraints towards de novo firms compared to SOE's, it deems necessary to find alternative means to offset bias established by the "Rules of the Game". This section will provide the support to our third hypothesis:

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[46] Hongbin, Li, Lingsheng Meng, Qian Wang, Li-An Zhou, "Political connections, financing and firm performance: Evidence from Chinese private firms", Journal of Development Economics 87 (2008,) pp. 283–299
[47] Opper, Sonja and Victor Nee (2007), "Political Connection in a Market Economy", working paper, Cornell University, p. 32
[48] Xin, Katherine and Jone Pearce, (1996) "Guanxi: Connections as Substitutes for Formal Institutional Support." Academy of Management Journal 39(6): pp. 1641-1642
[49] www.country-data.com, The Political Process
[50] www.iht.com, Political Reform: China will change in its own way

Hypothesis 3: *The government imposed constraints created the biases for those firms to use the alternative (informal) mechanisms which are limited in their scope.*

Without the regular market-supporting institutions, the new firms generally cannot rely on the courts to put into effect the contractual obligation, bank credits are either unavailable or in low amount for most of them. This further emphasizes De novo firm's reliance on alternative mechanisms for firm growth. Hence, we will discuss the widely used alternative measures de novo firms engaged for offsetting the lack of formal institutions from legal, financial and political avenues. These are self help mechanisms, trade credits and the guanxi.

With respect to the legal system, it should be mentioned that there are two possible channels which respond to the self-defeating incentives. The initial one is the law in the face of written binding contracts followed by a sufficiently rigorous sanction for dishonest behavior. The other countermeasure arises from repetition of the game, or relational contracting. "The legal system may not always be available to provide contractual assurance and when the law is dysfunctional, private order might arise in its place". As we have already mentioned, the common binding factor in many transition economies is dysfunctional legal system due to inexistence of laws or the lack of enforcement mechanisms. Hence, in such countries the presence of bilateral relationships, collective norms and trade associations can play the important role. However, it doesn't necessarily imply that in countries with good legal system the need for private order diminishes. This is not the case, since in some circumstances people may prefer of appealing to the private order mechanisms than to the courts, since the former entails lower transaction costs than the latter.

Hence, reputation incentives have substituted for court enforcement of contracts. Where courts and regulations were malfunctioning for dispute resolutions, firms relied on their clients to pay their bills and the traders to deliver quality products out of the prospect of future transactions.

Moreover, as evidence suggests writing good laws or importing them from several institutions as applied in Chinese case, does not automatically provide solutions, it takes time to establish well functioning institutions with an efficient court system and provide trainings to judges and lawyers. [51] Hence, to sum it up, we can state that he newly emerged de novo firms mostly succeeded by *self-help*, they built for themselves substitutes for the missing institutions.

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[51] McMillan, John and Christopher Woodruff (2000), "Private Order under dysfunctional Public Order", Michigan Law Review, 98(8):pp. 2421-2458

When it comes to overcoming the lack of formal financial channels, it should be mentioned that Kellee Tsai delineates in the chart below, based on fieldwork conducted in 1994-2001, the primary sources of credit according to their relative legality as different forms of financing alternatives for private entrepreneurs in China. “The extremes of “legal” versus “illegal” forms of financing are distinguished by the definition the People’s Bank of China (PBOC), which depends largely on whether they mobilize savings from the general public and offer/charge interest rates above the repressed interest rate ceilings” With respect to the informal and “illegal” financing channels in China, there is a report by the Party School of the Central Committee of the Chinese Communist Party from 1999 according to which, “Self-employed individuals, private business owners, and entertainers have gained the most benefit from China’s [first] twenty years of the reform.” [52] These forms are similar in nature and we would highlight interpersonal lending and trade credit, which are among the most central methods that entrepreneurs use to manage short-term liquidity requirements. The above mentioned report conducted in 1999 explicates that private owners gained a large share of profit in China’s reform process, we see a strong correlation in the success of these methods. Yet limitations set by the bias of the government, still plays a large role in constraining the further potential growth of de novo firms.

Legal	**Quasi-Legal**	**Illegal**
Interpersonal Lending (minjian jiedai)	**Rural Cooperative Foundations** (nongcun hezuo jijinhui) Until 1999	**Professional Brokers and Money Lenders** (Loan Sharks) (yinbei, gaoli dai,)
Trade Credit (hangye xinyong)	**Fake Collectives, Red Hats, Hang-on Enterprises** (jia jiti qiye, dai hongmaozi, guahu qiye)	**Private Money Houses** (siren qianzhuang)
Rotating Credit Associations [in some areas] (lunhui, biaohui, hehui)	**Mutual Assistance Societies** (huzhu hui, hezuo chu jijinhui)	**Rotating Credit Associations** [in some areas] (lunhui, biaohui, hehui)
Pawn Shops (diandang ye, dangpu)	**Cooperative Savings Foundations** ((diandang ye, dangpu)	**Pyramidal Investment Associations** (ponzi schemes) (taihui, paihui,)

Table 1
Source: Tsai Kelly, Beyond Banks: The Local Logic of Informal Finance and Private Sector Development in China

[52] For more information, please see Tsai, Kellee. Beyond Banks: The Local Logic of Informal Finance and Private Sector Development in China. Sept. 2001.

A widely used informal channel is trade credit (loans from firm to firm along the supply chain), which substituted for bank credit. With poorly developed formal financial institutions, it was difficult for de novo firms to receive funds in a conventional means, as through the state banking system, they in turn used informal financial channels, one being trade credits. Trade credit is mostly used for financing reasons which allowed the financially constrained players, in the micro-level, to bypass difficulties in financing through more formal channels. This allows suppliers and firms to borrow and lend to each other informally, which promulgates business flow.

Moreover, in the findings of Ge and Qui, "for almost every industry, non-state firms have significantly higher average accounts payable to total asset ratio, accounts payable to sale ratio and net trade-to-total asset ratio" Their results support the early findings that non-state owned firms in China grow tremendously with limited support from banks and show that non-state firms tend to on average use more trade credit than SOE's. They further illustrated that that this higher usage of informal alternative mechanism is predominantly serves as a financing method rather than transactional mode. Hence, their results suggest that, in a country with a poorly developed formal financial sector, firms can support their growth through non-formal financial channels that mainly rely on implicit contractual relation, as we have already discussed in more detailed above.[53] Also, as delineated by Nilsen Jeffrey the small firms increase trade credit, which is an indicator for a strong loan demand. The studies also support that the increase of a less desirable alternative measure is a clear sign that it doesn't occur on voluntary basis, rather it's a widely used tool by de novo private firms suffering the loan decline.[54] However, compared to bank loans, there is a shorter term allowance in repayment, possibly due to little or interest rate, in light of the informal borrowing characteristic.

And finally, to offset the political impediments firms develop networks and relationships, which have become critical for the success and survival of organizations in a transitional economy where formal systems are lacking. In China, interpersonal relationships are called guanxi. Although guanxi is embedded in every aspect of Chinese social life, companies demonstrate different needs and capacity for guanxi cultivation. Chinese firms develop guanxi as a strategic mechanism to overcome competitive and resource disadvantages by cooperating and exchanging favors with competitive forces and government authorities.

[53] Ge, Ying. and Jiaping. Qiu. (2006), "Financial Development, Bank Discrimination and Trade Credit", Journal of Banking and Finance 31(2): pp. 513-530
[54] Nilsen, Jeffrey (2002), "Trade Credit and the Bank Lending Channel", Journal of Money, Credit, and Banking, 34 (1): p. 226

From some extent it helps to manage uncertainties and external dependency.[55] Additionally, according to the findings of Xin and Pearce, “guanxi” is important for de novo private firms in a less protective business environment. Executives of private firms are more likely to have business connections to the people holding government positions to protect themselves against expropriation from the government, in comparison to executives of state owned firms. The findings are supported by the interviews conducted with executives in Chinese state-owned, collective-hybrid, and private companies. According to the results they found, the de novo private firms sought to compensate for their lack of formal institutional support by cultivating personal connections. Even after controlling for organizational age and size, they produced robust results indicating that for those firms business connections were more central than for SOE’s. [56] Hence, in the presence of government imposed constraints and with underdeveloped formal institutions, the political obstacles can be to some extent be overcome by such connections. However, all the above discussed alternative mechanisms are limited in scope.

5.1 Limited scope of alternative mechanisms

These alternative methods taken by de novo firms pose a number of limitations; first with the increasing market liberalization, there are more opportunities to make new business relationships, hence the inclination for automatic cooperation falls and the need for formal institutions to promote the upholding of contractual obligations arises as the cost of informal relationships falls. Hence, the self-help mechanisms is a temporary solution for entrepreneurs for small de novo firms, where bilateral relationships through informal norms serve as a substitute to underdeveloped formal systems, due to the created bias of the government. The interesting question arises, particularly why it’s beneficial for both parties to collaborate rather than cheat? The answer seems rather practical. Such informal institutional methods operate better under a small-knit community where social networks and informal gossip can substitute for the formal legal system, due to the several lock-in effects. In such communities, when people interact with each other quite often, that makes it. Coordination in the framework of repeated game, as in the standard prisoner's dilemma, many different outcomes are consistent with rational behavior. Nonetheless, if they won’t to grow from a certain size, firms need to manage anonymous transactions and expand the circle of trading partners. In

[55] Seung, Ho Park and Yadong Luo (2001), “Guanxi and Organizational dynamics: Organizational Networking in Chinese Firms”, Strategic Management Journal, 22(5): pp.455-456

[56] Xin, Katherine and Jone Pearce (1996), “Guanxi: Connections as a substitute for the formal institutional support”, Academy of Management Journal, 39(6): pp. 1641-1658

addition to this, large scale investments also require legal protection.[57] To sum up the discussion, cooperation seems to be beneficial in the repeated games environment, when the rules of the games are endogenously established and thus led to self enforcing through continuous interactions of parties, particularly in the early stages of transition. In other words, three main effects can be identified within this process, which are the repeated game effect, local business and group punishment effect. Hence, cooperation becomes less beneficial once the participating parties increase scope of operation and when these 3 effects become no longer optimal for business transactions.

Moreover, as delineated by Ellen Katz private order is not, as McMillan and Woodruff appropriately concluded, a substitute for public order. She claims that even though the evidence demonstrates that private norms yield benefits that the public system cannot effectively deliver, public order institutions are yet needed to confer public legitimacy on well-functioning private-order norms. The good example which is illustrated in her paper is that the coordination in the repeated game framework may yield collusive anticompetitive behaviors and large number of illegal agreements, such as price-fixing. This may lead not only to physical aggression, but also to other forms of criminal actions. [58] Hence, when transactions become complex, need for formal institutions become necessary to handle the created situation.

Furthermore, in a transition economy the access to formal financial institutions can determine the future potential growth of these firms. Consequently, trade credits and informal lending cannot completely replace formal financial institutions due to the limited scope of funds and sophistication; therefore it does not provide a good means to expand firms in longer term investment and finance. In addition to that, trade credit put limits on the purchase of goods which turns it into less flexible method than bank loans. Thus, even though trade credit could play an important role in granting access to external finance to support the growth of de novo firms, only an effective formal financial system can be a requisite for sustained country's long run growth and private firms further development.

This simply implies that firms are affected by legal, financial and political constraints as we tried to prove in the earlier sections.

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[57] McMillan,John and Christopher Woodruff. (2001), "The Central role of Entrepreneurs In Transition Economics", Journal of Economic Perspectives, 16(3):pp. 159-164

[58] Katz, Ellen (2000), "Private Order and Public Institutions: Comments on McMillan and Woodruff's 'Private Order under Dysfunctional Public Order", Michigan Law Review, 98(8): pp. 2481-2493

6. Method, Model and Data

The analysis are based on the economic identities and transactions of firms in China using the World Bank Investment Climate Survey conducted in 2003. The concept "investment climate" describes several factors that contribute to shaping the decisions of firms to invest productively. An environment with less political, financial and legal impediments strengthens incentives for firms to innovate and to increase their productivity, which is a key factor in sustainable development.[59] Moreover, as we tried to establish in earlier sections an emerging private sector creates new employment opportunities and contributes taxes necessary for public investment in education, health and other services. On the contrary, a poor investment climate in the face of the above mentioned obstacles decreases a country's prospects for attaining its potential in terms of employment, production, and welfare.

The data set includes 2400 firms established from the time periods 1950 to 2000 with the average firm conception at 1987 with a standard deviation of 14 years. For the further analysis we use the financial variable to test the hypothesis:

Hypothesis 4: *The amount of line of credit is negatively correlated with being a private de novo firm.*

For this reason we will use the OLS regression to test how being the private firm is making it less possible to get high percentage of loans from formal institutions. The dependent variable is the amount of line of credit, which is regressed upon independent variables ownership type, political ties, age of the firm and sector.

6.1 Model Specification

We have used the linear regression model, which writes as: $Yi=\beta_1 + \beta_2 x_i + e_{i.}$ where β_1 *and* β_2 are parameters of the model, y is the dependent variable, and x is the explaining or independent variable, and ε is a random error term. The error term accounts for the variability which can not be explained by the linear relationship between *x* and *y*. Using this form of a simple linear regression we can expand it to include more explanatory variables with i indexes and n number of observations, which can be rewritten as[60]

$$\mathbf{Yi=\beta_1 + \beta_2 x_{i1} + \beta_3 x_{i3} + \dots \beta_n x_{in} + e_{i.}}$$

The independent variables, $x_{i1,}$ $x_{i2,}$ x_{i3} … $x_{in,}$ in our model are ownership, change in ownership status, government help to credit access, CEO holds party position, CEO appointed

[59] http://rru.worldbank.org/InvestmentClimate, China 2003 survey

[60] Greece, William, "Econometric Analysis", Third addition, New York University, pp.220-221

by the government, log of firm age, and sector. This estimation of the model will show how these different variables affect our dependent variable, the amount of the credit.

6.2 Dummies

In the WB Investment Climate Survey the questions are posed in a quantitative manner with multiple answers. The format of the survey, if unchanged, can create distortionary effects. In our analysis, to obtain clear results, we redefine the answers into relevant data. To simplify the results into decipherable correlations, we generate dummy variables, via values 0 and 1, which indicates the presence or absence of a certain characteristics. Through the creation of dummy variables, we combine similar results into 2 categories.

6.3 Dependent Variable

In our analysis, we chose the amount of line of credit from formal institutions as the dependent variable to demonstrate that for de novo private firms access to bank loans is one of the impediments imposed by the government. This form of unequal treatment is an important factor particularly in a transitional economy, where the access to formal financial institutions can determine the potential growth of the private sector. However, at the end of 2000, less than one percent of loans from the entire national banking system have gone to the private sector. A supportive evidence for the above mentioned can serve the private entrepreneur's typical response to the survey conducted by Kellee Tsai; "A State Bank would not give me a credit if a Chairman Mao himself rose from the dead and told them to give me one." [61] Among the government imposed impediments of legal, financial and political respects, we chose the financial factor, because it's the strongest quantifiable variable. Moreover, the absence of government support is confirmed in the presence of alternative informal mechanisms, such as guanxi, self help and trade credits, which allowed the private sector to flourish as presented in early sections. Also, given the format of the WB survey the financial means are pretty straightforward to isolate in comparison to the legal and the lack of political capital, which are hard to quantify objectively.

[61] Tsai, Kellee (2002), "Back-Alley Banking: Private Entrepreneurs in China", Cornell University press, p. 2

6.4 Explanatory/Independent Variables

To build the regression model we chose the following explanatory variables ownership type, age of the firm, political ties and sector which will be discussed in details next. The number of observations, mean and standard deviation of chosen variables is presented in the table below.

Independet Varaibles	Obs	Mean	Std. Dev.
Private,non-listed company	1864	1.636803	0.4810501
Change in Ownership Status since 1999	2379	1.117697	0.3223162
Gov't help to credit access	2353	0.159371	0.3660995
CEO holds party position	2351	0.6682263	0.4709504
CEO appointed by gov't	2367	0.2585551	0.4379331
Log of Firm age	2400	2.429834	0.7994084
Sector	2400	5.914167	3.713832

Table 2
Source: World Bank Investment Climate Survey 2003

6.4.1 Ownership

According to the theory presented in early sections, the ownership type can be a core determinant for getting access to bank loans; hence we generate ownership types, which include the ownership in a private sector, ownership in the government and hybrids (collectives). Furthermore, it is difficult to distinguish between newly privatized SOEs and de novo firms given the limitations of the dataset, but we'll use the cumulative private sector percentage of ownership in our analyses. Hence the 75% of private firms presented in the table below includes both privatized and de novo firms.

Ownership	Obs	Percent	Cum.
Private	1807	75.32	94.79
State	467	19.47	19.47
Hybrid	125	5.21	100
Total	2399	100	

Table 3
Source: World Bank Investment Climate Survey 2003

However, we will use the proxy "Did the company in 1999 have the same ownership status as it does now?", whether the ownership status has changed since 1999 to some extent separate those two categories. Because if they did change ownership that would indicate the private firm being previously SOE.

Given the results of 88% responding in change in ownership, we can assume that they used to be SOEs, in order to isolate for de novo firms. Taking into consideration the analysis and the corresponding proxy presented above, we can assume that almost 12 % of firms listed in the WB survey are private de novo firms. This assumption may not necessarily be the case in all situations, but all things held constant, we will base our model on this assumption. In our analysis, we use the variables indicating private, non-listed company, and the variable indicating change of ownership type from 1999 to define private de novo firm.

6.4.2 Firm Age and Size

Firm age and size will help to differentiate between privatized SOE's and entrepreneurial de novo firms. In order to simplify our statistical analysis we chose the firm age, because there is one concrete variable stated in the dataset. As for the firm size, it is difficult to accurately determine given too many available variables such as log of sales, the asset value of the firm, the debt equity ratio, plus the other relevant proxy which translates into the average number of total employees at a given year. Due to the possible colinearity problems, which will distort the individual effects of the explanatory variables, thus creating problems of estimating the statistical model precisely, we do not include firm size in the regressions. In choosing only firm age, we assume that the older the firm has been established, the larger the credit access available for greater opportunities for expansion. The firm age is also determining factor in access and the amount of credit, because it can indicate less sophisticated regulation for older firms with the presence of publically available information and vice versa.

6.4.3 Political Ties

The next explanatory variable is political connection. The motivation for including it, is supported by the huge set of economic literature. It has been found that political connections help firms to secure favorable regulatory conditions and particularly access to resources such as bank loans. This goes in line with our model. Hence, in a country like China party membership, to some extent, offsets the biases set by rules of the game.[62]

With respect to the next independent variable political ties, we selected two proxies, which translates to CEO who holds party membership and CEO who was appointed by the government, respectively. First we translated the proxies into dummy variables respectively.

[62] Li et al (2007), "Political Connections, Financing and Firm Performance: Evidence from Chinese Private Firms", Journal of Development Economics 87, p. 283

In redefining the first proxy of party membership, we separated the answers into two definable categories, of holding the party membership designated by 1, and 0 otherwise. We combined the following choices 1. party secretary, 2.deputy party secretary, 3. party committee member or executive member, 4. party member into the first category of party membership; then choice 5, not a party member, falls into the second category. The same approach is used for redefining for second proxy, which posed the question how the General Manager was appointed. Both questions are similar in nature in correlating government influences trough party participation and are chosen within the same branch of variables, but they are slightly different because in the first one the firm is an active player in terms of pursuing party membership and in the second case the firm is directly affected by the government decision to appoint the general manager. We chose two variables in order to link the presence of political ties with the government as a tool to gain various economic advantages, particularly to access of formal financial institutions. As the results depict, approximately 67% of the respondents have party membership and approximately 62% are appointed by the government, which exhibits a strong association between firms and the government. Though it is worth to mention that the sample set includes all ownership types, including SOE's where there is a logical correlation with party membership and appointment. According to Nee and Opper's observation on the same dataset, only about 50% (457) of CEOs holding an active party position are actually placed in SOEs, 115 are found in legally registered private firms, 40 are placed in stock listed firms, and 44 in international joint venture firms.[63]

Even for a newly emerged private firm, political connections can secure advantages. In this sense, political capital can be used by both small and large de novo firms. There is a cost and value in government interaction.

Accordingly, does direct government support lead to better economic results and do economic actors, particularly private de novo firms with political connections gain certain competitive advantages in market distribution? The two proxies within the dataset indicate the cost which translates into the time spent in association with the government and another proxy, which translates into government help within 6 fields (locating foreign technology; obtaining bank financing; identifying foreign investors, foreign clients, foreign suppliers, and domestic clients) actualizes the value of such interactions. A clear demonstration of the cost-value effect can be seen in the figure below, which illustrates, from 1149 respondents out of

[63] Opper, Sonja and Victor Nee (2007), "Political Connection in a Market Economy", working paper, Cornell University, pp. 17-18

2400 surveyed, the different forms of government assistance. As the results illustrate, there is a 26% of assistance by the government to obtaining bank loans.

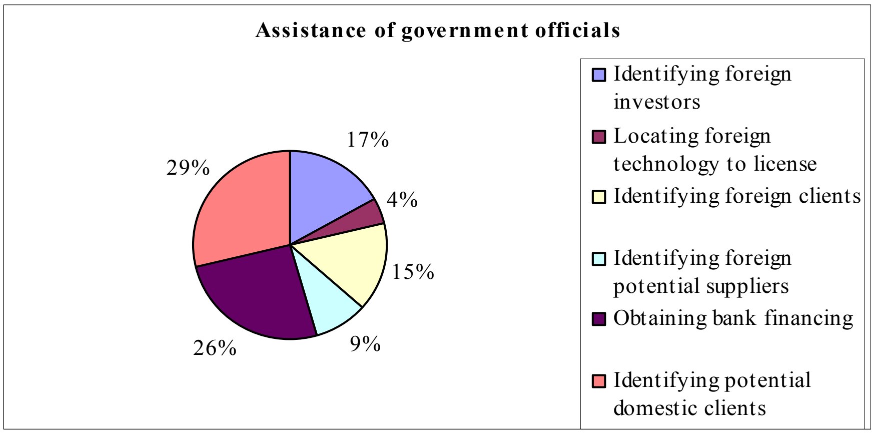

Figure 4.
Source: World Bank Investment Climate Survey 2003

6.4.4 Sectors

As for the sectors, it's important to note that funding can depend also upon the sector that you are in, hence we included industrial dummy variables indicating 14 different sectors. The government shows preferences to certain industries, particularly those that are high in capital as accounting and engineering. The table below shows the different sectors involved in the survey based on their ownership type.

	Ownership			
Sector	**State**	**Private**	**Hybrid**	**Total**
Garment & leather pro	37	301	15	353
Electronic equipment	15	161	9	185
Electronic parts maki	46	214	16	276
Household electronics	4	58	1	63
Auto & auto parts	68	256	34	358
Information technolog	37	160	6	203
Accounting&non-bankin	10	143	4	157
Advertisement & marke	27	125	1	153
Business services	127	125	18	270
Food processing	15	51	5	71
Chemical products & m	16	41	9	66
Biotech products & Ch	6	28	2	36
Metallurgical product	43	113	2	158
Transportation equip.	16	31	3	50
Total	467	1,807	125	2,399

Table 4
Source: World Bank Investment Climate Survey 2003

When it comes to the proxy which reflects the government's assistance in certain areas, as identifying potential foreign and domestic clients and obtaining bank financing., it should be mentioned that there is certainly preferential treatment across different industry sectors. From the World Bank statistics, it suggests the government agency's industrial sector's preference, the strongest in Chemicals and pharmaceutics at 30.6% government assistance in obtaining loans, 20.3% for Electronics, 20.7% for Auto, 15.7% for Garments, 14.5% for the IT sector; very little assistance to Accounting and finance at 2.6%, advertising at 4.7%, none for telecommunications. Hence, we will use the sector variable in refining our model.

6.5 Regression, results and analysis

To illustrate the relations between the dependent variable, the amount of credit, and the explanatory variables, we use the Stata statistical program. We start by generating the ownership types through private, non-listed company. The statistical results reveal several important conclusions. First, the correlation level determines of how significant the values are. The significant codes applied in this thesis are as follows: two stars (**) indicate the significance at 5% level and the one star (*) denotes significance at 10 % level.

As the regression results illustrate, we got a negative coefficient of -0.043 with a p-value of 0.077 at the 10% significance level. A negative correlation would indicate an adverse relationship between the amount of credit received and ownership type, hence as the value of one variable increases, the value of the other variable decreases, and vise versa. In our model, a one unit decrease in the amount of private firms, would lead to a 0.043 unit increase in our dependent variable. This supports our hypothesis that being a private firm is negatively correlated with the quantity of credit obtained from formal institutions.

Most of the variables are significant seem to follow the predictable pattern. In assessing whether there exists a bias in government, we check for a negative correlation between the independent and dependent variables. Though an interesting variable is the sector, which doesn't tell us much about the government incentives to provide funding based on the actual sectors that the firms are in, since the sign is positive. Another interesting finding is that party membership shows a negative correlation at -0.042 with a significance value at p=0.007, but according to our expectations, the correlation should be positive with attaining bank loans and party membership. The same applies to government help to credit access, which produced the high significant value at p=0 but didn't generate the expected correlation. Nonetheless, this finding is consistent with the evidence provided by Boycko et al., that enterprises who pursue political connections just became the tools for politicians which control them. Hence they put a greater emphasis on addressing the objectives of politicians rather than maximize efficiency.[64] However, in the Chinese context, the opposite seems to be the case that political connections do help to secure advantages in legal, political and financial areas, particularly government assistance in helping to get bank credit is a decisive factor. But our model failed to capture these effects. Also, in the proxy, where CEO is appointed by the Government, there is a positive correlation at 0.039 at p=0.125, which shows insignificant at the 10% level. Hence, it follows our assumptions, but does not prove significant. The probable clarification could be that the combined influence of political variables used in our model is greater than each one independently, hence this can explain the patterns illustrated in the regression table below.

The amount of line of credit	Coef.	Std. Err.	t	P>t	Beta
Private,non-listed company	-0.0427886	0.0242093	-1.77	0.077*	-0.0474697
Change in Ownership Status since 1999	-0.0583106	0.0312396	-1.87	0.062*	-0.0432074
Gov't help to credit access	-0.2838213	0.0270144	-10.51	0**	-0.2428331
CEO holds party position	-0.0629103	0.0232735	-2.7	0.007**	-0.0690347
CEO appointed by gov't	0.0397924	0.0259127	1.54	0.125	0.0396693
Log of Firm age	-0.0273049	0.0141811	-1.93	0.054*	-0.0501892
Sector	0.0095881	0.0031473	3.05	0.002**	0.0820564

Table 5

Number of observations 1749, Multiple R-Squared 0.1157, Adjusted R-Squared 0.1034, Root MSE 0 .40942

P-value 0.0000, F-value 9.40

Source: World Bank Investment Climate Survey 2003

The interesting question to look at while analyzing the regression results is posed in the article by Deidre Mccloskey and Stephen Ziliak, which addresses the following issue "Does the paper discuss the size of the coefficients? That is, once regression results are presented, does the paper make the point that some of the coefficients and their variables are economically influential, while others are not?"[65] We tried to approach this question by using the regress command (beta) in Stata which gives the standardized regression coefficients. Since the beta coefficients are all measured in standard deviations, instead of the units of the variables, it makes them comparable in their absolute values. Hence, we can to obtain the relative influence of the various variables within a regression model, which shows that the strong and weak influence are found in the variables taken from the political ties in absolute

[64] Boycko, Maxim, Shleifer, Andrei and Vishny, Robert (1996), "A Theory of Privatization", The Economic Journal: 106(435), p. 309

[65] McCloskey, Deidre and Ziliak Stephen (1996), " The Standard Error of Regressions", Journal of Economic Literature 34(1): p.103

values, which are government help to get an credit access and CEO was appointed by the government respectively. Given the fact that the purpose of our analysis is to prove that there is indeed a negative correlation between being a private de novo firm and the amount of credit obtained from formal institutions, we can state if the variable private, non stated company increases by one standard deviation, this will ceteris paribus yield to 0.047 standard deviation decrease in the amount of credit obtained.

It is important to note the difference between the numbers in the coefficient column and the beta column while interpreting results, which is in the units of measurement.[66]

Also, it is worth noting that 18 cities, which are available in the dataset, are also included in the regression to give us the average affect through different locations. This leads more precise picture about the correlation of chosen dependent and independent variables.

However, since many regulations and policies are regional specific, the regional variation can distort our picture, there is a need to control for that. The reason for such variation to exist is China's unequal distribution of wealth, where the inland regions lagging far behind from the coastal regions. Moreover, the cities face exceptional development due to the workers transfer from rural areas in search of employment opportunities, resulting in considerable inequities among getting credits.[67] However, given the limitations of the dataset there wasn't any proxy for regional identities. This can provide a potential explanation why our model produced a low R square with the value of 0.1157. The interpretation of this is that only 10% of the variation in total is explained by the variation of chosen variables. On the other hand, according to econometric estimates R^2 it can be made large by adding more variables, even though they don't have any specific economic justification. So this kind of manipulations will result in higher R^2, but yet less robust results. However, in our model, we strongly believe that if we could control for regional variations, we would produce higher R^2 and generate more accurate results.

[66] http://www.ats.ucla.edu/stat/stata/, Simple and Multiple Regressions
[67] Shi, Li and Renwei Zhao (2007), "Changes in the Distribution of Wealth in China 1995-2002", UNU-WIDER Research Paper No. 2007/03

7. Conclusion

In this paper we tried to prove four hypotheses, which followed the logical chain and reflected the growth path in the Chinese private firms' development.

In establishing the first three hypothesis, we have used previous literature showing that China's GDP growth is largely affected by emerging private firms indicating their importance. We then showed that the presence of alternative methods is the direct result of lack of formal support from the government. It followed that alternative mechanisms, such as Red Hats, Trade Credits, and Guanxi, indicate low levels of formal institutions that were reliable to private firms. In disclosing China as a relation-based over rule-based economy by GEI standards[68], we manifest the legal, financial, and political impediments placed by the government. Through a plethora of previous literature, we are able to state solidly that emerging private de novo firms in China are important to the national growth towards a market economy. However, there are constraints imposed by the government in comparison to SOE's which created the biases for the informal institutional framework to take precedence.

Finally, to support the forth hypothesis we used econometric analysis based on World Bank Investment Climate Survey conducted in 2003. Our analysis were referred to the financial sector, since among the government imposed impediments of legal, financial and political respects, it's the strongest quantifiable variable. We focused on the amount of line of credit indicating that there exists less possibility to obtain high amount of bank loans for private de novo firms. Our results illustrated that most of the variables used are significant and the main coefficient assumes its predicted sign according to our hypothesis. Particularly, the private, non-listed variable showed a negative correlation with strong significance, while political connections were less transparent in their patterns in our model. In our attempt to isolate the variables into a foretelling model of the amount of credit from banks, we find that our R^2 is acceptable, yet low, due to the limited variables included in the dataset, particularly the regional indicators.

In light of the impediments that are faced to Chinese private de novo firms, which we have indicated and attempted to prove, there is a cyclical balance between government and the private industry in mode of relation-based over rule-based transactions. Also, it is worth noting, that without a dominant religion, the most essential force determining China's social values and institutions is the widely held set of beliefs related to Confucius; these beliefs

[68] Shamin, Li (2005), "Why a poor governance environment does not deter foreign direct investment: The case of China and its implications for investment protection", 48(4): p. 299

define family and social orders and trust, and are different from western beliefs on the rule of law. [69]

Finally to sum up, to continue to develop and prosper, China needs to recognize the importance of private emerging firms and foster their formal institutions to limit impediments to their development. Since China's private companies turn to alternative mechanisms, which are limited in scope, the need for rational banks and well-functioning formal institutions, such as legal, political foundations, are still strong.

[69] Franklin, Allen ,Jun Qian and Meijun Qian (2006), "Law, Finance, and Economic Growth in China", Journal of Financial Economics, 77(1): p.7

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