THE TAOF OF INNOVATION

It's small business versus big government in the world's largest market

Launching a semiconductor startup in the United States is not for the faint of heart. In an industry that demands constant innovation, the wheels of funding and finance can seem to turn at geological speed. The government requires so many pounds of paperwork and tons of taxes that it's sometimes hard not to wonder whether the reward is worth the hassle. However, if you think being an entrepreneur in the United States is daunting, try launching a startup in China.

China may have the fastest-growing economy in the world, but the financial infrastructures that support new businesses—venture capital, entrepreneurial support, IP protection—are rudimentary at best. You may think you have it rough in the U.S., but the typical Chinese entrepreneur—ironically the source for all that economic growth—must fight a relentless uphill battle against the government merely to survive. Although there are a few government policies that help companies innovate, the overall business climate is one where Marxist meddling and endemic corruption make the lives of entrepreneurs a daily misery.

Chicken heads and cow tails
Open any U.S. business journal, and you'll likely see at least one article touting the Chinese economic miracle. With China's gross domestic product growing at 10 percent a year and indus-

By Geoffrey James
trial production surging at 17 percent a year, only the United States has a bigger economy. If current trends continue, China's economy may become the largest in the world within 15 years.

The engine behind the miracle is the private sector, which "is extremely dynamic and growing at around 20 percent a year, more than twice as fast as the economy as a whole," according to Usha Haley, professor of international business at the University of New Haven. Private firms constitute up to 60 percent of China's burgeoning GDP, are responsible for most of the country's job creation and represent almost two thirds of the country's fixed capital investment.

Despite their economic clout, most private-sector businesses are small by U.S. standards; 90 percent employ fewer than eight people. That's not surprising, considering that most Chinese prefer to work for themselves. "There's a proverb in China that 'it is better to be the head of a chicken than the tail of a cow'", says Stan Shih, founder of Acer, the largest PC manufacturer in Asia. "This means that most Chinese entrepreneurs prefer running their own small business to working for a large company." An unintended by-product of the cultural penchant for forming one's own business is a private sector that's naturally nimble and unburdened by internal bureaucracy.

Given that privately owned companies hold the keys to China's future, you'd think the Chinese government would be doing everything possible to help them along. Think again. The government, seemingly hypnotized by Mao's shambling ghost, looks askance at private ownership and instead continues to foster state-owned enterprises that act as a drag on economic growth. To survive, private-sector businesses must cope and compete with state-sector suppliers, distributors and customers that, secure in their privileged status, can demand (and get) special favors from both the government and other companies that aren't as well connected.

Private-sector firms quickly discover that their theoretical property rights are meaningless when it comes to collecting debts or getting contracts honored. "The government is still inclined to meddle, even taking stakes and muddying ownership while conflicting rules, regulations and bureaucratic fiat abound," explains Haley.

Privately owned firms are at a particular disadvantage when it comes to financing growth, because the government policy actively discourages venture capital and public stock offerings. The Chinese government's financial policies are so ill conceived that the Chinese miracle may not remain miraculous too much longer. "To continue to develop, China's private companies need infrastructure support, specifically banks that lend based on financial viability, rather than government clout, and a well-functioning stock market," says Haley. "If the private sector is China's brightest hope, the financial system is its weakest link."

Privatization newspeak
Nowhere is government policy more broken than in the area of privatization. With few, if any, exceptions, it seems that the only way for a communist country to convert to a market economy is to go through a sometimes painful process of privatization. However, rather than confront the challenge and figure out how to make the transition less painful, the Chinese government has elected to play word games.

Officially, there is no "privatization" in China. None. The word, with all its capitalist connotations, is entirely taboo. Instead, Chinese economists must use terminology such as "reform" and "creating share-holding companies." This double-talk is symbolic of a profound distrust of the private sector within the Chinese government, where Marxism is far from dead. Despite a decade of "reform," the Chinese constitution still refers to public ownership as "sacred" and public ownership still retains preferred status over private ownership, putting the private sector at a permanent disadvantage.

To be fair, it is understandable that Beijing might not want a repeat performance of the privatization debacle in Russia. "The current problems and disorder in Russia are due to the emergence of economic oligarchs after the dumping of state-owned enterprises," explains Hua Ma, a businessman who works on Hainan Island, one of China's most active centers of entrepreneurial activity. "Russia's experience tells our government to be wary of hurting society and the economy's sustainable development, which can result from improper privatization." Because of this, the government's policy is now "to control the big and set free the small and medium." To implement this policy, the government has banned management buyout of state-owned enterprises with assets of more than $50 million. However, although the outward intent of the policy is to encourage entrepreneurial behavior, privatized state-owned enterprises, in actual practice, become semigovernmental entities, with close financial ties to government bureaucrats. Many of the "reformed share-holding companies" actually become private fiefdoms under the control of local officials.
The government is demanding that foreign companies comply with idiosyncratic Chinese technical standards. "It's a clear attempt to force foreign companies to continue to partner with Chinese firms to sell products into the Chinese market."

—James Mulvenon, deputy director of the center for Asia-Pacific policy at RAND

even if those companies are, on paper, owned by management or employees, according to Haley.

A yuan for money
The Chinese government's suspicion of private ownership leaves privately owned companies at a disadvantage compared to state-owned enterprises, especially when it comes to financing. Bank loans go overwhelmingly to state-owned enterprises, even though those enterprises generally represent far worse credit risks than private companies, because they're still being managed as if they were not-for-profit government agencies. Not surprisingly, "Chinese banks are burdened with a large amount of nonperforming loans," according to Professor John Wong, research director of the East Asian Institute, a policy research organization connected with the University of Singapore.

Because they're forced to make sweetheart loans to state-owned enterprises, the only way Chinese banks can keep risk at an acceptable level is to be extraordinarily conservative when lending to private firms. That's true even when the loan is going to a highly successful company. For example, even though Semiconductor Manufacturing International Corporation (SMIC) is the largest and most successful semiconductor company headquartered in China, it had to create a consortium of 11 banks to float a $600 million five-year loan to finance an expansion of its three 300-mm fabs in Beijing (see chart, "China's Semiconductor Industry at a Glance").

If a company such as SMIC must jump through hoops to get funding from a Chinese bank, imagine how difficult it is for an unknown startup. Chinese banks lend money only to private firms that can guarantee repayment by putting property up for collateral, according to Ma. In many cases, even that isn't enough and the private business owner must also slip a bribe to the banker. Ma cites the example of a Hainan-based metals material processing firm that needed a $500,000 loan to expand capacity in response to a big order. The bank required a mortgage before it would write the loan, but the firm's total real estate assets were assessed at only $400,000. When the loan officer told the CEO that the bank could loan only $300,000, the CEO secretly sent the loan officer a "gift." The loan officer changed the assessment to read $700,000, rather than $400,000, at which point the bank "prudently" lent out the full $500,000.

Private-sector firms that can't bribe bankers and don't want to deal with loan sharks must look elsewhere for funding. Many finance their growth with retained earnings, according to John Frisbie, president of the US-China Business Council, a nonprofit organization that represents the interests of United States firms doing business in China. If retained earnings are unavailable, Chinese entrepreneurs often try to borrow from friends and family. Entrepreneurs without valuable family connections are forced to find expensive black market loans, which account for an entire percentage point of China's GDP, according to Haley.

The lack of an effective banking sector makes it difficult to raise money for long-term projects, such as research and development. "Not enough Chinese firms are growing into companies that can compete globally or develop the proprietary technologies that can result in long-term competitive advantage," says Haley.

Nothing ventured
If getting money from a Chinese bank is difficult, getting venture capital is next to impossible. Although a local venture capital industry has slowly begun to evolve in China, led by firms such as ChinaEquity but with a motley collection of 300 financial institutions commanding just $6 billion in assets, the industry is scattered and minuscule by U.S. standards. "In most Asian countries, the venture capital market is not well developed, except perhaps in Hong Kong and Singapore," says Wong.

Venture capital investment in China is limping along at less than $1 billion a year, according to Beijing VC research firm Zero2IPO. When compared with
China’s gross domestic product (GDP), that’s less than a tenth of the proportional venture capital investment that takes place in Japan or the United States (see graph “Venture Capital Investment as Percentage of GDP”). This measly investment level is the direct result of the Chinese government’s hostility toward private property and foreign investment, which leaves investors without viable exit strategies.

Venture capitalists typically make money when a company goes public, but that seldom happens for China’s private-sector firms. The domestic stock market is generally reserved for state-owned enterprises, and even then investors are sometimes required to hold onto shares for months or years before cashing them in. To make matters worse, foreign investors need the approval of both the government and all other investors before transferring shares out of the country.

It is possible for Chinese companies to get listed on a foreign exchange, of course. In March 2004, for example, SMIC floated a $1.8 billion offering on both the Hong Kong and New York stock exchanges. Despite SMIC’s success, obtaining government permission for an international listing can take years and even then might be denied at the last minute. Some Chinese firms get around these difficulties by setting up offshore subsidiaries, but private equity firms that sell to offshore traders can easily run afoul of the Chinese Ministry of Commerce, which considers such activity a violation of China’s antimonopoly restrictions.

Even if the government cased the restrictions, venture capital investors might look askance at pouring large sums of money into a country where “independent auditing” is an oxymoron. “Generally, foreign venture capital firms must be prepared for the realities of business in China: corruption, poor corporate governance, a weak rule of law and plain old fraud,” says Haley.

Bedeviled foreigners

The vast majority of foreign investment comes to China in the form of joint ventures. These function as something of a loophole in the government’s business xenophobia, because they have functioned as one-way corridors through which valuable intellectual property has flowed into China, at very little cost to the economy (see “Fighting for Your Rights,” August 2004, page 58). Theft of foreign IP, largely through joint venture partnerships, is epidemic. Entire provinces in China depend on copyright and patent violations for the bulk of their revenue, according to Haley.

For Chinese entrepreneurs, the flow of “free” IP is largely beneficial. However, IP theft is a two-edged sword for Chinese firms, because if they create their own IP, there’s a very real risk that it might be stolen, if not by a foreign firm then by another Chinese firm. “Unless the government starts enforcing its IP laws, as required under the WTO, Chinese companies may suffer as they become more successful and branch into the global market,” warns Rob Mulligan of the AeA, a nonprofit trade association that represents the technology industry.

However, the Chinese government is unlikely to enforce IP laws simply to protect privately owned Chinese firms. After all, from the Marxist point of view, IP theft is simply an ad hoc way to mitigate the evils of private ownership. Furthermore, if Chinese firms squabble over IP, it’s the privately owned firm—that is, the one most likely to have created its own IP—that’s likely to get the short end of the stick. “In everyday business operations, such as gaining political access to obtain official licenses or unsupervised travel, the discrimination in favor of state-owned enterprises is always in evidence,” says Haley. State-owned enterprises caught stealing IP from private-sector firms are highly unlikely to be punished or forced to make restitution.

Social infrastructure

This is not to say that everything the Chinese government does is hostile to the private sector. In fact, there are a few ways the Chinese government, despite its worst intentions, is actually helping the private sector along.

One area is standardization. Rather than adopt international standards for key electronics technology such as DVDs, 3G telephony, and WiFi, the government is demanding that foreign companies comply with idiosyncratic Chinese technical standards. “It’s a clear attempt to force foreign companies to continue to partner with Chinese firms to sell products into the Chinese market,” says James Mulvenon, deputy director of the center for Asia-Pacific policy at RAND. Although that’s lousy news for U.S. electronics firms looking to sell into China, it’s a pretty good deal from the viewpoint of a Chinese entrepreneur in the electronics industry.

The government also gives a home-
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—Usha Haley, author, The Chinese Tao of Business

Chinese Ministry of Science and Technology. That's more than seven times as many trained engineers per year as in the U.S. and twice as many relative to the size of the population. (see graph "Engineering Graduates per Year," page 56).

The government has also not prevented successful Chinese businesses from becoming innovation incubators. In July 2004, for example, Chartered Semiconductor Manufacturing formed a collaborative network with four incubation and service centers in China to nurture the growth of local IC-design startup companies. The collaboration is intended to help the startups transition successfully to SoC product development and integration.

Despite these scattered bright spots, entrepreneurs must constantly struggle with an immature financial system, a paranoid government hypnotized by outmoded economic theories and an epidemic of corruption that permeates the business infrastructure. The real Chinese economic miracle isn't that the economy is growing at such a fast pace but that it continues to grow at all. If the Chinese private sector could only throw off its government shackles, then the world might see economic performance in China beyond anyone's dreams.

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