The Technicalities

Small Business To The Rescue?

By Andrew Batson

Premier Li Keqiang's most successful economic reform so far is deregulation that has led to a surge in registrations of new private businesses. The next step will be to let these little companies become big ones.

Something is stirring in China's small business sector. Startup companies are forming at a rate unseen in recent years: the number of domestic private companies is up more than 20% so far in 2014, the fastest increase since 2005. This surge is particularly surprising given the slowdown in economic growth and exports this year, trends that usually curb entrepreneurs' enthusiasm rather than whet it. The unusual activity is driven by recent regulatory changes that have made it much easier to form and register new companies.

These changes are among the most significant economic reforms yet introduced by the new administration, and deserve more notice than they have so far received from outside observers. Lowering the bar for starting new private companies is good for an economy trying to move away from an excessive reliance on public-sector investment. But China will not reap the full benefit of policies encouraging startups until it deregulates markets to make it possible for these new firms to compete with and displace larger and state-owned firms. That means removing barriers to companies exiting the market, as well as to entering it.

All Chinese companies must register at the State Administration for Industry and Commerce (SAIC). As of June, the agency recorded 64mn "business entities," most of which are not strictly speaking corporations: about 46mn are sole proprietorships (*getihu*), and another 1mn are farm

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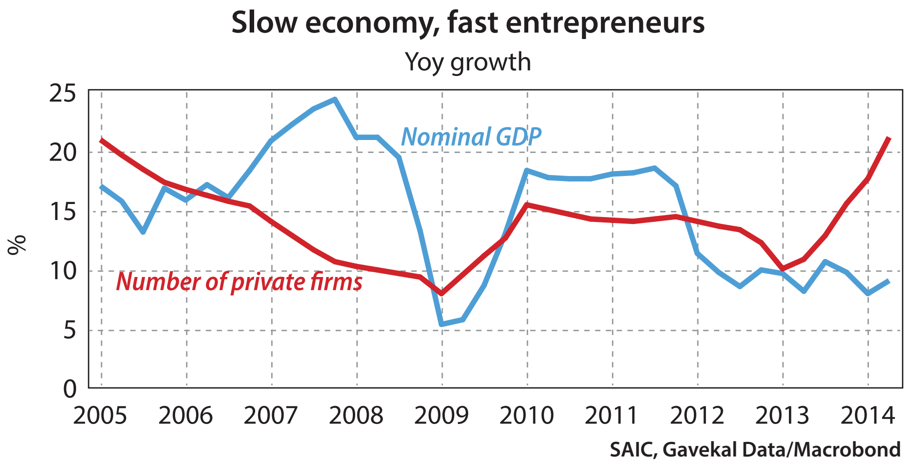


cooperatives. The remaining 16.5mn or so actual companies include about half a million foreign-invested firms, and a bit more than 2mn state-owned enterprises, leaving nearly 14mn domestic private companies. The number of private firms has more than tripled over the past decade, and private firms' share of total company registrations has risen from under half to 84%. Private firms are thus the backbone of China's corporate sector, and the biggest beneficiaries of policy changes that have made it much easier to register a new company at SAIC.

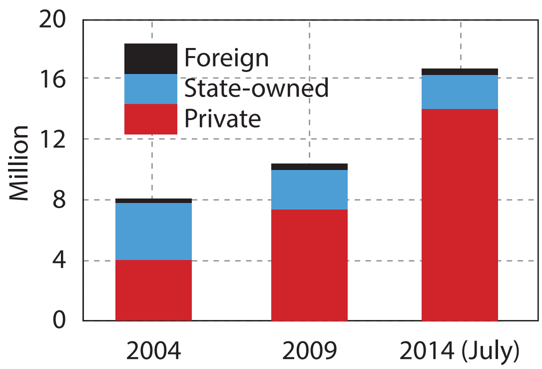
Breaking down the registered-capital barrier

The overhaul of the company registration system has been gathering pace since late 2012, when the market-friendly province of Guangdong began experimenting with a simpler process. In May 2013, Premier Li Keqiang gave a very public blessing to those efforts in a speech focusing on the importance of the private sector. "Recently I saw some numbers: while the number of newly registered companies nationwide fell 6.7% in the first quarter of the year, in some localities that took the lead in business registration reform, the rate was as high as 40-50%," he said. Making it easier to start new businesses would help create more jobs, he argued. In the following months, more localities followed Guangdong's lead by making it easier to register new firms, and in October Li announced a nationwide plan to overhaul the registration system.

The principle behind the various changes is to move from a system where the government conducted rigorous checks before issuing a business license, to one where the default is to grant the license first and then verify compliance at a later date. One of the most substantive changes was the abolition of registered-capital requirements. Previously, these meant that registering a new company required putting up large amounts of cash in advance. While the registered-capital requirements varied by type of firm, they were high by international standards. Most countries do not require any minimum capital to be paid in when forming a new company, and relative to income China's requirements were higher than those in many other developing countries. Implementing this State Council decision required rewriting the relevant sections of the Company Law, which was done in short order: a revised version of the law passed the legislature in December 2013, and took effect on March 1, 2014. The legal changes made it possible to establish a company with essentially no capital—great for small businesses—and also simplified some of the cumbersome requirements on how capital contributions had to be made, which helps larger firms.

Corporate China's changing face

Registered companies by ownership



SAIC, Gavekal Data/Macrobond

There is no doubt that this is a profound change for China; one law firm described the switch as "previously unimaginable." Much economic research has found that high establishment costs for new companies correlate with lower levels of income and productivity. Lowering these costs is generally thought to increase competition and improve productivity (in part because those high costs keep firms too small to be able to realize significant economies of scale). The World Bank's "Doing Business" initiative, an international ranking of business regulations, encourages countries to reduce these kind of start-up costs. (China's abolition of registered capital-requirements should improve its score in the next Doing Business Report; it was most recently ranked 96th out of 189 economies.)

In short, these moves are probably the most substantive accomplishment of Li Keqiang's drive to clear the thicket of government regulations that unnecessarily impede private business. The fact that new company formation has surged since 2013, at a time when the economic climate is not particularly encouraging, suggests there was indeed a lot of pent-up demand from entrepreneurs who were ready to register a new company but could not meet the old requirements.

Li has not been shy about trumpeting this accomplishment. In late

July he held a widely publicized meeting with small entrepreneurs who had benefited from the reforms, and talked about just how great they were. "The reason the economy has remained stable with job growth even exceeding that of last year, despite the large downward pressure in the first half, is due to the important supporting role played by deregulation and related policies," he said. This assertion is debatable at best. But one can forgive Li for trying to draw attention to a real achievement at a time when many other reforms remain in the planning stages. "The premier frankly acknowledged that the transformation of government is still in progress, and many [reforms] are not yet in place," as the Xinhua news agency put it in an account of the meeting. While the legal changes easing company registration could be delivered fairly quickly by a top-down decision, Li has found mobilizing the bureaucracy to delivering on promised reforms much more challenging.

Next step: smash the glass ceiling

Nonetheless the government's rhetoric around these changes probably overstates the economic contributions of new small businesses. The conventional justification, repeated in China as often as it is elsewhere, is that small businesses create most jobs, so by supporting the creation of small businesses the government can help create jobs. While it is true that newly launched companies do create a lot of jobs, they also destroy a lot of jobs, since most new companies fail. In China, half of all companies do not survive longer than seven years, according to SAIC data. Nor is lowering the bar for registering a new company necessarily a boost to innovation and productivity: while the terms "startup" or entrepreneur can convey the impression of tech-savvy youngsters taking on the world, the reality is that huge numbers of new small businesses are shops and restaurants that are not particularly creative.

High barrier to entry

Registered capital requirement, as % of national per-capita income

Country	Minimum capital
112 countries: Afghanistan to Zimbabwe	0
Russia	1.2
Europe average	3.5
Latin America average	3.6
Indonesia	38.5
Middle East & North Africa average	45.4
China (before change in Company Law)	**78.2**
India	124.4
Sub-Saharan Africa average	125.7
Myanmar	7,016.0

Source: World Bank

The real economic benefits from the creation of new companies do not come from just having lots more small businesses, since most small firms are not very productive and (by definition) do not employ that many people. The benefits come from small firms that are successful and go on to become large companies. These are the ones that create lots of permanent jobs, and the ones that improve economy-wide productivity by shaking up markets and introducing new products and services. So what China really needs is not just lots more small companies, but the conditions that allow more small companies to become large ones—in other words, less government favoritism for entrenched market players.

Currently there is a widespread perception of a "glass ceiling" that limits the size to which private-sector companies are allowed to grow. Lists of the nation's largest firms are dominated by state-owned enterprises, and the tiny handful of private-sector exceptions like the internet giants Tencent and Alibaba only prove the rule. This reflects the difficulty that new entrants often have in challenging existing market leaders, which particularly in service sectors tend to be state-owned firms. In previous research we have found that the rate at which Chinese companies close down and exit the market appears to be low, especially in state-dominated sectors. For this recent surge in the birth of new companies to benefit China, it needs to be matched by the death of more old companies.