Wanted: More Creative Destruction

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If, as Joseph Schumpeter said, creative destruction is the "essential fact about capitalism," then just how capitalist is China? Schumpeter coined the phrase creative destruction to refer to a process of corporate innovation that "incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one." More recent economic research supports his insight that destruction is closely tied to creation: strong economic growth rooted on productivity gains is often associated with the replacement of older firms by upstarts, rather than the continued dominance of a static group of large companies.

Fascinating new data published by China's State Administration for Industry and Commerce (SAIC), the agency that registers new companies and revokes the licenses of failed ones, allows us to make a stab at assessing just how vibrant and Schumpeterian the nation's corporate landscape is. Even at first glance it is clear that the dismantling of the planned economy over the past two decades has led to a tremendous boom in the creation of new private-sector firms. There are now nearly 60m registered companies, or 96% of the total, that are part of the private sector, broadly defined. Most of these are tiny sole proprietorships (*getihu*), but the figure also includes larger and more formal private firms formed by domestic or foreign investors. And the creation of new firms continues at a rapid pace: 11.3m new firms were registered in 2013, 95% of them private companies or sole proprietorships (see table).

Over the past two decades, China has had a huge surge in the formation of new private-sector companies

China's corporate landscape is now mostly private

Number and average size of registered legal entities, end-2013

Type of firm	Number of legal entities (million)	Share of total (%)	Capital per firm (Rmb, million)
Sole proprietorships	44.36	73.2	0.05
Private companies	12.54	20.7	3.13
State-owned enterprises	2.29	3.8	19.74
Rural cooperatives	0.98	1.6	1.93
Foreign-invested companies	0.45	0.7	27.47

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So China doesn't seem to have much of a problem with the "creation" part of the equation. But the SAIC data show interesting and more worrisome patterns on the "destruction" side. One is that the rate at which Chinese companies fail and exit the market is systematically lower than in more established market economies (we compare the US and UK, mainly for reasons of data availability). Another is that some kinds of firms and sectors seem to be more protected from the harsh winds of competition:

market exit is relatively less common in sectors that are more dominated by state-owned enterprises.

Future productivity gains depend not just on creating new firms, but on allowing existing firms to fail

This pattern means China will likely have problems boosting productivity growth in service sectors, many of which are state-dominated, unless the government follows through on promises to really open up to new, private-sector competitors who are allowed to directly challenge the state-owned incumbents. Ironically, this stability is not good news for SOEs themselves: in other research we have argued that the slow pace of market exit for state firms, particularly in recent years, has harmed their incentives and led to a substantial deterioration in their financial performance (see **An Exit Strategy For China's SOEs?**). So whether one little-noticed pledge made at the Communist Party's Third Plenum in November—to "improve the market exit system in which the good eliminates the bad"—is actually implemented could have monumental consequences for China's economic future.

Chinese firms are mortal...

Government policies often seek to avoid company closure, and the formal process of bankruptcy is rarely used

Accepting market exit not just as a necessary evil but something to be actively encouraged may not come easy to Chinese policymakers. Many of China's distinctive economic policies seem to be devoted to avoiding corporate failures: the steady flow of funds from both state-owned banks and the shadow financial system, the panoply of formal and informal support given to major employers by local governments. Though China created a legal process for corporate bankruptcy in 1986 and revised it in 2007, firms rarely use it: less than 1.0% of the 735,000 companies that went out of business in 2012 were actually declared bankrupt.

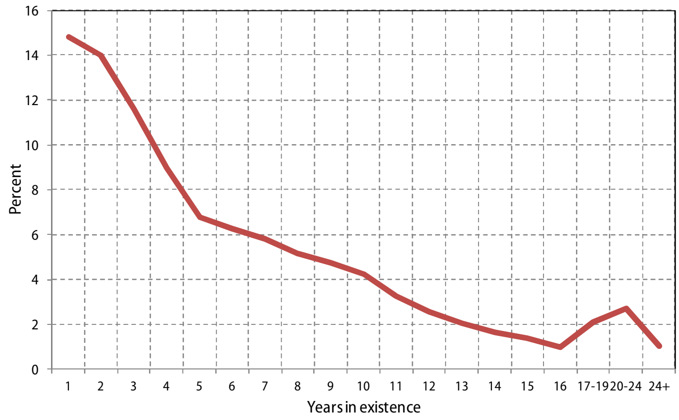
Because of the high rate of new company formation, most Chinese firms in existence at any moment are young

Nonetheless, Chinese firms are indeed mortal, and the patterns of their death are in many ways familiar. A plurality of firms currently in existence are relatively new ones: in 2012, 40% of all firms were three years old or younger, and 29% were two years old or younger (these and other statistics in this paragraph refer to corporations excluding sole proprietorships and cooperatives). Three years of age seems to be make-or-break time for new businesses in China: while most businesses survive their first couple of years, they start closing down in much larger numbers in their third, fourth and fifth years of operation. Based on data from 2000 to 2012, the most dangerous year for Chinese companies is their fourth year of existence, when 9.5% of them closed. After their sixth year of operation, the probability of a firm shutting down starts to decline more rapidly.

This pattern has produced a fairly young corporate sector for China: 56% of all Chinese companies registered at the end of 2012 were five years old or younger, that is, created since 2007. Over 85% of all firms in existence at the end of 2012 were only formed after China joined the WTO at the end of 2001. And only 1% of Chinese companies—or less than 137,000 firms out of 13.2m—have been around since 1987, the year before China passed its first law for private enterprises. That represents an almost complete replacement of the corporate sector.

Most Chinese companies are quite young

Share of registered companies at each age, as of end-2012



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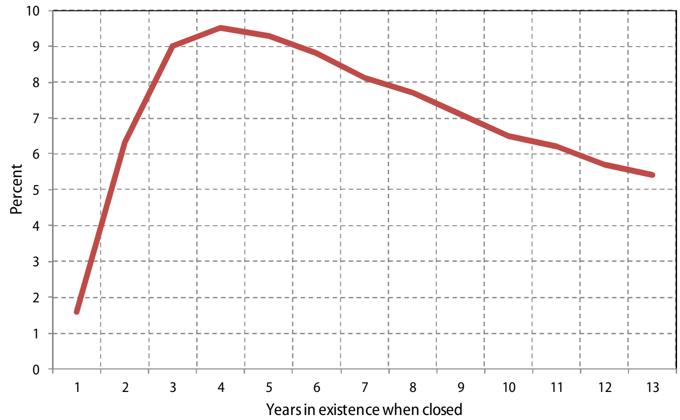
Few Chinese companies make it to their teens

Share of registered companies that close at each age, 2000-12



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...but perhaps not as mortal as others

Closures of Chinese firms—what we might call the "death rate"—do, rather unsurprisingly, follow the business cycle. During 2008, when exports collapsed amid the global financial crisis, 9.3% of all registered firms went out of business. But the death rate declined in subsequent years as growth recovered, and was down to 6.1% by 2012. The surprising differences show up when we compare these figures to corporate death rates in other economies. The timing of the business cycle is not the same: the toll from the financial crisis hit the US and UK most strongly in 2009, when corporate death rates for both countries were high. But the most interesting fact about China's corporate death rate is that it never got as high as in the US or UK (see table).

Is China's low rate of corporate closures due to strong growth or structural rigidities in the economy?

China's corporate failure rate looks low

Percentage of all existing firms that closed in each year

Year	US	UK	China
2008	12.9	9.6	9.3
2009	15.6	11.8	8.4
2010	13.8	10.6	7.8
2011	13.0	9.8	7.2
2012	n/a	n/a	6.1

US Census Bureau, UK Office for National Statistics, China SAIC

This could simply reflect the fact that China is growing much faster than the US or UK, and so there is just not as much pressure on firms to close because their sales are bad. But the SAIC's data do suggest that China may have other, more structural differences: notably, the role of state-owned enterprises. Certainly most firms that die in China are private, and that is simply because the overwhelming number of firms in existence are private firms. While the SAIC does not break down death rates of state- and non-state firms, its figures do show that larger firms are in much less danger of

Large, well-capitalized firms do not fail as often, and such firms are more likely to have state backing

failure than smaller companies. Within three years of founding, 34.5% of smaller firms (defined as having less than Rmb1 m in capital) shut down, whereas only 4.1% of larger firms (defined as having more than Rmb10 m in capital) meet the same fate. Size is not a neutral factor in China: while there are certainly many medium- and large-sized private firms today, the largest firms are primarily SOEs and foreign-invested companies. This is why firms in Zhejiang and Jiangsu, provinces dominated by smaller private companies, have the shortest life expectancy of firms anywhere in the country.

Further suggestive signs come from the distribution of corporate failures by sector. Between 2008 and 2012, 61% of all Chinese companies that closed were from three broad sectors—wholesale and retail trade, manufacturing, and shipping and storage—that happen to be predominantly occupied by private enterprises. By contrast, the sectors that suffered the fewest deaths during this period had a higher proportion of SOEs: mining, electric power, finance and education. The contrast was even sharper in 2012, with over 9% of hotels and related entertainment companies failing, while only 3% of financial firms met the same fate.

While China's manufacturing sector appears fairly dynamic, its service sector is much less so

A comparison with the US is instructive: China has a larger proportion of its corporate failures in manufacturing than the US, but then China's manufacturing sector is relatively a much larger part of its economy. But China's service sector looks less dynamic and prone to creative destruction. About 67% of US economic output comes from services, and 81% of its corporate failures are in the service sector, broadly defined; by contrast, about 45% of China's economic output comes from services, and 49% of its corporate failures are in services. Tellingly, China's service-sector corporate failures are in retailing and wholesaling, a haven for small-scale private firms; corporate failures are rare in the state-dominated finance sector and other service sectors.

There is a big difference between mostly private service sectors like retailing and those with a bigger state presence

China has few corporate failures in state-dominated service sectors

Percentage of total firm closures by sector

Sector	US (2008-11)	China (2008-12)
Agriculture	2.7	2.3
Mining	0.4	0.8
Construction	9.9	4.7
Manufacturing	6.5	17.1
Transport and shipping	4.2	7.9
Wholesale and retail trade	24.3	36.2
Finance	9.8	1.6
Other services	42.2	3.6

US Census Bureau, China SAIC

While the fact that China's corporate death rate has come down in recent years may be welcomed as a sign that the economic recovery, a falling death rate is not necessarily a good sign. Since the end of World War II, the average lifespan of Western companies has shrunk as markets have become more competitive and government protections have been withdrawn. As a result, today American and European companies are five times as more likely to die in their first year as Chinese companies.

While the lifespan of Western companies has shrunk as competition has increased, China has been moving in the other direction

The drift of Chinese economic policy over the past decade has instead been in the other direction, with the government increasingly trying to support a "national team" of SOEs and a few selected private-sector firms. It has tried to increase corporate longevity, and decrease turnover, by removing some of the pressures on companies to shut down. But corporate creative destruction, as long as it is supplemented by a social safety net and paths to re-employment, has real benefits in introducing new products and practices to the market more quickly and bringing positive change to the entire economy. The companies in advanced economies that achieve longevity do so by continuously adapting to their environment, providing innovative products and services, and being financially conservative. China's new leadership has signaled a clear break with the priorities of the past decade; if it continues down the path of promoting more competition for firms young and old, private and state-owned, then more Chinese companies will endure because of ingenuity rather than privilege.