Family Businesses in China

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Executive Summary: The role of family businesses in China

Family Businesses in China are hard to distinguish from ‘privately-owned enterprises’. The exact size of the family businesses sector is thus unknown but, holds a vast pool of capital in private hands, despite being largely restricted to the economy’s less regulated sectors. Beijing has introduced a number of reforms to try and encourage the private sector in recent years but its impact has so far been limited. While Beijing wants to encourage a larger role for private equity, it must also protect the interests of the CCP’s ‘commercial face’, the State Owned Enterprises (SOEs). The EU should take advantage of this by taking measures to attract idle Chinese capital and talent.

Main points:

- China has a vast surplus pool of capital in private hands which cannot leave the country and yet cannot be invested in most sectors of the economy which remain dominated by SOEs.

- On the mainland, Chinese family businesses have never regained the status they enjoyed prior to 1947, when the Kuomintang began nationalising most industries. Most feel they never will, as long as the CCP remains in power. Wealthy families remain extremely nervous and feel that they are vulnerable targets for the CCP or corrupt local officials. Many worry that they will be accused of making their money illegally or avoiding taxes.

- The central government hopes to redirect investment away from the overheated property sector by opening up more sectors to private enterprise. However, few feel that it will succeed.

- In the countryside, central government wants to reform banking and make credit more available to rural entrepreneurs. In the hi-tech sectors, Beijing has announced policies such as the ‘36 clauses’ for the non-state economy, to support private enterprise in certain favoured sectors.

- China’s vast pool of private wealth and talent represent a huge opportunity for the EU as most Chinese business families are searching for ways to either emigrate or invest abroad. Traditionally, Chinese families have always sought to reduce risks by diversifying their portfolios through holding assets in Hong Kong or the United States. The EU should develop policies to attract private Chinese capital instead of wooing CCP-controlled SOEs. It should pressure Beijing to ease capital controls to facilitate the outflow of capital held in private accounts. It should also court wealthy families to bring certain industries back to Europe.
Introduction: what is China’s private sector?

There is no agreed definition of China’s private sector and, in practice, it is hard to separate ‘privately-owned enterprises’ from ‘family businesses’. Some claim that the private sector accounts for 70% of GDP and 160 million jobs. According to the All-China Federation of Industry and Commerce, private companies now account for 74 percent of China’s enterprises. The total registered funds of the private sector reached 19 trillion yuan by the end of 2010, with an average growth rate of 20.1 percent year-on-year and an accumulated growth rate of more than 150 percent over the past five years.

Other commentators have argued that the private sector is actually half that size, employs 60 million, and is both starved of capital and excluded from the most important economic sectors by state-owned enterprises (SOEs) whose power has been inflated by the post-2008 stimulus program. At present, the private sector only plays a role in 41 of 80 domestic industries, while foreign capital has investment in 62 sectors. The top 500 national strong companies are SOEs.

The private sector accounts for only about 40 of the 1,600 Chinese companies listed on the domestic and overseas stockmarkets and their combined market capitalisation is less than 3 per cent of the total. Further, less than 10 per cent of credit goes to private enterprises which pay much higher interest rates than SOEs.

- A recent report by Bain Capital put the number of rich Chinese with assets of over 10 million RMB at 320,000 in 2009. Another report said China has 60,000 people with a personal wealth exceeding 100 million yuan.
- Bain says the total value of investable assets held by individuals in China in 2008 equaled RMB 38 trillion. It said over half of China’s wealthy are clustered in Guangdong, Shanghai, Beijing, Jiangsu and Zhejiang. In order to spread their risk, nearly 80 percent of Chinese high net worth individuals (HNWIs) would like to further diversify their investment portfolios. At present, Hong Kong is the major destination for Chinese HNWIs’ offshore investments.
- Unlike other offshore markets, more than half of the capital in Hong Kong is used for investing in local assets like Hong Kong stocks, property and insurance.
- Many of China’s wealthy are also travelling in organised buyers’ tours to invest in property in Vancouver, Singapore, California and other parts of America.

A brief history of the role of family businesses in China

In Republican China (1911-1948) family-owned businesses created and owned China’s largest commercial enterprises. Family run companies like the Wuxi-based Rong (or Yung family) sprang up with dominating roles in textiles, shipping, banking, insurance, milling, property, railroads and retail sectors. Many businessmen started off as compradors for foreign companies but were considered patriotic because they competed successfully against foreigners - above all, the Japanese, who dominated the textile industry (then the region’s most important industrial and export sector). The Chinese industrialists benefitted
from numerous nationwide boycotts of foreign goods. In the ‘golden era or the Chinese bourgeoisie’, they were independent, self-regulating and widely-admired. By comparison, SOEs like coalmines, railways, cotton mills or shipping lines performed poorly.

After 1945, the KMT began to nationalise the private sector and to appropriate their gold and foreign currency savings. Even before the Communist takeover in 1949, many family businesses had fled, settling in Hong Kong, Taiwan, North America and South America. Hong Kong owes almost all of its prosperity to the influx of Shanghai money and entrepreneurs after 1949 and much the same can be said for Taiwan. From Hong Kong, the Shanghaiese expanded around the region establishing factories in export processing zones - setting up first in Taiwan, then in countries all over the region, and finally in Africa, the Caribbean and Central America. They exploited the textile quota system, the absence of trade unions and taxes in these enterprise zones, and from cooperation with Japanese firms who were forced to go abroad to escape the strong Yen and quota restrictions.

Members of the old Shanghai capitalist families who stayed behind were persecuted and then slowly rehabilitated after 1979. Rong Yiren of the Yung family once again became the richest private individual in China (and Vice President after 1979). Deng Xiaoping brought back former Shanghai capitalists and gave them leading roles in newly established hybrid ventures like CITIC or Everbright in which the children of top Party officials and Shanghai capitalists were given leading roles.

Although few Shanghaiese ended up in South East Asia, many poor Chinese emigrated there in 1911-1948 from Guangdong, Fujian and Zhejiang provinces. They would often undertaking menial work such as tapping rubber trees on plantations in Malaysia. The descendants of those who did well are known as today as the ‘coolie billionaires’. These overseas Chinese dominate the economies of countries like Thailand and Indonesia.

As a consequence, a strong entrepreneurial tradition took root in the Yangtze Delta region, especially in towns like Wuxi, Shanghai, Nantong, Ningbo, plus former treaty ports like Wenzhou, from which many emigrants went abroad in search of work. Families established factories making garments, buttons, jewellery, small plastic toys, etc. They set up private banks and lent money to each other or borrowed from relatives living abroad. In the Mao era from 1949 to 1976, ‘capitalist’ provinces like Jiangsu, Zhejiang, Fujian, Guangdong were deprived of state investment but after 1980 they quickly prospered despite recurrent political campaigns against capitalists that lasted until 1995. These are now the richest areas in gross terms and per capita in China.

Generally-speaking, most experts who talk about China’s private sector mean these ‘Wenzhou’ style entrepreneurs. Although they have a passing resemblance to the Shanghai capitalists of the Republican era, there are profound differences. The Shanghai capitalists who flourished from 1900-1949 were major league industrialists dominating key sectors with access to capital from major banks, who incorporated their firms and listed them on the Shanghai stock market, then the largest in Asia. The larger enterprises had branches or outlets around the country and created famous brands. In contrast, the Wenzhou entrepreneurs are excluded from the stock market and ignored by state banks. Although
they are very wealthy, they cannot enter the ‘commanding heights’ of the economy which the Party reserves for itself.

Many of the Wenzhou entrepreneurs became involved in the textile industry. As they expanded, they employed millions of temporary migrant workers from the interior because this meant that they did not have to pay the same social and pension charges as the state-owned textile and garment factories who folded in the 1990s.

These family-run businesses remain under the thumb of the Communist Party. This is largely because industrialised countries missed a vital opportunity to strengthen the independence of the private sector when the international trade in textiles was regulated by the Multi-Fibre Agreements. Instead of allocating import quota licenses directly to ‘private-owned’ factories, the United States and the EU delegated that power to Chinese government industry organisations. The Communist Party wielded the whip over these family companies by issuing export quotas and export tax rebates.

The Party used this power to rebuild the state-owned textile sector, move it out of Shanghai and other old industry centres, re-equip new modern factories with modern machinery, and discard all of the old pension liabilities that came with older enterprises. China now has the world’s largest textile industry which controls more than half the world’s textile trade. This industry is once again dominated by massive state-run enterprise subsidised by low cost bank loans from state banks.

In the last fifteen years, the private sector has been squeezed out of textiles and has had to concentrate on the low-capital intensive garment sector, which employs around four million out of the 20 million employed in textiles. With the abolition of quotas, the margins in this sector have dropped considerably from around 20 percent to just 2 or 3 percent. Rising labour costs, and higher commodity prices are forcing the garment businesses to relocate to the interior, or to Vietnam, Cambodia or Bangladesh. Many have closed down.

Many of these ‘Wenzhou’ style businesses have expanded into other sectors but in general they have invested their capital to speculate in commodities, shares and, above all, in property. Since China privatised property after 1998, many of these individuals have made larger profits from property than from manufacturing and building up national service businesses - the property boom has seen property price rises of 300-600 per cent. Many are very keen to invest their capital abroad but are deterred by capital controls.

**Peasant Entrepreneurs**

When calculating the size of the private sector, some estimates include peasants, i.e. anyone living off the proceeds of farming a small plot, growing staples or cash crops. After 1979, these individuals were allowed to start small enterprises selling agricultural ‘side products’ like fish, eggs, or fruit in markets. Many peasants also opened small businesses such as restaurants, repair shops, building companies and other enterprises. This was allowed provided there were not more than 10 workers or did a combination of all things. In the
In the 1980s, many became quite rich and ploughed their capital into building new houses providing a boost to the construction sector. In the last twenty years, peasant incomes have stagnated partly because, they were not given land tenure and could not mortgage or sell their land, nor could they obtain operating capital from the rural banking sector. This is now being addressed by the government, which is beginning to give tenure to peasants in some places and is destined to become the norm in China.

In practice, many families in rural China will have members working the land, working in local enterprises or running a market stall, or working in the cities as a migrant worker.

**Rural Enterprises**

*XiangzhenQiye* or TVEs (township and village enterprises) are rural enterprises that were set up by officials in villages, small towns, counties and former people’s commune administrations. Some of them started off in the 1970s when they secretly undertook work for SOEs in Shanghai. Most were financed by rural credit banks or cooperatives. They constitute the largest group of small and medium-sized enterprises in the country. Some of them are factories which went bankrupt under state management and were sold off. Many are now substantial enterprises which are involved in every sector from mining to steel-making or even aeronautics. For example, half of China’s coal is produced by mines outside the planned state sector. The state has tried to close all of these down by merging them with half a dozen big coal mining enterprises, but high prices have meant that the private or collective coal mines are still running. Many Wenzhou businessmen have invested in these.

Another group of enterprises in the private sector sprang up in the 1990s when the state-sector was down-sized and many subsidiary enterprises owned by SOEs – shops, kindergartens, car fleets, hotels, orchestras, etc. – were privatised. State workers were therefore often suddenly transferred from the state to the private sector. In addition, all bureaucracies - even the ministry of foreign affairs and the People’s Liberation Army - had also to set up private enterprises to absorb the large numbers of laid off pen-pushers and demobilised soldiers.

In general, statistics on these SOEs are obscure or misleading. Some of these enterprises are truly privately owned and managed but more are controlled by local party committees or relatives of party officials.

**Private Equity**

There is now a large group of valuable hi-tech firms set up by professors and returning students in new sectors of the economy often to do with software, online sales, mobile telephones and the like. The private equity industry is now flourishing in China – some claim it is one of the largest in the world. Many of these like Baidu, Alibaba, or Tencent, have listed
abroad. Out of the 500 start-ups listed abroad almost all have listed in America and few in Europe.

The National Development and Reform Commission got the ball rolling in 2006 and 2007 by approving the formation of 10 industrial Private Equity (PE) funds. But after the government unleashed the stimulus package in late 2008, funds took off by tapping the abundant supply of stimulus cash sitting in the accounts of SOEs and local governments. The nation's 105 RMB-based PE funds raised nearly 86 billion RMB in 2010. Some of these have listed start ups on China’s NASDAQ called ChiNext. In the last two years, the average PE investment stock price has risen to more than 15 times the price-earnings ratio.

**New Government Policies**

As the stimulus program wound down in 2010, the government hoped that the private sector would take the lead in creating jobs and redirect capital away from the overheated property section.

The May 2010 ‘Measures for Encouraging and Guiding the Healthy Development of Private Investment’ better known as the “36 clauses for the non-state-owned economy” promised to open up more sectors of the economy to private investment, including banking, education and public services.

An official from the National Reform and Development Commission claimed the “new 36 clauses” represent the State Council’s “first comprehensive policy document aimed at the development, management and regulation of private investment” since 1979. But all the observers interviewed for this paper thought the policy would be so difficult to enforce that it would have little impact - at best, these individuals believed its effect would only be gradually felt over the next decade.

“The policy will be so difficult to enforce that I am afraid it will only exist on paper,” said Zhao Xiao, an economics professor at the University of Science and Technology in Beijing. “State-owned companies dominate industries like telecommunications, railways and finance. It is doubtful that new private companies can compete. It remains to be seen how many barriers to private capital they remove. It is a real test of the government’s commitment to reform.”

The state released the first version of these 36 clauses five years ago. However they did little to strengthen the development of the private sector. On the contrary, SOEs have actually strengthened their grip over the economy and have been encouraged to push private investors out of many sectors like coal, oil, steel, aviation, etc. Their access to the lion’s share of multi-trillion dollar lending has even enabled them to take over the real estate industry which hitherto was one domain where private investment thrived.

Between 2005 and December 2008, the State Council added four supplementary documents to the original “36 clauses.” In addition, central ministries and commissions tacked on 38
documents, and every province and city around the country also added their own – too many to be counted. Some measures, even those tightly bound to government interests, failed to eliminate systematic barriers to the development of the private economy.

The latest version of the 36 clauses covers six sectors and 18 industries. Detailed measures and supplements are expected to follow. The sectors listed are communications, telecommunications, energy, basic infrastructure, municipal public services, industrial science and technology of national defence, low cost housing construction (supported by the government), financial institutions, logistics, cultural, education and sports development, media and social welfare, and so on.

Beijing certainly wants private equity to play a bigger role but it also wants to continue protecting the interests of the SOEs which are more or less the commercial face of the Chinese Communist Party (CCP). This has led to conflicting opinions. For example, in the oil sector, soon after the policy was announced, The Shanghai Securities News quoted Zhao Youshan, President of Petroleum Circulation Commission of China Commerce Federation, saying that “some of the biggest private run petroleum related enterprises immediately began researching how to exploit the “New 36 Clauses” to take part in the oil exploration. Six private firms have for the first time been given the green light to take part in building the strategic oil reserve by relevant government authorities. And that was the direct result of implementing the “New 36 clauses”.

But in the same paper Chen Shunsui, President of Guangdong Provincial Petroleum Industrial Association admitted that “it would be difficult for the private investment to take part in the oil and gas exploration work in the near future[...] There is almost no room left for the private sector in this sector.” Guo Haitao, a researcher at the China Strategic Energy Research Centre said that “the policy allows private funds to invest in oil and gas exploration in theory, but in practice, it is still a question mark on whether that could be realised”.

Private Banking

Encouraging private investment in listed banks and rural financial institutions is part of a new State Council initiative to support private enterprise in the countryside since 2005. Among other things, it permits injections of private capital to establish financial institutions and encourages private investment in township and village banks, leasing companies and rural credit cooperatives. The government has also vowed to loosen limits on private investment in other financial institutions. Local loan companies, for example, now have a chance to restructure and rise to the level of full-blown financial institutions. But some analysts have warned that, if bank start up and supervision requirements do not change, much of the financial sector will still be off-limits to private capital.

The 2005 policy made private involvement possible in regional joint-stock banks and credit cooperatives. And private enterprises that met certain conditions were allowed to offer intermediary financial services. According to the All-China Federation of Industry and
Commerce (ACFIC), private investment accounted for only 9.6 percent of the sector’s investments in 2008. Small and medium-sized companies cannot obtain loans because there are so few private banks. Restrictions on sponsors for establishing banks and inadequate regulatory enforcement at local levels are still the main barrier restricting private inroads in the financial industry. However the latest guidelines stress, for the first time, that "no explicit ban means access," while listing six major areas for private investment, including financial institutions.

The China Banking Regulatory Commission (CBRC) began promoting rural banks and other types of new rural financial institutions in 2006 but approved only 172 new rural financial institutions between March 2007 and the end of 2009. CBRC followed up last year with a plan called the Overall Work Arrangement for New Rural Financial Institutions for 2009-2011, which called to set up 1,294 new rural financial institutions nationwide within three years. These were to include 1,027 town and village banks, 106 credit companies and 161 rural fund cooperatives. Of the 382 institutions scheduled to open during the first year, only 50 got off the ground.

Last year, the CBRC also released Temporary Guidelines for Small Loan Companies Restructuring into Rural Banks, which said small loan firms could become rural banks. But it stipulated that a commercial bank must be the majority or sole shareholder. In addition, eligible firms had to be debt-free, more than three years old, and have sustained profitability for two previous fiscal years. The State Council also loosened a requirement that says a major shareholder in rural banks must come from institutions in the banking sector. Currently, the largest shareholder in village banks must be a bank with at least a 20 percent stake. The 20 percent requirement may be lowered to 10 percent soon in one province, Inner Mongolia. In practice this has meant that only banks could be the founders or major shareholders at a new rural bank. Private capital could only be a minority shareholder, at best.

Conclusions
• Although China now has a very mixed economy, similar to those in established market economies, its private sector is marked by certain features. Most of the sector consists of family-owned businesses that have gravitated towards less regulated sectors, such as property and services. It tends to be concentrated either in the quasi-illegal low cost end of the spectrum, or the very new hi-tech sectors at the other end.
• These firms invariably employ migrant workers from the countryside and try to escape the costly and burdensome employment regulations and taxes increasingly imposed on urban workers in foreign or state-run sectors. They also flourish by avoiding Intellectual Property Right payments, flaunting environmental laws, child
labour laws, planning laws etc. This means they rarely invest in brands or develop their own manufacturing or marketing know how.

- Even so many of the private enterprises are very different from what they were 30 or 20 years ago. They are increasingly well run and managed by better educated managers who employ a workforce with expectations different from the earlier generation.
- The efforts by the private sector to invest in aviation, oil, coal, banking, textiles etc. have been thwarted by determined opposition of the state sector. Despite the government’s new policies to encourage private investment, many family businesses are skeptical and they doubt they will ever be allowed to prosper in China.
- Many businesses operating in China are increasingly geared towards the domestic consumer market and building up trans-national outlets, rather than focused on exports as in the past. Here, however, they are at a disadvantage from the larger state-sponsored enterprises or foreign managed ventures that are quickly creating nationwide giant retailing or beverage and food chains which now compete successfully against family run restaurants and shops.
- If the Chinese government does not wish to employ the vast amount of idle capital and pent up entrepreneurial talent in China, the EU should try to take advantage of this by attracting some of that wealth and energy to Europe.
- The EU could copy the successful policies of the past – organising tours of private investors and providing Chinese language introductory brochures. They could be directed towards regions suffering very high rates of youth unemployment. Early generations of Chinese investors who went abroad were attracted by special enterprise zones or export processing zones where there were simpler employment legislation and five-year tax waivers. In some parts of China, land, labour and electricity are higher than in the United States. The EU needs to persuade Chinese businesses that this also goes for parts of Europe.