

# Bank Financing in China's Private Sector: The Payoffs of Political Capital

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**Summary.** — In Reform Era China, bank financing plays a significant role in entrepreneurial development, despite a severe information asymmetry problem and a discriminatory legal/regulatory environment. This paper offers a political explanation for how Chinese entrepreneurs obtain bank loans by arguing that entrepreneurs actively invest in political capital to overcome bank financing obstacles. Pursuing membership in the legislative or semi-legislative organs of the Chinese government is an effective strategy for private entrepreneurs to obtain political capital. Empirical analysis suggests that a legislative membership helps entrepreneurs get access to bank loans; and it may be more useful for small and medium enterprises.

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**Key words** — Asia, bank financing, China, entrepreneur, legal and regulatory constraints, political capital

## 1. INTRODUCTION

China's domestic private sector has experienced rapid growth during the Reform Era.<sup>1</sup> While most private firms have been small or medium enterprises (SMEs) established by individual entrepreneurs, their significance in the national economy snowballed even before the central government adopted the privatization policy on a large scale for state-owned enterprises and township and village enterprises in 1995 (Qian, 2000). By 1997, the private sector accounted for one-third of national industrial output and one-fifth of national non-farm employment (International Finance Corporation (IFC), 2000). By 2004, its contribution to national GDP had surpassed 50% (*China Industry News*, April 26, 2005).

The private sector was allowed to reemerge in China during the early reform period for very pragmatic reasons. After 30 years (1949–78) of a socialist planned economy, China encountered severe shortages of consumer goods and services, low morale in factories and on collective farms, and a high real urban unemployment rate by the late 1970s (Lin, Cai, & Li, 1996; Naughton, 1995). In many regions, peasants protested the collective farms, urging that they be dismantled. The central reformers finally adopted the household responsibility system (HRS), which was spread throughout rural areas within only five years, from 1979 to 1984 (Naughton, 1995). The tremendous success of the HRS in increasing agricultural products greatly alleviated the long-lasting grain shortage problem and inspired the central reformers to allow peasants, as well as unemployed urban citizens, to establish family or individually owned small businesses to produce consumer goods and services. Many private firms thus got started.

The emergence of the private sector invited harsh critiques from ideologically conservative forces, initially. And, although the economic reformers welcomed the emergence of private firms, they did not want to openly challenge socialist ideology for fear of losing their political legitimacy. As a compromise, private firms were restricted to playing a marginal, stop-gap role in the economy in the early reform period (IFC, 2000). Regulatory restrictions included the following, among many others at the time: a private firm could employ only up to seven employees; and it could enter only a small number of industries that produced consumer goods and services; it could

not obtain factor resources directly from state-owned institutions (Asian Development Bank (ADB), 2003; Byrd & Lin, 1990; IFC, 2000).

Since 1988, especially following Deng Xiaoping's Southern Tour in 1992, a more pragmatic approach to the private sector has been adopted, under which some of the previous regulatory restrictions, such as the limit on firm size, have been lifted, and many others have been loosened (Naughton, 1995). Two problems, however, have remained largely untouched throughout the 1990s. One of these problems is the weak protection of private property rights: the state does not provide substantive legal protection for and enforcement of private property rights. Another problem is the unlevel playing field between private firms and state-owned enterprises: The state still arbitrarily keeps the private sector at a subordinate, near pariah status and discriminates against it (ADB, 2003; IFC, 2000; Nee, 1992; Peng, 2004; Tsai, 2002; Xin & Pearce, 1996; Young, 1995).<sup>2</sup>

These legal and regulatory constraints seem contradictory in the context of the rapid growth of the private sector throughout the 1980s and 1990s. One consequence of the constraints has been the exacerbation of the problem of bank financing, which refers broadly to external financing not just from banks but from all formal financial institutions, for private firms. Researchers have shown consistently that private entrepreneurs are often wealth constrained and need to obtain external financing to pursue their opportunities, making financing central to the process of entrepreneurship (Casson, 1982; Evans & Leighton, 1989; Shane & Cable, 2002). Therefore, legal and regulatory constraints can exacerbate external financing problems, and particularly the bank financing problems, of Chinese entrepreneurs in at least three ways, thus impeding entrepreneurial growth.

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Table 1. *Sources of finance (post-start-up investments) in Chinese private enterprises, 1993–98 (%)*.

	Retained earnings and principal owner	Banks and formal credit cooperatives	Informal finance	Outside equity	Corporate bonds	Others	Sample size
1993	70.7	18.2	7.8	0	0	1.4	1,440
1995	52.1	22.6	12.6	1	1	10.7	628
1997	58.7	32.6	5.45	2.18	0.27	0.82	1,946
1998	62	18	9	1.3	0.3	9.4	628

Note: Categories given above, except for “informal finance” and “others,” are comparable.

Source: The data for 1993 and 1997 come from the 1993 and 1997 National Surveys of Chinese Private Enterprises (see Zhang & Ming, 1999), and those for 1995 and 1998 are based on the four city survey conducted by International Finance Corporation in 1999 (see IFC, 2000).

First, weak protection of private property rights can worsen the information asymmetry problem. Entrepreneurs usually have problems in getting external financing, especially bank financing, because of the generic information asymmetry problem between entrepreneurs and lenders (Amit, Glosten, & Muller, 1990; Gompers, 1995). Since entrepreneurs possess information about themselves and their opportunities that lenders do not possess, lenders face high risks when lending to entrepreneurs because entrepreneurs may behave opportunistically toward them. The information asymmetry problem is particularly severe in this case. Because of the weak protection of private property rights, Chinese entrepreneurs have been even more cautious about revealing information to outsiders, thus exacerbating the information asymmetry problem and, thereby, the external financing problem (IFC, 2000).

Second, weak protection of private property rights can create uncertainty for the future of the private sector. Many people have been worried that the private sector will suffer setbacks as the political environment changes, as it did after the 1989 Tiananmen Square Movement. This could explain partly why many financiers have been conservative in dealing with private firms, especially in the early reform period (IFC, 2000; Tsai, 2002).

Third, the unlevel playing field can impede private firms and entrepreneurs in obtaining bank financing even more directly and more severely. Because of preferential treatment by the state, state-owned enterprises have dominated access to finance through the state-owned banking system. Until 1998, the central bank had annual lending quotas, which took into account only the demand for finance from state-owned enterprises, while the demand from private firms was completely outside the considerations of the central bank (Tam, 2004).

Nevertheless, the accumulated evidence, as presented in Table 1, suggests that despite the legal and regulatory constraints, bank financing still plays a significant role in China's private sector growth. Most of the categories in the table, except perhaps “informal finance” and “others,” are comparable, although the surveys use slightly different categories for finance. Not surprisingly, Table 1 shows that entrepreneurs depend primarily on internal sources, namely retained earnings and principal owner financing. However, the table also shows that external financing is also crucial for the private sector, suggesting that Chinese entrepreneurs may indeed be wealth constrained. Noticeably, bank financing is the most important source among various sources of external financing, followed by informal financing,<sup>3</sup> while public and private equity markets play only a trivial role.<sup>4</sup> In 1997, for example, 32.6% of the private firms in a national survey reported that they relied primarily on bank financing for post-start-up investment compared to 5.45% that relied on informal financing and 2.45% that relied on public and private equity markets.

Given the legal and regulatory constraints and the resulting exacerbation of the bank financing problem, how do we make

sense of the significant role played by bank financing in China's private sector growth? In other words, how have entrepreneurs obtained bank loans in China? This study offers a political explanation to tackle this puzzle. From the resource dependence perspective (Pfeffer, 1982; Pfeffer & Salancik, 1978), I argue that Chinese entrepreneurs actively participated in politics in order to overcome the legal and regulatory constraints, as well as to mitigate the information asymmetry problem. I analyze one political strategy used by private entrepreneurs: getting a membership in various levels of the legislative (or semi-legislative) organs of the Chinese government, namely the People's Congress (PC) and the People's Political Consultative Conference (PPCC). A membership in the PC or PPCC brings political capital to the entrepreneur, which is highly valued for resource acquisition in many transitional economies (see Dickson, 2003; Liu, 2003; Róna-Tas, 1994). My first research question is whether a PC or PPCC membership helps private firms and entrepreneurs in obtaining bank financing; and, if so, why it helps. My second question is how such memberships affect the probability of obtaining bank financing for firms of different sizes. Since SMEs are more constrained in getting bank loans, they might benefit more from the political capital of their entrepreneurs.

The rest of the paper is organized as follows: Section 2 discusses the political capital of Chinese entrepreneurs and its benefits in overcoming resource acquisition problems, including bank financing obstacles. Section 3 presents the data and methods used for evaluating the hypotheses. Section 4 reports the regression results. These results suggest that a PC or PPCC membership helps private entrepreneurs get access to bank loans; and it may be more useful for SMEs. Section 5 concludes.

## 2. ENTREPRENEURS' POLITICAL CAPITAL AND BANK FINANCING OBSTACLES

### (a) Political capital of Chinese entrepreneurs

There is a small yet growing literature in social sciences which aims at understanding the relationship between political capital and political/economic outcomes (see Birner & Witter, 2003; Booth & Richard, 1998; Newton, 2001). Here, political capital can be defined as the resources that an actor can use to influence policy formation processes and achieve outcomes that serve the actor's perceived interests (Birner & Witter, 2003). Such resources include being trusted by a political organization/network and political connections obtained through affiliation with a political organization/network. Political capital, however, comes from not only affiliation with the political organization/network, but also the activities associated with this affiliation or membership. In this sense, it can be seen as a special type of social capital, which usually refers to the re-

sources that individual actors can mobilize due to their belonging to exclusive networks (Bourdieu, 1986).

It is useful here to discuss some of the important characteristics of political capital. First, like financial capital, political capital can be gained through investment. For example, membership in the Chinese Communist Party (CCP) is considered political capital in China, and investment in such political capital involves making an effort to join the party and, in the process, subjecting oneself to a greater degree of political scrutiny and responsibility (Liu, 2003). Second, as a special type of social capital, political capital must be spent to be useful. Some forms of political capital, such as political connections, may even fragment and disorganize if left unused. Third, political capital needs continuous investment. If left alone without further investment after obtaining membership, the value of political capital may be discounted at a rapid pace. And, as one exits the political organization/network, political capital will generally expire.

Existing research suggests that Chinese entrepreneurs have a strong interest in obtaining political capital through political investment. In imperial China, merchants were, politically, at the bottom of the four major social strata—scholars, peasants, partisans, and merchants—and were thus interested in gaining honorary official titles from the imperial court through political donations in order to elevate their political status. One line of research has documented how during the Reform Era, private entrepreneurs began investing in securing CCP memberships even before 2000, when Jiang Zemin officially expressed the Three Represents Theory, through which he welcomed private entrepreneurs to join the CCP (Dickson, 2003; Ng, 2006). To date, CCP membership still remains a credential for successful careers in most government-controlled institutions (Ng, 2006), and is often considered the most important form of political capital because of the one-party political system (Liu, 2003).

Recent reports also suggest that more and more private entrepreneurs have acquired membership in the PC or the PPCC (Jiang, 1999; Yip, 2006; Zhang & Ming, 2000). The PC is China's legislative body and the PPCC is kind of like the upper house in Great Britain, but its functions are limited to consultation (for simplicity, hereafter I use legislative membership to refer to both PC membership and PPCC membership).<sup>5</sup> Although a significant proportion of the positions in both the PC and PPCC are preserved for current or semi-retired party/government officials, people from other social strata are also represented in all levels of the two political organs. While there were almost no private entrepreneurs in the two organs before the reform because of the elimination of the whole stratum, entrepreneurs have been increasingly represented in both the PC and PPCC since the reform. By the late 1990s, around 10% of private entrepreneurs with at least eight employees were already members of either the PC or PPCC nationwide (Zhang & Ming, 1999).

From the state's perspective, there are several reasons to grant private entrepreneurs a membership in the CCP, PC, or PPCC. First, doing so may be related to the party's overall interest in maintaining political control, which has been weakened since the economic reform began. Private sector growth has been especially hazardous to political stability by some party leaders. The collapse of the Soviet Bloc has often been associated with the emergence and growth of a private sphere; in China, private forces, including private entrepreneurs, have also been implicated in the democratic movement in 1989 (Dickson, 2003; Tong, 1994; Yip, 2006). Because the state cannot simply eliminate the private sector as it did in the 1950s, for fear of reversing the economic reform, co-opting private

entrepreneurs into the one-party political system, such as granting CCP, PC, or PPCC memberships, thus becomes a second best option. Second, the state's granting of such memberships may be traced to the changing ideology of the CCP. After Deng's Southern Tour in 1992, the CCP acknowledged that the Chinese economy was a socialist market economy. To accommodate this profound ideological change, the CCP began to accept people from the newly emerged social strata, such as private entrepreneurs, to join the CCP, PC, or PPCC. In this sense, Jiang's Three Represents Theory serves to legitimize and make a big push for the recent practice of the admission of private entrepreneurs into the political system. Third, this may be related to the alliance of local governments and business elites based on the pursuit of local economic growth. Local governments have depended on local business leaders to generate economic growth since the reform began, so granting memberships in the CCP, PC, or PPCC on a selective basis is a way to reward local business leaders.<sup>6</sup>

Nevertheless, this changing opportunity structure alone cannot explain entrepreneurs' interest in getting political capital. A remaining issue is the need to understand the incentives for their political investment behavior. Although membership in the CCP, PC, or PPCC may be not obtained through active pursuit, but granted by CCP committees at various levels on a selective basis, maintaining its value requires substantial continuous investment, as discussed above. Such continuous investment can take the form of participating regularly in routine political activities, contributing almost obligatorily to government-sponsored social programs, maintaining interactions with sometimes corrupt party/government agencies and officials, *etc.*, all of which are burdensome for an entrepreneur. As such, the benefits from political investment must be substantially greater than the costs in order for an entrepreneur to invest in political capital. How then can private entrepreneurs benefit, particularly in an economic sense, from political capital?

#### (b) *Benefits of legislative membership*

In this study I focus exclusively on the political capital gained from legislative membership, and analyze one of its benefits, that is, the economic benefits of solving bank financing obstacles. There are two reasons for studying only legislative membership. First, there is little existing research on the effects of legislative membership as compared to a growing literature on those of CCP membership (e.g., Liu, 2003; Mor-duch & Sicular, 2000; Xie & Hannum, 1996). Second, I doubt that an entrepreneur's CCP membership can significantly affect the decision making of formal financial institutions in the reform period. One reason for this is that a common member of the CCP has little political power (Wu, 2006). Another reason resides in what Jiang (1997) called the "ill-functioning lower-level party committees" with which most CCP members are associated. Since the economic reform began, lower-level party committees have lost most of their political and economic functions, and thus many have become disorganized and even have not had routine organizational meetings for years. The consequence of this is that many CCP members have lost effective channels, such as routine organizational meetings and other party initiatives, for continuous political investment. Thus, the value of political capital from CCP membership has been severely discounted.<sup>7</sup> In sharp contrast to lower-level party committees, the PC and PPCC have gained more political functions and gotten better organized since the reform because the central reformers have encouraged more orderly political participation. As a result,

legislative membership may provide more political capital than CCP membership. This may partly explain why private entrepreneurs have been so enthusiastic about obtaining PC or PPCC membership (Dickson, 2003; Zhang & Ming, 1999).

From the resource dependence perspective (Pfeffer, 1982; Pfeffer & Salancik, 1978), Chinese entrepreneurs' political investment behavior can be seen as a rational strategy to manage their external dependencies on government-controlled agencies, which the majority of formal financial institutions still are, under the legal and regulatory constraints. The political capital gained from legislative membership may benefit the entrepreneur not only politically, such as elevating his/her political status, but also economically, because it helps break the legal and regulatory constraints, thus mobilizing critical resources, such as bank financing, through enhancing the *organizational legitimacy* and the *institutionalized social networks* of the private firm and entrepreneur.

Organizational legitimacy is a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions (Suchman, 1995). In this study, organizational legitimacy refers more narrowly to perception of desirability of the organizational activity within the larger economic and political system. As mentioned above, the private sector was treated as inferior to the state-owned sector throughout the 1980s and 1990s. And the state-controlled media, in addition to public opinion in many regions, was often prejudiced against private entrepreneurs throughout most of that period (He, 1999; Peng, 2004). All these factors suggest that the private sector lacked full organizational legitimacy.

Lack of organizational legitimacy has severe consequences for private firms. It partly explains why private firms have difficulty in getting a variety of critical resources, most of which are still controlled by the state. During most of the reform period, the state had distributed these resources more on the basis of political considerations than economic ones (Walder, 1991). As a result, politically legitimate firms, such as state-owned enterprises, have enjoyed preferential treatment while private firms, being less legitimate, have been discriminated against in terms of obtaining access to government-controlled resources. Even in Zhejiang, the province with a reputation for the most supportive government policies in relation to the private sector, one official report suggests that local officials still set limits on private businesses' ability to obtain land, water, electricity, raw materials, and bank loans until very recently (He, 1999).

High political capital can bring political legitimacy, thus helping solve the resource acquisition problem. A legislative membership signals the recognition of the entrepreneur's contribution to the economy and sociopolitical order by the state. Therefore, entrepreneurs with legislative membership have generally been treated differently from other entrepreneurs when the state allocates resources, and, thus, they may obtain government-mandated loans from the local branches of state-owned banks. Many private entrepreneurs in Fuyang (a county in Zhejiang Province), for example, have reported that they enjoyed "the freedom of doing business," such as easy access to bank loans, protection from unfair competition, and positive media coverage, *only* after being co-opted into the PC or PPCC (He, 1999).

Political capital gained from legislative membership can also help mobilize resources through enhancing the institutionalized social networks of the entrepreneur. Sociologists have argued that social networks are often based on social similarity (Burt, 1992). Thus, enjoying high-status can increase the probability of having other high-status people in one's personal

networks (Suchman, 1995). According to this study, legislative membership, which indicates high political status, can increase the probability that entrepreneurs will have other politically important people, such as politicians, bureaucrats, bankers, or other political elites in the PC or PPCC,<sup>8</sup> in their personal networks. These high-status contacts can provide needed help in solving the resource acquisition problems. I discuss how these contacts might help entrepreneurs get access to bank loans below.

First, high-status contacts can facilitate relationship lending. It is mentioned above that the information asymmetry problem is especially severe in China because of the weak protection of private property rights. To deal with the information asymmetry problem, one important contracting method often used by banks is relationship lending (Berger & Udell, 1998; IFC, 2000). However, as discussed previously, Chinese banks have not usually had incentives to establish relationships with private entrepreneurs because of the uncertainty of the future of private businesses under the legal and regulatory constraints (IFC, 2000; Tsai, 2002). With legislative membership, an entrepreneur can use associated high-status contacts to help establish relationships with bank officials. Given that direct and indirect ties between the entrepreneur and the bank officials may create social obligations between the two parties, which may cause them to behave generously toward each other (Gulati, 1995; Shane & Cable, 2002), such high-status contacts may facilitate access to bank financing.

Second, some high-status contacts can even directly intervene on behalf of the entrepreneur in the credit decisions of banks. During most of the reform period, bank officials have not generally been able to make independent credit decisions, as local governments have had strong control over local branches of state-owned banks and have often intervened in their credit decisions (Naughton, 1995). In the late 1990s, although the central government reorganized the provincial network of the People's Bank (the central bank) and eliminated the credit quota system in order to break the links between local governments and state-owned banks, local governments were still finding new ways to preserve some role in the allocation of financial resources through the banking system (IFC, 2000). With legislative membership, therefore, an entrepreneur can secure bank loans by using some of his/her high-status contacts to intervene in the credit decisions of banks on behalf of him/her.

Given the above discussed benefits of legislative membership, the following hypotheses are proposed:

**Hypothesis 1.** Legislative membership reduces a private entrepreneur's reported bank financing obstacle.

**Hypothesis 2.** Legislative membership enables a private entrepreneur to more successfully secure bank financing as a primary source for investment capital and working capital.

One may reason that a higher-level member of the PC or PPCC can secure support from higher-level and thus from more resourceful government, and may also have social ties with higher-level political elites who may be more powerful. Therefore, it may be argued that the level of legislative membership may also matter, with higher-level membership enjoying more advantages. Thus, it is hypothesized:

**Hypothesis 3.** Higher-level legislative membership is more useful than lower-level membership in getting access to bank financing.

Since the majority of the private firms in China are SMEs, it is practically important to understand how they fare in getting access to bank financing. A large body of empirical literature has shown consistently that financing obstacles are negatively



associated with firm size (e.g., Beck, Demirguc-Kunt, & Maksimovic, 2005; Schiffer & Weder, 2001). Specifically, compared to large firms, SMEs are considered to have more problems in getting access to external financing because they have much weaker capacity to provide adequate collateral and/or proper guarantees and are less transparent concerning their financial information, given their less formal firm structure (IFC, 2000). As SMEs are more constrained in obtaining external financing, it might be argued that they may benefit more from the legislative membership of their owners. Thus, we have:

**Hypothesis 4.** Legislative membership is more critical for SMEs than for large firms in getting access to bank financing.

### 3. DATA AND METHODS

The data for this study come from the 2000 National Survey of Chinese Private Enterprises, which was designed and administered by a joint research team from the All China Federation of Industry and Commerce (ACFIC) and the Chinese Academy of Social Sciences (Zhang & Ming, 2000). Following the definition of private enterprise specified in the *Tentative Stipulations on Private Enterprises* promulgated in 1988 by the central government, the 2000 survey included only domestic private firms that had at least eight employees and were owned by private entrepreneurs. Using a stratified sampling method, the survey selected an almost nationally representative sample of 3,073 private firms with at least eight employees from each of the 31 provinces (including autonomous regions and province-level municipal cities). The sampling involved two stages. In the first stage, a pre-specified number of counties were randomly selected in each province. In the second stage, a pre-specified number of private firms were randomly selected in each county. The number of private firms selected in each province was proportionate to the population size of the private enterprises in that province. After a sample of firms was selected, a total of 39 questions were asked face-to-face with both the entrepreneurs and the accountants of the firms to collect information about the entrepreneurs and their firms in 1999. The data provide detailed information on the borrowing behavior of the entrepreneurs and their political capital, thus enabling us to test the relationship between the two.

#### (a) Dependent variables

I use three variables to indicate bank financing obstacles. *Self-reported degree of difficulty to obtain bank loans* is an ordinal variable ranging from 1 to 5, with 1 meaning "very easy," 2 "easy," 3 "sometimes difficult but sometimes easy," 4 "difficult," and 5 "very difficult." This variable may have perception biases because it is based on self-reporting by the entrepreneurs. So, two objective measures are also used. *Working capital primarily relying on bank loans* and *investment capital primarily relying on bank loans* are two binary variables, which are coded 1 if the firm relied on bank loans as the most important source for working capital or investment capital, but 0 if it relied on its own savings or informal financial sources or other sources. Relying on bank loans as primary source of financing may suggest that the firm had fewer bank financing obstacles.

#### (b) Independent variables

*Legislative membership* is a binary variable. It is coded 1 if the entrepreneur was a member of the PC or PPCC, 0 otherwise.

Legislative membership has five-levels—township, county, city, provincial, and national. Thus, one way to indicate the level of legislative membership is simply to create five dummies for the five-levels. A more parsimonious yet theoretically meaningful way is to differentiate between local-levels and provincial/national-levels. In fact,  $\chi^2$  tests suggest that there are no statistically significant differences between the effects on the dependent variables of the three local-level memberships or between the effects of provincial- and national-level memberships. Thus, I create the following dummy variables to indicate the level of legislative membership with *no legislative membership* as the reference category. *Local-level legislative membership* is coded 1 if the entrepreneur was a member of the PC or PPCC at one of the three local-levels—township, county, or city, 0 otherwise. *Provincial/national-level legislative membership* is coded 1 if the entrepreneur was a member of the provincial or national PC or PPCC, 0 otherwise.

#### (c) Control variables

One set of the control variables involves the characteristics of the entrepreneur (the owner of the firm). Gender and human capital are often used as control variables in entrepreneurship studies (e.g., Amit *et al.*, 1990; Evans & Leighton, 1989; Hamilton, 2000). *Female* is a binary variable coded 1 if the entrepreneur was a female, and 0 otherwise. The survey asked the entrepreneurs their level of education. I create three dummies to indicate the educational level—*lower than senior high school degree*, *senior high school graduate*, and *college graduate or above*. Work experience is defined as 2000 minus the first year the entrepreneur began to work. As the distribution of this variable is skewed, its natural logarithmic form is used.

Two other political capital variables, both of which are binary variables, are also included in all regressions. One is whether the entrepreneur was currently a member of the CCP. The other is whether the entrepreneur was a cadre before establishing the firm (no entrepreneurs in the data held a cadre position currently). Cadre position here refers to any government position once held, which is found to have positive effects on resource acquisition for private entrepreneurs in other transitional economies (Róna-Tas, 1994).

Another set of the control variables involves the characteristics of the firm. Consistent with the existing literature (Beck *et al.*, 2005; IFC, 2000; Schiffer & Weder, 2001), I create three dummy variables to indicate firm size. A firm is defined as a *small firm* if it had less than 50 employees, a *medium firm* if its employee size was no less than 50 but smaller than 500, and a *large firm* if it had 500 or more employees. Variables concerning firm age, firm scope, and dummies for main industry are all self-explanatory and are commonly used variables in organizational or economic studies on firms (e.g., Acs & Audretsch, 1988; Hannan & Freeman, 1989). The natural logarithm of firm age is used because of the skewed distribution of this variable.

*Location of the main establishment of the firm*, that is, whether it was located in a village, town, or city, is controlled to capture possible environmental differences among these three locations. I also control for whether the firm was once registered as a state-owned or collective firm. Being registered as a state-owned or collective firm might help the firm get access to bank loans more easily (Nee, 1992). No firm was currently registered as a state-owned or collective firm in the data.

Table 2 reports all the above study variables with their means and standard deviations and the number of non-missing observations. This table gives us some basic knowledge about the

Table 2. Means and standard deviations of study variables.

Variables	Mean	SD	N
Dependent variables			
Self-reported degree of difficulty in obtaining bank loans (1–5; 1 = very easy, ..., 5 = very difficult)	2.228	1.093	2,857
Working capital primarily relying on bank loans (0/1)	0.114		2,960
Investment capital primarily relying on bank loans (0/1)	0.310		2,771
Characteristics of the entrepreneur			
Political capital variables			
Legislative membership (0/1)	0.615		2,516
Local-level legislative membership (0/1)	0.582		2,516
Provincial/national-level legislative membership (0/1)	0.043		2,516
Cadre before establishing the firm (0/1)	0.235		2,717
CCP membership (0/1)	0.198		3,073
Human capital variables <sup>a</sup>			
High school graduate (including high school, trade school, and mid-professional school) (0/1)	0.391		3,066
College graduate or above (including associate degree, bachelor degree, master's degree, and doctoral degree) (0/1)	0.384		3,066
Work experience (2–58)	3.131	0.433	2,951
Female (0/1)	0.111		3,070
Characteristics of the firm			
Firm age (1–46)	11.226	6.147	3,022
Firm size <sup>b</sup>			
Medium firm ( $50 \leq \text{number of employees} < 499$ ) (0/1)	0.473		2,861
Large firm (number of employees $\geq 500$ ) (0/1)	0.065		2,861
Firm scope = number of industrial sectors the firm entered (1–4)	1.415	0.717	3,073
Main industrial sector (0/1)			
Agriculture	0.043		3,073
Mining	0.011		3,073
Manufacturing	0.363		3,073
Utility	0.010		3,073
Construction	0.058		3,073
Geological and transportation	0.022		3,073
Restaurant	0.187		3,073
Financial and real estate	0.031		3,073
Social service	0.056		3,073
Health care, education, and research	0.042		3,073
Others	0.087		3,073
Industrial data missing	0.089		3,073
Location of the firm <sup>c</sup>			
Firm located in villages (0/1)	0.144		2,869
Firm located in towns (0/1)	0.584		2,869
Firm once registered as a state or collective firm (0/1)	0.212		3,004

Source: National Survey of Chinese Private Enterprises (2000).

<sup>a</sup> The omitted category for educational level of the entrepreneur is lower than high school degree.

<sup>b</sup> The omitted category for firm size is small firm (number of employees < 50).

<sup>c</sup> The omitted category for location of the firm is firm located in cities.

borrowing behavior and the political capital of the surveyed entrepreneurs. Let us start with the borrowing behavior. For self-reported degree of difficulty in obtaining bank loans, tabulation of the variable (not shown in Table 2) suggests that 31% reported that the process was “very difficult”; 32% “difficult”; 22% “sometimes difficult but sometimes easy”; 12% “easy”; and only 2.6% “very easy.” This suggests that bank financing obstacles were indeed a big problem for private entrepreneurs. Nevertheless, it is still seen that 31% of the firms relied primarily on bank loans for investment capital. The number is 11% for working capital. Tabulation of the original variables for creating these two variables suggests that for both investment capital and working capital, bank financing was the second most important source, following self-financing. These numbers are consistent with patterns found in the previous regional and national surveys reported in Table 1.

Many entrepreneurs had political capital, as seen in Table 2. First, 61.5% of the entrepreneurs in the data were members of the PC or PPCC—58.2% were local-level members and 4.3% were provincial/national-level members.<sup>9</sup> Although previous national statistics suggest that indeed a large number of private entrepreneurs were PC or PPCC members,<sup>10</sup> the high percentage of PC/PPCC members in the data might lead us to question whether the sample was randomly selected. However, if the survey indeed overly sampled members of the PC or PPCC, it only facilitated, rather than inhibited, the comparison between legislative entrepreneurs and non-legislative ones because of the greater number of PC/PPCC members sampled and thus more variation in the independent variables.<sup>11</sup> Second, 19.8% of the entrepreneurs in the data were CCP members. This proportion is quite close to that obtained from other surveys. The 1997 National Survey of Chinese Private

Enterprises, for example, reported that 16.6% of entrepreneurs were CCP members in 1996 (Zhang & Ming, 1999). According to another nationwide representative sample collected by Andrew Walder in 1996, 14.8% of private entrepreneurs were CCP members (see Dickson, 2003).

(d) *Model specification*

As the surveyed firms were nested within provinces, which were heterogeneous in their stages of market and political reforms (Naughton, 1995), I estimate the fixed effects model with each province dummy added as a group-specific constant term in each of the regressions to control for environmental heterogeneity across provinces (Greene, 2000). A general representation of the regressions that I estimate is shown in the following equation:

$$Y_{ij} = \alpha + \gamma' L_{ij} + \beta' X_{ij} + \eta_j + \varepsilon_{ij}, \quad (1)$$

for  $i = 1, \dots, n_j$  firms in province  $j$ ;  $j = 1, \dots, 31$  provinces.

In the above equation,  $Y_{ij}$  is the dependent variable;  $\alpha$  is the intercept;  $\gamma$  is the effect of legislative membership on the dependent variable, because  $L_{ij}$  denotes legislative memberships that vary over the  $i$  firm/entrepreneur in each  $j$  province;  $\beta$  is a vector of all other firm-level effects on the dependent variable, because  $X_{ij}$  is a vector of firm-level control variables that vary over the  $i$  firm in each  $j$  province;  $\eta_j$  is a vector of province-specific constant term and is thus the same across all units in province  $j$ ; and  $\varepsilon_{ij}$  is a mean zero firm-level error term.

Among the three dependent variables, *working capital primarily relying on bank loans* and *investment capital primarily relying on bank loans* are binary variables. Therefore, for these two dependent variables, Eqn. (1) is specified as fixed effects logit model (Greene, 2000). The variable—*self-reported degree of difficulty in obtaining bank loans*—is an ordinal variable, and thus Eqn. (1) is specified as a fixed effects ordered logit model (Long, 1997).

To test Hypothesis 4, which proposes differentiated benefits of legislative membership for firms of different sizes, I model effects of the membership separately (but in the same equation) for different-sized firms (Greene, 2000). In these equations, there are three intercepts: one for small firms, one for medium firms, and one for large firms. These equations take the form

$$Y_{ij} = (\alpha_1 + \gamma_1' L_{ij1}) + (\alpha_2 + \gamma_2' L_{ij2}) + (\alpha_3 + \gamma_3' L_{ij3}) + \beta' X_{ij} + \eta_j + \varepsilon_{ij}, \quad (2)$$

where each term is equivalent to the standard equation (1), but where the subscript “1” denotes that the term is for small firms, the subscript “2” denotes that the term is for medium firms, and the subscript “3” denotes that the term is for large firms. Mathematically, Eqn. (2) is equivalent to the conventional specification of adding two interaction terms between legislative membership (two categories) and firm size (three categories) to the Eqn. (1). The conventional specification is appropriate for testing whether there exists a larger effect of legislative membership for smaller firms (i.e., whether  $\gamma_1 > \gamma_2 > \gamma_3$ , in absolute values). Compared to the conventional specification, Eqn. (2) is less restrictive, but still enables us to understand whether legislative membership is more useful for small and medium firms than for large firms.

#### 4. REGRESSION RESULTS

Table 3 reports regression results for testing Hypotheses 1 and 2. Overall, the coefficients for legislative membership in

all three regressions have the expected signs and are statistically significant. For *self-reported degree of difficulty in obtaining bank loans*, the odds of reporting “very difficult” versus the combined outcomes from “difficult” to “very easy” are 0.80 ( $e^{-0.218}$ ) times less for entrepreneurs with legislative membership, holding all other variables constant.<sup>12</sup> The odds of *working capital primarily relying on bank loans* and those of *investment capital primarily relying on bank loans* are 1.58 ( $e^{0.46}$ ) times and 1.25 ( $e^{0.224}$ ) times greater for entrepreneurs with legislative membership, respectively. Thus, Hypotheses 1 and 2 are supported, and legislative membership is indeed found to reduce bank loan obstacles and facilitate access to bank financing.

Results from tests of Hypothesis 3 are reported in Table 4 where two categorical variables indicating the levels of legislative membership are included. This hypothesis is also supported. For *self-reported degree of difficulty in obtaining bank loans* and *working capital primarily relying on bank loans*, the coefficients have the expected signs and are significant. The odds of reporting “very difficult” versus the combined outcomes from “difficult” to “very easy” are 0.80 ( $e^{-0.221}$ ) times less for local-level PC/PPCC members and are 0.59 ( $e^{-0.53}$ ) times less for provincial/national PC/PPCC members compared to entrepreneurs with no legislative membership. The odds of *working capital primarily relying on bank loans* are 1.53 ( $e^{0.422}$ ) times greater for local-level PC/PPCC members and are 1.93 ( $e^{0.658}$ ) times greater for provincial/national PC/PPCC members compared to entrepreneurs with no legislative membership.

For *investment capital primarily relying on bank loans*, the coefficient for local-level membership is correctly signed and significant; the one for provincial/national membership is also correctly signed and larger than that for local-level membership but not statistically significant. A possible explanation for this is that, given their high political capital, provincial/national PC/PPCC members had more options for formal external financing, such as issuing corporate bonds and even stock shares which were subject to the approval of provincial-level regulators, and thus they did not have to borrow from financial institutions for large investments. However, if these high-level PC/PPCC members needed to borrow from banks for investment capital, they still had better access than local-level PC/PPCC members and non-legislative members, as shown by the large coefficient for provincial/national membership. Thus, overall, Table 4 suggests that higher-level legislative members had more advantages in obtaining bank loans.

Table 5 reports the results from testing whether legislative membership was more critical for SMEs than for large firms (Hypothesis 4). Indeed, it is found from this table that legislative membership may have been useful for SMEs but not for large firms. For *self-reported degree of difficulty in obtaining bank loans*, legislative membership was found to significantly reduce bank financing obstacles for medium firms (but not for small and large firms). For *working capital primarily relying on bank loans*, legislative membership was found to significantly benefit both small and medium firms (but not large firms). And for *investment capital primarily relying on bank loans*, legislative membership was found to benefit small firms significantly (but not medium and large firms). In any equation, there is no statistically significant evidence that legislative membership benefited large firms. Moreover, these patterns do not change at all when I replace the dichotomous measure of legislative membership with the two dummies for levels of legislative membership, but still use Eqn. (2) for model specification. When the two dummies for levels of legislative membership are used, it is also found that provincial/national-level

Table 3. *Determinants of bank financing obstacles, dichotomous legislative membership.*

Explanatory variables	Dependent variables		
	Degree of difficulty in obtaining bank loans	Working capital relying on bank loans	Investment capital relying on bank loans
Constant	0 <sup>d</sup>	−3.868 (4.79) <sup>***</sup>	−0.229 (0.19)
Legislative membership	−0.218 (2.12) <sup>**</sup>	0.460 (2.59) <sup>***</sup>	0.224 (1.84) <sup>*</sup>
Medium firm <sup>a</sup>	−0.417 (4.01) <sup>***</sup>	0.279 (1.62) <sup>*</sup>	0.124 (1.01)
Large firm <sup>a</sup>	−0.755 (3.78) <sup>***</sup>	0.271 (0.85)	0.091 (0.39)
Female	0.224 (1.62) <sup>*</sup>	−0.353 (1.24)	−0.110 (0.63)
Cadre before establishing the firm	0.087 (0.78)	−0.004 (0.02)	0.175 (1.32)
CCP membership	−0.099 (0.92)	0.192 (1.05)	0.024 (0.18)
High school graduate <sup>b</sup>	0.331 (2.62) <sup>***</sup>	0.005 (0.02)	0.065 (0.46)
College graduate or above <sup>b</sup>	0.143 (1.02)	−0.114 (0.52)	0.134 (0.86)
Log work experience	0.091 (0.78)	0.209 (1.02)	−0.207 (0.69)
Log firm age	−0.058 (0.83)	0.026 (0.22)	−0.029 (0.33)
Firm scope	0.057 (0.91)	0.242 (2.24) <sup>**</sup>	0.016 (0.20)
Firm located in towns <sup>c</sup>	−0.247 (2.25) <sup>**</sup>	0.265 (1.44)	0.293 (2.29) <sup>**</sup>
Firm located in villages <sup>c</sup>	−0.179 (1.15)	0.477 (2.02) <sup>**</sup>	0.188 (1.03)
Firm once registered as a state/collective	0.067 (0.59)	0.021 (0.12)	0.074 (0.58)
$\chi^2$ test for industry dummies (df = 11)	20.77 <sup>**</sup>	15.34	7.74
$\chi^2$ test for province dummies (df = 30)	182.15 <sup>***</sup>	24.67	50.85 <sup>***</sup>
Observations	1,888	2,007	1,836
Pseudo $R^2$	0.05	0.07	0.04

Note: Absolute values of robust z-statistics in parentheses.

Source: National Survey of Chinese Private Enterprises (2000).

\* Significant at the 10% level.

\*\* Significant at the 5% level.

\*\*\* Significant at the 1% level.

<sup>a</sup> The omitted category is small firm (number of employees < 50).

<sup>b</sup> The omitted category is lower than high school degree.

<sup>c</sup> The omitted category is firm located in cities.

<sup>d</sup> The intercept here is zero because for ordered logistic regressions, Stata sets the constant to zero and estimates the cut points for separating the various levels of the response variable. Such treatment has no effect on the estimation of other coefficients.

membership is significantly more helpful for both small and medium firms than local-level membership.<sup>13</sup>

Two factors might explain why legislative membership was useful for SMEs but not for large firms. First, large firms had fewer bank financing obstacles because they were usually supported by local governments for their significant contributions to the local economy and because they had stronger capacity to provide adequate collateral and might also have been more transparent on their financial information. This is shown clearly in the much lower self-reported degree of difficulty in obtaining bank loans for large firms than for small and medium firms in Tables 3 and 4. Using Table 3 for interpretation, the odds of reporting “very difficult” versus the combined outcomes from “difficult” to “very easy” are 0.47 ( $e^{-0.755}$ ) times less for large firms, but are 0.66 ( $e^{-0.417}$ ) times less for medium firms compared to small firms. Second, large

firms usually had considerable retained profits and were even allowed to issue corporate bonds and stock shares, and thus did not have to borrow from formal financial institutions. This is implied in the insignificant coefficients for large firms in regressions of *working capital relying on bank loans* and *investment capital relying on bank loans* in Tables 3 and 4. Whereas both small and medium firms had not only much higher bank financing obstacles, but also far fewer opportunities to obtain other types of formal finance. Therefore, SMEs may have benefited from legislative membership, but large firms might not have.

The effects of some of the other variables in Tables 3–5 are as follows. First, consistent with our expectations, CCP membership has no effect on bank financing obstacles in all regressions; neither does previous cadre status. And the insignificant effects of CCP membership and previous cadre status are not a



Table 4. *Determinants of bank loan obstacles, levels of legislative membership.*

Explanatory variables	Dependent variables		
	Degree of difficulty in obtaining bank loans	Working capital relying on bank loans	Investment capital relying on bank loans
Constant	0 <sup>c</sup>	-3.908 (4.93) <sup>***</sup>	-0.220 (0.19)
Local-level legislative membership <sup>a</sup>	-0.221 (2.15) <sup>**</sup>	0.422 (2.38) <sup>**</sup>	0.199 (1.64) <sup>*</sup>
Provincial/national legislative membership <sup>a</sup>	-0.530 (1.96) <sup>**</sup>	0.658 (1.67) <sup>*</sup>	0.273 (0.93)
Medium firm <sup>b</sup>	-0.410 (3.96) <sup>***</sup>	0.286 (1.67) <sup>*</sup>	0.152 (1.24)
Large firm <sup>b</sup>	-0.673 (3.30) <sup>***</sup>	0.293 (0.91)	0.092 (0.39)
Female	0.200 (1.44)	-0.335 (1.18)	-0.098 (0.56)
Cadre before establishing the firm	0.081 (0.73)	-0.012 (0.06)	0.175 (1.32)
CCP membership	-0.086 (0.79)	0.221 (1.22)	0.016 (0.12)
High school graduate <sup>c</sup>	0.352 (2.81) <sup>***</sup>	0.039 (0.21)	0.033 (0.23)
College graduate or above <sup>c</sup>	0.192 (1.38)	-0.101 (0.47)	0.122 (0.78)
Log work experience	0.117 (1.00)	0.216 (1.07)	-0.221 (0.74)
Log firm age	-0.071 (1.02)	0.004 (0.04)	-0.037 (0.42)
Firm scope	0.042 (0.67)	0.234 (2.20) <sup>**</sup>	0.034 (0.43)
Firm located in towns <sup>d</sup>	-0.265 (2.42) <sup>**</sup>	0.237 (1.29)	0.284 (2.24) <sup>**</sup>
Firm located in villages <sup>d</sup>	-0.198 (1.30)	0.482 (2.08) <sup>**</sup>	0.214 (1.18)
Firm once registered as a state/collective	0.057 (0.49)	0.040 (0.22)	0.107 (0.83)
$\chi^2$ test for industry dummies (df = 11)	23.86 <sup>**</sup>	15.79	6.82
$\chi^2$ test for province dummies (df = 30)	185.24 <sup>***</sup>	28.02	52.50 <sup>***</sup>
Observations	1,888	2,007	1,836
Pseudo $R^2$	0.05	0.07	0.04

Note: Absolute values of robust z-statistics in parentheses.

Source: National Survey of Chinese Private Enterprises (2000).

\*Significant at the 10% level.

\*\*Significant at the 5% level.

\*\*\*Significant at the 1% level.

<sup>a</sup>The omitted category is no legislative membership at all.

<sup>b</sup>The omitted category is small firm (number of employees < 50).

<sup>c</sup>The omitted category is lower than high school degree.

<sup>d</sup>The omitted category is firm located in cities.

<sup>e</sup>The intercept here is zero because for ordered logistic regressions, Stata sets the constant to zero and estimates the cut points for separating the various levels of the response variable. Such treatment has no effect on the estimation of other coefficients.

result of multicollinearity, as the correlation coefficients among all explanatory variables are below or around 0.30. This finding might provide support for the notion that political capital needs continuous investment, as discussed previously. Second, female entrepreneurs have higher financing obstacles, which is consistent with the pattern found in other market economies. Third, it may be odd to see that high school graduates have higher bank financing obstacles than those with lower education. A possible explanation for this is that they have higher business aspiration and thus higher demand for finance than those with lower education. Fourth, firms located in towns have fewer bank financing obstacles and can get bank loans for investment capital more easily; and firms located in villages can obtain bank loans for work-

ing capital more easily. These results may be explained by alliances of local governments and business elites based on the pursuit of local economic growth. Since the late 1990s, town- and village-level local authorities in many regions have begun to support private firms after the steady decline in the profitability of township and village enterprises was seen to be irreversible.

It should be acknowledged that legislative membership may be selective based on the characteristics of the firm and the entrepreneur. Thus, there may be the problem of reverse causality: An entrepreneur may be rewarded with a PC or PPCC membership because his/her firm has better performance and thus better access to bank finance. Most of the firm and entrepreneurial characteristics that are important for the selection

Table 5. *The effects of legislative membership on bank loan obstacles among different-sized firms.*

Explanatory variables	Dependent variables		
	Degree of difficulty in obtaining bank loans	Working capital relying on bank loans	Investment capital relying on bank loans
Small firm	0 <sup>c</sup>	-3.854 (4.78) <sup>***</sup>	-0.279 (0.24)
Legislative membership $\times$ small firm, $\gamma_1$	-0.098 (0.72)	0.442 (1.73) <sup>*</sup>	0.391 (2.41) <sup>**</sup>
Medium firm	-0.267 (1.75) <sup>*</sup>	-3.608 (4.35) <sup>***</sup>	0.062 (0.05)
Legislative membership $\times$ medium firm, $\gamma_2$	-0.350 (2.36) <sup>**</sup>	0.490 (2.06) <sup>**</sup>	0.037 (0.21)
Large firm	-0.607 (0.94)	-3.432 (2.97) <sup>***</sup>	-0.109 (0.08)
Legislative membership $\times$ large firm, $\gamma_3$	-0.319 (0.48)	0.284 (0.34)	0.227 (0.35)
Female	0.221 (1.60)	-0.351 (1.23)	-0.116 (0.66)
Cadre before establishing the firm	0.088 (0.79)	-0.004 (0.02)	0.178 (1.34)
CCP membership	-0.102 (0.94)	0.193 (1.05)	0.020 (0.15)
High school graduate <sup>a</sup>	0.326 (2.59) <sup>***</sup>	0.004 (0.02)	0.058 (0.41)
College graduate or above <sup>a</sup>	0.141 (1.01)	-0.114 (0.52)	0.131 (0.83)
Log work experience	0.092 (0.78)	0.209 (1.02)	-0.216 (0.72)
Log firm age	-0.060 (0.85)	0.026 (0.22)	-0.030 (0.34)
Firm scope	0.056 (0.89)	0.242 (2.23) <sup>**</sup>	0.013 (0.16)
Firm located in towns <sup>b</sup>	-0.243 (2.21) <sup>**</sup>	0.264 (1.43)	0.296 (2.32) <sup>**</sup>
Firm located in villages <sup>b</sup>	-0.180 (1.16)	0.477 (2.02) <sup>**</sup>	0.185 (1.01)
Firm once registered as a state/collective	0.068 (0.60)	0.021 (0.12)	0.075 (0.59)
$\chi^2$ test for industry dummies (df = 11)	19.96 <sup>**</sup>	15.31	7.28
$\chi^2$ test for province dummies (df = 30)	180.54 <sup>***</sup>	24.68	50.73 <sup>***</sup>
Observations	1888	2007	1836
Pseudo $R^2$	0.05	0.07	0.04

Note: Absolute values of robust z-statistics in parentheses.

Source: National Survey of Chinese Private Enterprises (2000).

\* Significant at the 10% level.

\*\* Significant at the 5% level.

\*\*\* Significant at the 1% level.

<sup>a</sup> The omitted category is lower than high school degree.

<sup>b</sup> The omitted category is firm located in cities.

<sup>c</sup> In this ordered logistic regression, Stata sets the constant for small firm in Eqn. (2) to zero and estimates the cut points for separating the various levels of the response variable. Such treatment has no effect on the estimation of other coefficients.

process, however, have already been controlled, such as firm size, geographic location, industry, CCP membership, and human capital. For a robustness test, I have also tried all estimations described above by controlling for the available performance measure: *return on capital*, which is not controlled in Tables 3–5 because it has too many missing values. The results show that the coefficients of legislative membership still have expected signs, and are still statistically significant after controlling for the performance measure, but the number of cases in each regression drops substantially.<sup>14</sup> Therefore, it appears that the effect of legislative membership found in this analysis should be robust.

In the above analysis, PC membership and PPCC membership are combined as one variable (legislative membership).

One may wonder whether the effects of the two types of membership differ. Additional tests suggest that both PC membership and PPCC membership can help to reduce bank financing obstacles, and the effects of the two types of membership are statistically indifferent in all regressions.<sup>15</sup>

## 5. CONCLUSIONS

External financing is crucial for entrepreneurship because private entrepreneurs are often wealth constrained and, therefore, need to obtain it to pursue their opportunities. In China, severe legal and regulatory constraints have exacerbated the problem of bank financing for private firms.

Thus, previous studies have usually downplayed the role of bank financing, but emphasized the role of informal external financing in China's private sector growth (e.g., Tsai, 2002).

This study suggests that bank financing has in fact been one of the most important sources of finance for private firms in China. It also offers a political explanation for the significant role played by bank financing in private sector growth under the legal and regulatory constraints. Given the significance of politics in businesses, many Chinese entrepreneurs have been eager to obtain political capital, as clearly shown by multiple national surveys (Zhang & Ming, 1999). And legislative membership has especially been sought by private entrepreneurs because of substantial legitimacy and social network benefits that it can bring to incumbents. The regression analysis suggests that legislative membership is associated with lower self-reported degree of difficulty in obtaining bank loans and higher probability of access to bank loans for private entrepreneurs; higher-level legislative membership is more useful in solving bank financing obstacles; and such memberships in general are more helpful for SMEs, which most private firms still are.

While a number of previous studies have focused on the benefits of membership in the Communist Party—another important type of political capital in China—this paper does not find evidences for positive effects of CCP membership on reducing bank financing obstacles. One reason for this may be that CCP membership does not necessarily confer political power on the member. Another reason may be that the value of CCP membership has been severely discounted after many party members have lost channels to invest in political capital continuously under the ill-functioning lower-level party committees. This paper also does not find evidence for positive effects of previous cadre status, which is also an important type of political capital in many transitional

economies. This may be because the political capital of a previous cadre often expires after leaving the position. Overall, these results might suggest that the value of political capital is contingent on the continuous investment in political capital.

Taken together, the findings suggest that politics plays an important role in entrepreneurial development in China; and to succeed in business, an entrepreneur often needs not only business skills but also continuous political investment, which, however, is a double-edged sword for entrepreneurial development. On the one hand, political investment activities can be seen as the grease for the wheels of commerce (Huntington, 1968) under the legal and regulatory constraints faced by entrepreneurs. Without political investment, resource acquisition problems would be even more severe for many private firms, especially for SMEs. On the other hand, political investment activities divert entrepreneurs' energies and attention from more productive activities that propel economic progress for the whole society (Baumol, 1990). Thus, the private sector would have developed more rapidly and strongly if the legal and regulatory environment for this sector had been more conducive.

Since China was accepted into the WTO in 2001 and, especially, since a new amendment was introduced into the Chinese Constitution in 2004, the Chinese government has been taking measures to provide more protection for private property rights and to level the playing ground between state-owned enterprises and private firms. This is a blessing for private firms, especially for small and medium ones. If such efforts were to succeed, then the economic rationale for entrepreneurs to invest in political capital might not exist any more; and the private sector as a whole might grow in an even faster and healthier fashion.

## NOTES

1. The private sector in this study refers only to the domestic private sector, which includes non-farming private enterprises (*siying qiye*) and individual enterprises (*getihu*). According to the *Tentative Stipulations on Private Enterprises* promulgated by the central government in 1988, the difference between private enterprises and individual enterprises resides in the number of employees. A private enterprise has at least eight employees and an individual enterprise less than eight employees. In the following, I use "private firm" to indicate both types of enterprises.

2. The state has only begun to tackle these problems seriously and on a large scale since the early 2000s. During 2000–01, for example, Jiang Zemin—the then general secretary of the Chinese Communist Party (CCP)—published the Three Represents Theory, which explicitly acknowledged the contributions of private firms and entrepreneurs and welcomed the new capitalists to join the CCP (Ng, 2006). In 2004, a new amendment was finally introduced into the Chinese Constitution to protect private property rights.

3. Informal finance ranges from casual interpersonal borrowing and trade credit among wholesalers and retailers to more institutionalized mechanisms such as rotating credit associations, grassroots credit cooperatives, and even full-service yet unsanctioned private banks (Tsai, 2002).

4. This is because both public and private equity markets in China have served primarily to finance state-owned enterprises even to date.

5. The PC spans five levels: township, county, city, provincial, and national, and the PPCC spans four levels (lacking the township level). One

can participate in multiple levels of either the PC or PPCC, but cannot hold membership in both organs. For the PC, direct elections are restricted to the township and county levels and candidacy depends on consultation with the CCP. Higher level PC membership is obtained through co-optation by the CCP committees at various levels. In contrast, PPCC membership depends completely on the co-opting process controlled by the CCP committees.

6. I am indebted to two guest editors for the second and third points.

7. CCP membership is found to have positive effects on individual income and career mobility in the existing literature. Such positive returns to CCP membership may be mostly because CCP membership remains a credential for successful careers in most government-controlled institutions since the reform began than because it provides political capital.

8. Remember, a significant proportion of the positions in both the PC and PPCC have been preserved for current and semi-retired party/government officials. Being a member of the PC or PPCC, thus, increases the probability of establishing social ties to political elites.

9. The percentages of local level and provincial/national level members do not add up to 61.5% because some entrepreneurs held membership at both local and provincial/national levels. The detailed distribution of the level of legislative membership is 38.5% for no membership, 3.1% for township level, 35.6% for county level, 19.4% for city level, 4.0% for provincial level, and 0.3% for national level.

10. In 1995, over 5,400 entrepreneurs belonged to the PC at the county level or higher, and over 8,500 belonged to the PPCC at the county level or higher (Dickson, 2003; Zhang & Ming, 1999).
11. The way to resolve the over-sampling problem is to use weights. However, designing appropriate weights is not possible for this study because the detailed sampling procedure has not been released.
12. According to the *proportional odds assumption* of the ordered logit model, one could say that the odds of reporting “very difficult” and “difficult” *versus* the combined outcomes of the other three categories are also 0.80 times smaller for entrepreneurs with PC or PPCC membership, and so on.
13. The results based on two dummies for levels of legislative membership are not reported in this paper, but are available from the author upon request.
14. Using the specification in Table 3 but including *return on capital* as an explanatory variable, the coefficient for legislative membership is  $-0.199$  ( $Z = -1.67$ ;  $n = 1,441$ ) for *degree of difficulty in obtaining bank loans*,  $0.441$  ( $Z = 2.09$ ;  $n = 1,496$ ) for *working capital primarily relying on bank loans*, and  $0.191$  ( $Z = 1.61$ ;  $n = 1,381$ ) for *investment capital primarily relying on bank loans*. These coefficients are a little bit smaller and less significant than those in Table 3, suggesting that omitting firm performance can bias the coefficients for legislative membership up, but the biases are small.
15. Using the specification in Table 3, it is found that for *self-reported degree of difficulty in obtaining bank loans*, the  $\chi^2$  statistic for testing the difference between the coefficient of PC membership and that of PPCC membership equals 2.37 ( $p$ -value = 0.12); for *working capital primarily relying on bank loans*, the  $\chi^2$  statistic is 0.13 ( $p$ -value = 0.72); and for *investment capital primarily relying on bank loans*, the  $\chi^2$  statistic is 0.28 ( $p$ -value = 0.60).

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